Questions & Answers

Business Associations

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Questions & Answers

Business Associations

Multiple-Choice and Short-Answer Questions and Answers

THIRD EDITION

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To all who use this text to advance their understanding of the law of Business Associations, thank you.

To Clare, Annie, and Elizabeth
—DMB

To Talia
—SCO

To JPS
—JTR

Contents

Foreword

We are excited to share this third edition of the *Q&A: Business Associations* for use by those exploring this fascinating but complex area of law. We appreciate your allowing us to assist you in your academic development.

We are pleased to expand upon our colleague Douglas Branson's rich work in the first two editions of the text. Among other revisions, this third edition adds a section on the law of agency and expands, clarifies, modernizes, and simplifies questions on partnership, limited liability companies, and corporations. For agency, we have focused on the Restatement (Third) of Agency. For unincorporated entities, we have focused on the Revised Uniform Partnership Act and the Revised Uniform Limited Liability Company Act. As it pertains to the law of corporations, we wanted to emphasize both the Model Business Corporation Act (as amended in 2016) and the Delaware General Corporation Law.

We have attempted to tailor coverage to reflect the content of a typical survey course in business associations. This is a bit of a challenge because opinions range greatly about what should be included in the course, but nevertheless, we persist in the mission. It is possible that we will cover material that is not included in your course or that we will not cover material that is included in your course. This is not to suggest that our text defines what is "typical" or that your professor is aberrant in including other topics. Our coverage of what might be considered more specialized topics like insurance, mergers and acquisitions, securities regulation, corporate finance, and business taxation is limited. We have also carefully reviewed the subject matter outline prepared by the National Conference of Bar Examiners for the forthcoming NextGen Bar Exam, and have been careful to ensure that we have included questions reflecting that scope. Accordingly, students studying for the bar exam may find this text a useful tool.

Importantly, this text is designed to be used by students as a formative assessment tool to engage with the subject matter; it is not a treatise on the law. Of course, not every issue lends itself well to this type of formative assessment and, instead, requires much deeper analysis in a different forum (i.e., a law review article). Other resources undertake the task of providing a thorough explanation of the law, history, policy, and nuance. Accordingly, we cannot — and will not — attempt to provide a complete, in-depth explanation of every legal issue. There will always be more to say than what we offer you. Instead, we have attempted to revise questions for clarity and explanations of answers for conciseness. We believe that every multiple-choice question should have a "best" answer and that we should be able to explain to you our analysis in a paragraph. If we can't do that, then how could we expect you to do the analysis in the time you would have on an exam?

Of course, answering the questions — whether right or wrong — is the easy part. The real work comes when you look at our answers and explanations for why we answered the way we did. The time you spend reviewing our explanation of the answer, focusing both on why the best answer choice is best and why incorrect answers are incorrect, is time well spent. Certainly, the most valuable achievement is not to simply answer the question correctly but to understand the ***why*** behind the questions. You may just find that you learn more (both in terms of the substantive law and in test-taking strategies) from understanding why the wrong answers are wrong than why the best answers are correct.

Again, we thank you for including this text in your academic development. We hope you will find these questions and our analysis useful. We wish you all the best.

About the Authors

Douglas M. Branson has occupied the W. Edward Sell Chair in Business Law at the University of Pittsburgh since 1996. Prior to 1996, he was a Professor of Law at the Seattle University (1973 to 1996). He also regularly visits the University of Alabama School of Law, where he has twice held the Charles Tweedy Professorship. He also holds the rank of Permanent Fellow at the University of Melbourne (Australia) where each year he has taught (with Professor J. Farrar) the corporate governance class to Master of Law students. He has been a visiting professor at Arizona State University, Cornell University, the University of Oregon, Washington University (St. Louis), and the University of Washington (where he was the Condon-Falknor Distinguished Professor), among others. He has taught the basic course in business organization law for over 30 years.

Professor Branson has also taught in New Zealand, South Africa, Malaysia, Hong Kong, Indonesia, Ireland, Spain, France, and England. He has been a Fulbright-sponsored lecturer at University of Ghent (Belgium) and a U.S. State Department-sponsored lecturer at several universities in the Ukraine. He has been a USAID-sponsored consultant to the Republic of Indonesia on matters of corporate law, corporate governance, and capital markets law. He has worked on similar projects for Macedonia and Afghanistan, endeavoring to aid those countries in modernizing their economic laws.

He is the author of over 70 law review articles and more than a dozen books. His books include the leading treatise *Corporate Governance* (1993) (with annual supplements); *Problems in Corporate Governance* (1997); *Understanding Corporate Law* (1999; 2d ed. 2004; 3d ed. 2009) (with Arthur Pinto); *No Seat at the Table: How Law and Governance Keep Women Out of the Board Room* (2007); *Business Enterprises: Legal Structures, Governance and Policy* (with Joan Heminway et al., 2009); *The Last Male Bastion: Gender and the CEO Suite at America's Public Corporations* (2010); *The Russell Sage Handbook of Corporate Governance* (Thomas Clarke & Douglas Branson eds., 2011); and *Tastes of Nuoc Mam: Service in the Brown Water Navy and Visits to Vietnam* (2011).

Seth C. Oranburg teaches Contracts Law, Business Law, Trade Secret Law, and Transactional Legal Practice at the University of New Hampshire Franklin Pierce School of Law. He previously taught Contracts, Business Associations, Corporations, Securities Regulation, Corporate Finance, and Venture Capital Law at Duquesne University in Pittsburgh, PA, where he earned tenure and promotion to Associate Professor before moving to UNH to help build the next generation of online education via its Hybrid JD program. He recently published a casebook on Contract Law and is currently writing a casebook on Business Associations.

Professor Oranburg also writes scholarship on business law topics and co-directs the Program on Business, Organization, and Markets at the Classical Liberal Institute at NYU School of Law. In

this capacity, Oranburg produces academic symposia, and the resulting papers were published in leading law reviews and journals.

John Towers Rice is an Assistant Professor of Law at the Lincoln Memorial University Duncan School of Law. Rice teaches and writes about the legal environment of business and social change, civil procedure, professional responsibility, and legislation. He is devoted to excellence in teaching and endeavors to provide students with training in legal theory, practice skills, and professionalism. Additionally, he has spoken nationally about Corporate Social Responsibility, corporate governance, legal ethics, and anti-discrimination laws, and his scholarship has been published in the Northeastern University Law Review and the FIU Law Review.

Prior to entering law school teaching, Rice served as a judicial clerk for the Supreme Court of Tennessee and practiced civil litigation in Knoxville. He is a member of the Tennessee and South Carolina Bars, and he is admitted to practice in the United States Court of Appeals for the Sixth Circuit. He has a distinguished record of service with the American Association of Law Schools and the American, Tennessee, and Knoxville Bar Associations, and he is a Fellow of the American Bar Foundation.

A native of Greenville, South Carolina, Rice graduated from Clemson University and then earned his law degree from the University of Tennessee College of Law. While in law school, Rice served as the President of the Student Bar Association and the Vice Chair of the Moot Court Board, competed in the Dean Jerome Memorial Evidence Moot Court Competition at Brooklyn Law School, and was honored with the Order of the Barrister and the ALI-ABA Scholarship and Leadership award.

Questions

The Law of Agency

Assume that each of the following questions involves facts arising in a jurisdiction that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency.

1. Introduction to Agency.

   Define "agency."

   Answer:

2. Painting Doctor's Office.

   Doctor decided that their medical office needed to be updated and refurbished. On the recommendation of a friend, Doctor reached out to discuss the project with Painter. Doctor explained that they desired for Painter to empty the waiting and patient consult rooms, deep clean the walls, lay drop cloths, paint the walls with a coat of primer and two coats of a particular type of paint, and do any other work reasonably required to accomplish the task. Doctor explained that they would be on site to supervise and provide most of the necessary equipment; however, Painter would be responsible to locate and order the paint and primer from a third party. Painter agreed to do the job as Doctor instructed, and Painter agreed to accept a flat rate at the end of the project. Doctor expressed that, if this went well, Doctor had additional work that they would consider contracting for Painter to perform. The two shook hands and Painter promised to return the next week to complete the job.

   What is the status of the relationship between Doctor and Painter?

   A. There was no principal–agent relationship between Doctor and Painter because Painter was an independent contractor.

   B. There was no principal–agent relationship between Doctor and Painter because the two never used the words "principal" or "agent" to describe their relationship.

   C. Painter is Doctor's agent because Doctor benefited from Painter's services.

   D. Doctor and Painter are in a principal–agent relationship because Doctor asked Painter to perform services at Doctor's behest and subject to Doctor's control, and Painter agreed to do so.

3. Power Washing.

Homeowner requested Power Washer to come and provide residential power washing services. Power Washer operates a power washing business and books jobs throughout the region. When Power Washer arrived at the home, Homeowner instructed Power Washer as to the scope of the job. Power Washer agreed to perform the job as instructed. Power Washer supplied their own tools and equipment and maintained their own liability insurance. Homeowner agreed to pay Power Washer half of the price for the job before Power Washer began work and half at the completion of the project. Power Washer told Homeowner that the job should take less than two hours and that they expected to leave promptly upon finishing the work to travel to their second job for the day across town. Power Washer began work, but because they were in a rush, became careless. During the job, Power Washer negligently caused damage to Neighbor's property. Neighbor has filed a lawsuit against Homeowner to recover the damage.

Which of the following, if true, would support Neighbor's lawsuit against Homeowner?

A. Homeowner had never met Power Washer before and was thus negligent in permitting Power Washer to perform services unsupervised.

B. Homeowner remained at the home and monitored Power Washer's activities, even giving Power Washer instructions for what to do.

C. Homeowner has hired Power Washer in the past to perform work for them.

D. Residential power washing is a low skill job that Homeowner could have performed themself.

4. Driving the Painting.

Gallery hired Driver to transport a valuable painting from one side of the state to the other. While driving on the interstate, Driver negligently caused a car accident that resulted in severe injury to Family. Family desires to file a lawsuit to recover their damages.

Against whom may Family assert claims for liability?

A. Gallery only

B. Driver only

C. Both Gallery and Driver

D. Neither Gallery nor Driver

5. Catering the Family Reunion.

In anticipation of their yearly holiday gathering, Family hired Chef to cater their meal. Family instructed Chef that they wanted an elaborate buffet spread, appetizers, dessert, and a bar. Chef did not work at a restaurant; rather, Chef caters from their home. Family was

aware of this and told Chef to do what it took to get the job done. When it came time to do the work, Chef purchased all the food and supplies necessary but quickly realized the job was simply too big for one person. Accordingly, Chef elicited the help of three friends and promised them payment by the hour. When it came time for the family gathering, the friends helped Chef deliver and set up all the food and equipment, and then they worked during the event to replenish food, remove empty dishes, and tend the bar. At the end of the evening, Chef presented Family with an invoice for services. Shocked, Family agreed to pay for all the food and supplies and Chef's fee, but refused to pay anything to Chef's friends. Family maintained that Chef had no authority to hire staff.

What is Chef's best argument that Family must pay the friends?

A. Family would be unjustly enriched if it does not pay for the friends.

B. Family is bound to pay the friends because it authorized Chef to hire them.

C. Chef could not have performed the task without help from the friends.

D. Chef has no argument that Family must pay their friends.

6. Surgery Gone Wrong.

One day, while playing kickball, Smith fell and broke his leg. Smith's friends took him to a local emergency room operated by Hillfield Hospital System. All medical personnel wore uniforms with the Hillfield logo on it, and all paperwork indicated that Hillfield was providing emergency medical care. The emergency room physician referred Smith to an orthopedist, also in the Hillfield Hospital System. During a consult, the orthopedist, wearing a white coat with the Hillfield logo embroidered on it, recommended that Smith undergo surgery. The orthopedist provided Smith with a pamphlet about the benefits and risks of surgery that included lines such as "Here at Hillfield Hospital System, we want you to be fully informed about your medical procedures" and "if you have any questions at all, please do not hesitate to ask your Hillfield medical team." Smith agreed and scheduled the procedure to take place the following week at a Hillfield Hospital surgical center. During the procedure, the orthopedist committed negligence and caused serious injury to Smith. Smith has filed a lawsuit against the orthopedist and Hillfield Hospital System. Hillfield has filed a motion for summary judgment, arguing that the orthopedist is an independent contractor and not an agent of the hospital system. In support of its motion, Hillfield filed the orthopedist's contract with the hospital, which included the clause "Orthopedist agrees that she is an independent contractor, and not an agent, of Hillfield Hospital System."

How should the court rule?

A. Dismiss the lawsuit because the orthopedist was an independent contractor, and thus, the orthopedist's negligence cannot be attributed to the hospital.

B. Dismiss the lawsuit because the orthopedist's contract with the hospital establishes that the orthopedist is an independent contractor.

C. Allow the lawsuit to proceed because Smith reasonably believed that the orthopedist was an agent of the hospital.

D. Allow the lawsuit to proceed because it would be bad public policy to not hold hospitals accountable for negligent procedures performed in their facilities.

7. Traveling Salesman.

Lavery was home one day when someone knocked on the door. He answered the door to see a man standing there dressed in a suit. The man introduced himself as "Chip" and explained that he was a sales representative for Acme Co. Chip inquired as to whether Lavery might be interested in purchasing a new set of knives. Chip offered to demonstrate the effectiveness of the knives, and Lavery agreed. Impressed with how sharp and accurate the knives were, Lavery asked Chip to process an order for him. Chip agreed to do so but insisted that payment was due "up front." Lavery paid Chip $150 cash, and Chip promised delivery within a week. A few hours later, struck with regret, Lavery looked up Acme Co.'s contact information and called to request that his order be canceled and his money be refunded. Lavery spoke with a representative who, to Lavery's dismay, informed him that Acme Co. did not employ door-to-door salespeople, does not sell knives, and would never take payment in cash up front. Lavery has been hoodwinked.

Is Acme Co. liable to refund Lavery's money?

A. Yes. "Chip" claimed to be an agent of Acme Co., and thus, Acme Co. is liable for the fraud.

B. Yes. Acme Co. is estopped from denying that Chip had authority to enter into a contract on their behalf because they should have had a warning posted on their website reflecting what the customer representative told Lavery.

C. No, because Lavery was reckless in believing that Chip was actually an agent for Acme Co.

D. No, because Lavery's belief that Chip was an agent for Acme Co. was not traceable to any manifestation from Acme.

8. A Land Transaction.

Big Corp. operates a line of large retail stores and is looking to expand into a new area. Concerned that social activists regularly protest expansion because of worries about how Big Corp. stores impact local, mom-and-pop" stores, and aware that landowners typically inflate asking prices when they find out they are dealing with Big Corp., Big Corp. wants to use a secret agent to purchase the land. The secret agent will negotiate the transactions as if the agent were the one who would be paying the purchase price and taking title to the property. In fact, however, Big Corp. is funding the transaction, and the agent will keep the land in escrow until it can be titled in Big Corp.'s name. Nobody will know that Big Corp. is

even involved until the deal has closed. The secret agent approached Nora and offered to buy a 40-acre parcel of real estate that she owned for $300,000. Nora accepted the offer, and the transaction was scheduled to close a week later. After the closing, when Nora saw a sign on the property that a Big Corp. store was "coming soon," she was livid. If she had known she was dealing with Big Corp., she would have doubled the asking price.

Does Nora have any basis to seek to void the transaction?

A. Yes, the secret agent deceived Nora as to the true identity of the parties to the transaction.

B. Yes, because Big Corp. unfairly benefited from the use of a secret agent.

C. No, because the secret agent had authority to enter into the transaction and bind Big Corp., even though Nora did not know about it.

D. No, because this is just how the market works.

9. The Title Agent.

Insurance Company contracted with Agent, a licensed attorney with specialized training and experience in real estate law, to permit Agent to write and issue title insurance policies on its behalf. As part of a commercial real estate transaction, Agent performed a title search. Through an act of ordinary negligence, Agent failed to identify that a lien had been recorded against the real property. Agent then issued a commitment for a title insurance policy to Customer on Insurance Company's behalf indemnifying Customer against any claims on the property. After the transaction was complete, Customer discovered the lien on the property and made a claim for damages against the Insurance Company under the title insurance policy that Agent had issued. An expert opined that most non-attorney title insurance agents would not have discovered the lien, but an agent who was trained as an attorney should have discovered the lien. Assume for purposes of this question that there is no applicable contract, statute, or rule defining the standard of care, that issuing title insurance does not constitute the practice of law, and that most title insurance agents are not attorneys.

` Has Agent breached any duty owed to Insurance Company under the law of agency?

A. Yes. Under the law of agency, the agent is strictly liable for any loss caused to the principal arising from the agent's conduct.

B. Yes. Under the law of agency, an agent with special skill or knowledge is held to a higher standard of care.

C. No. Under the law of agency, an agent does not breach its duty of competence to the principal if another agent, in the same or similar circumstances, would have conducted themself in the same way.

D. No. Under the law of agency, an agent only breaches its duty of competence to a principal through gross negligence.

10. Family Loyalty.

Family owns a local hardware store, and Nephew is one of the employees. Recently, Home Supplies, a national hardware chain, opened a location about five minutes away from Family Store. Family immediately noticed a decrease in customers and profit. Desiring to learn more about National Store's operations and vendor contacts, Family agreed that Nephew will apply for a job at National Store, investigate the operations and contacts, and report back to Family Store so that Family Store can try to better compete. Nephew applied for a job with National Store but made no mention of his affiliation with Family Store. Nephew was hired, and after working for National Store for several weeks, learned that National Store was selling shoddy products at inflated prices with the expectation that they would break quickly and need to be replaced. Nephew shared this information with Family Store and the local news. An investigative journalist investigated National Store and discovered, in addition to National Store's knowingly selling shoddy products, other predatory sales tactics. National Store wants to sue Nephew for damages.

Does National Store have a claim against Nephew?

A. No. This information was discovered by an investigative journalist, and so National Store had no expectation of privacy.

B. No. This is simply part of market competition, and National Store got its due.

C. Yes, because an agent has a duty to not disparage their principal.

D. Yes, because Nephew was working to advance an interest adverse to National Store.

11. So Much Stuff.

Franklin has worked as a manager for Bakery for the past seven years. Franklin is responsible for the day-to-day operations of the Bakery, including being the only contact with vendors. Recently, the daughter of the owner of Bakery graduated from culinary school, and the owner wants to bring the business back into the family. Accordingly, the owner informed Franklin that she was being let go and would no longer serve as manager. Upset about losing her job, Franklin called several of Bakery's vendors and ordered unusually large (but not unheard of) quantities of products. Franklin knew that this would be an unexpected cost for Bakery, that Bakery did not have adequate storage for all the products, and that many of the products would go bad before they could be used. When the enormous shipments arrived, the owner refused to accept or pay for the products.

Will the owner have to pay for the products?

A. No, because Franklin had been terminated, and thus, had no authority to make the order.

B. No, because the vendors should have been suspicious about the size of the orders, and they should have contacted the owner to confirm.

C. Yes, because the vendors reasonably believed that Franklin had the authority to order the products on the owner's behalf.

D. Yes, because it would be unfair to the vendors for the owner to not pay.

General Partnerships

Assume that each of the following questions involves facts arising in a jurisdiction that has implemented the Revised Uniform Partnership Act (RUPA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency.

12. Pike Patrol.

Aaronson, Baker, and Caulfield (ABC) together operate a successful business equipping and guiding tourist fishers. They registered the name "Pike Patrol" and opened a business bank account at a local bank. They operated profitably for several years. Then, one spring, they realized they had booked more clients than they could serve properly that summer. They emailed local fishers Dooley and Estrada (DE) and made the following offer: "Pike Patrol has more clients than it can service this summer. If you supply your own necessary equipment, then we will assign to you any client overage, that is, when we have over six clients per day, we will assign excess clients to you." Dooley and Estrada then each purchased fishing equipment costing about $4,000 each. During that summer, Pike Patrol had six to eight clients every day. Pike Patrol paid Dooley and Estrada for the fishing trips they conducted. At the end of the summer, Aaronson, Baker, and Caulfield decide to retire. When Pike Patrol ceased doing business, it had $100,000 in its business bank account. Dooley and Estrada contend that the arrangement constituted a partnership and that Dooley and Estrada are entitled to two-fifths of the bank balance.

You are the lawyer for Aaronson, Baker, and Caulfield. What is the best argument that ABC did not form a partnership with DE?

A. Aaronson, Baker, and Caulfield never intended to form a partnership.

B. Dooley and Estrada received different dollar amounts than did Aaronson, Baker, and Caulfield.

C. The equipment Dooley and Estrada purchased remained their separate property.

D. Dooley and Estrada received wages; provided their own equipment as would an independent contractor; never made a contribution to partnership property; and never voted or otherwise participated in upper-level decision making.

13. Home State Athletics, Part I.

Sammie is a coach and former track star at Home State University West (West). Tyrese is a coach and former basketball star at Home State University East (East). Ursula is a wealthy industrialist who lives in Home State. Through her support for Home State athletics, Ursula has become friends with Sammie and Tyrese. Sammie and Tyrese have rights to distribute Mercury running shoes in Home State. Sammie, Tyrese, and Ursula agreed to perform as follows: Ursula shall invest $250,000 to finance the purchase of running shoes for resale, house the inventory in her warehouse in Home State, and provide a part-time shipping clerk to manage the inventory; Sammie shall market the shoes to retailers in the western part of Home State; and Tyrese shall market the shoes to retailers in the eastern part of Home State. In exchange for their contributions, Sammie shall receive 10 percent commission on all shoes she sells, Tyrese shall receive 10 percent commission on all shoes he sells, and Ursula shall receive 10 percent commission on all shoes sold. The three agree to share equally anything left over after payment of expenses, including commissions.

Sammie, Tyrese, and Ursula visit you in your law office. They ask you, what is the nature of the legal relationship among the parties? Are there alternative ways in which their relationship might be characterized? What should you do to resolve the ambiguity?

Answer:

14. Home State Athletics, Part II.

Sammie is a coach and former track star at Home State University West (West). Tyrese is a coach and former basketball star at Home State University East (East). Ursula is a wealthy industrialist who lives in Home State. Through her support for Home State athletics, Ursula has become friends with Sammie and Tyrese. Sammie and Tyrese have rights to distribute Mercury running shoes in Home State. Sammie, Tyrese, and Ursula agreed to perform as follows: Ursula shall invest $250,000 to finance the purchase of running shoes for resale, house the inventory in her warehouse in Home State, and provide a part-time shipping clerk to manage the inventory; Sammie shall market the shoes to retailers in the western part Home State; and Tyrese shall market the shoes to retailers in the eastern part of Home State. In exchange for their contributions, Sammie shall receive 10 percent commission on all shoes she sells, Tyrese shall receive 10 percent commission on all shoes he sells, and Ursula shall receive 10 percent commission on all shoes sold. The three agree to share equally anything left over after payment of expenses, including commissions.

Sammie, Tyrese, and Ursula ask you to be their lawyer and to draft an agreement for them. What type of agreement would you draft for them? What would be three salient features of the agreement?

Answer:

15. Home State Athletics, Part III.

Sammie is a coach and former track star at Home State University West (West). Tyrese is a coach and former basketball star at Home State University East (East). Ursula is a wealthy industrialist who lives in Home State. Through her support for Home State athletics, Ursula has become friends with Sammie and Tyrese. Sammie and Tyrese have rights to distribute Mercury running shoes in Home State. Sammie, Tyrese, and Ursula agreed to perform as follows: Ursula shall invest $250,000 to finance the purchase of running shoes for resale, house the inventory in her warehouse in Home State, and provide a part-time shipping clerk to manage the inventory; Sammie shall market the shoes to retailers in the western part of Home State; and Tyrese shall market the shoes to retailers in the eastern part of Home State. In exchange for their contributions, Sammie shall receive 10 percent commission on all shoes she sells, Tyrese shall receive 10 percent commission on all shoes he sells, and Ursula shall receive 10 percent commission on all shoes sold. The three agree to share equally anything left over after payment of expenses, including commissions.

What might happen if Sammie, Tyrese, and Ursula never draft an agreement? What is their legal relationship, and what are the consequences of that relationship?

Answer:

16. Home State Athletics, Part IV.

Sammie is a coach and former track star at Home State University West (West). Tyrese is a coach and former basketball star at Home State University East (East). Ursula is a wealthy industrialist who lives in Home State. Through her support for Home State athletics, Ursula has become friends with Sammie and Tyrese. Sammie and Tyrese have rights to distribute Mercury running shoes in Home State. Sammie, Tyrese, and Ursula agreed to perform as follows: Ursula shall invest $250,000 to finance the purchase of running shoes for resale, house the inventory in her warehouse in Home State, and provide a part-time shipping clerk to manage the inventory; Sammie shall market the shoes to retailers in the western part of Home State; and Tyrese shall market the shoes to retailers in the eastern part of Home State. In exchange for their contributions, Sammie shall receive 10 percent commission on all shoes she sells, Tyrese shall receive 10 percent commission on all shoes he sells, and Ursula shall receive 10 percent commission on all shoes sold. The three agree to share equally anything left over after payment of expenses, including commissions.

Eighteen months later, Home State experiences the rainiest winter in its history. Sammie and Tyrese receive reports from retailers that much of the merchandise shipped to them is water damaged. They visit Ursula's warehouse and find the roof leaking badly. Ursula's shipping clerk's duties have been delegated to an after-school part-time high school student who has given free shoes to all of his friends, and who never inspected the inner portions of the

warehouse where the bulk of the inventory has been stored and the leaks occurred. An estimated $150,000 of inventory is worthless. Sammie and Tyrese are furious with Ursula. They want to end the business relationship.

What actions should Sammie and Tyrese take in order to end the relationship?

Answer:

17. Home State Athletics, Part V.

Sammie is a coach and former track star at Home State University West (West). Tyrese is a coach and former basketball star at Home State University East (East). Ursula is a wealthy industrialist who lives in Home State. Through her support for Home State athletics, Ursula has become friends with Sammie and Tyrese. Sammie and Tyrese have rights to distribute Mercury running shoes in Home State. Sammie, Tyrese, and Ursula agreed to perform as follows: Ursula shall invest $250,000 to finance the purchase of running shoes for resale, house the inventory in her warehouse in Home State, and provide a part-time shipping clerk to manage the inventory; Sammie shall market the shoes to retailers in the western part of Home State; and Tyrese shall market the shoes to retailers in the eastern part of Home State. In exchange for their contributions, Sammie shall receive 10 percent commission on all shoes she sells, Tyrese shall receive 10 percent commission on all shoes he sells, and Ursula shall receive 10 percent commission on all shoes sold. The three agree to share equally anything left over after payment of expenses, including commissions.

Eighteen months later, Home State experiences the rainiest winter in its history. Sammie and Tyrese receive reports from retailers that much of the merchandise shipped to them is water damaged. They visit Ursula's warehouse and find the roof leaking badly. Ursula's shipping clerk's duties have been delegated to an after-school part-time high school student who has given free shoes to all of his friends, and who never inspected the inner portions of the warehouse where the bulk of the inventory has been stored and the leaks occurred. An estimated $150,000 of inventory is worthless. Sammie and Tyrese are furious with Ursula.

Do Sammie and Tyrese have any legal claims against Ursula? If they file a court complaint, what theory or theories should they pursue in their case?

Answer:

18. Joint Microbrewery.

Liam and Clare each own an Irish pub in the same city. To cash in on the microbrew craze, Liam and Clare wish to go together to establish a small microbrewery that will supply two or three locally brewed beers to each pub. The brewery will be located off-site, in the industrial

part of town. The premises will be leased. Liam and Clare jointly sign the lease, hire the brewmeister, and purchase supplies and equipment. They do not memorialize their business arrangement.

What is the best way to describe the legal status of their business arrangement?

A. A partnership

B. A joint venture

C. A limited liability company

D. Both a partnership and a joint venture

19. The Partnership Lease Renewal.

Developer entered into a 20-year lease with Landlord to develop and operate a commercial strip mall. Lacking the resources to fully fund the project, Developer partnered with Investor. They agreed that Investor would provide capital necessary to finance the project and, in return, would receive 60 percent of the partnership's profits. Likewise, Developer would manage the day-to-day operations and receive 40 percent of the partnership's profits. Developer and Investor agreed to split the debts equally. The arrangement worked well for several years and was profitable, but then the partnership experienced a few rough financial years and the relationship between Developer and Investor soured. As the lease neared the end of its term, Developer and Investor were barely on speaking terms. Unaware of the relationship between Developer and Investor, Landlord approached Developer to inquire if they would be interested in entering into a new lease of the space for an additional 20-year term after the current lease expired. Developer never told Investor about the new lease opportunity. Having built up enough capital so that Investor was no longer needed, however, Developer accepted Landlord's offer and signed a new lease. After the new lease period began, Investor discovered the arrangement and was furious.

Has Developer breached any fiduciary duty owed to Investor?

A. Yes. Developer owed Investor the punctilio of an honor the most sensitive, which Developer breached by entering into a new lease without Investor.

B. Yes. Developer owed Investor a duty of loyalty, which Developer breached by entering into a new lease without Investor.

C. No. Developer only owed a fiduciary duty to the partnership, not to Investor individually.

D. No. Developer owed a fiduciary duty to both the partnership and to Investor, but Developer's actions did not violate that duty, and there is no indication that Developer failed to exercise any obligations to the partnership or to Investor in good faith.

20. Partnership Auto Purchase.

The Moss family owns your client, British Auto Imports, Inc. Sterling Moss, the fleet sales manager, reached out to you, his attorney and counselor, about an order from the managing partner of Wycoff and Van Duzer, LLP, a law firm with 30 partners. The managing partner has placed an order for 40 luxury automobiles. The purchase is to be financed through British Auto Import's in-house finance department. Moss wants to know what, if any, partnership paperwork he needs before he accepts and places the order with the factories for the new cars.

What is the safest practical advice an attorney should give Moss?

A. The managing partner, or any partner, has the inherent authority to do such a deal. Go ahead and place the order.

B. Ask around to determine if the managing partner has done transactions like this in the past. If he has, there exists implied actual authority. Go ahead and place the order.

C. The managing partner, by being given the title, an office, letterhead stationery, and so on, has the apparent authority to do the deal. Go ahead and place the order.

D. Do not place the order. Require that the law firm produce a certified copy of a valid resolution adopted by its partners at a partnership meeting.

21. A Ponzi Scheme.

Turner and Kelley are law partners. Turner's practice is primarily divorce while Kelley does general civil litigation. Without Kelley's knowledge, Turner has been promising divorce clients high rates of return if they leave the proceeds of divorce settlements with Turner. Your client, Norma, left $400,000 with Turner, who paid her high interest for five years. Turner has now filed personal bankruptcy and is judgment proof. He stopped paying interest last year. The entire affair turns out to have been a "Ponzi scheme." You represent Norma in a suit against Kelley and the law firm, and you seek to show that the partnership is liable. The defense proposes to put on the stand the state bar association president and partners from two other local law firms who all will testify that investing client funds is not "carrying on in the usual way the business" of a law partnership, such that the partnership did not authorize the action and is not liable.

Is there a good argument for excluding the testimony?

A. Yes. The proper test is the reasonable expectations of third parties and the public regarding what law firms do.

B. No. Norma was contributorily negligent in leaving the settlement proceeds with Turner.

C. No. The testimony is relevant as expert testimony about the scope of the ordinary practice of law.

D. It is a toss-up. The judge could rule either way without abusing her discretion.

22. Can't Stop Shopping.

Joseph and Larry have practiced law together since law school graduation two years ago. Joseph discovers that Larry is an obsessive online shopper: Larry orders computers, printers, servers, and other computer accessories on a weekly basis. The law office is filled with Amazon boxes. Larry's excesses vastly inflate the firm's accounts payable. Joseph has asked Larry to stop, to no avail. Joseph has also sent a registered letter to Amazon to cease shipments, but Amazon keeps shipping products anyway.

What is the most appropriate next step for Joseph to take if he does not want to be liable for these Amazon purchases?

A. Notify Amazon that, as partner, Larry has no authority to bind the partnership in these matters.

B. Invoke a partner's veto powers under the emergency doctrine and declare that Larry no longer has power to bind the partnership, notifying creditors.

C. Associate a new partner and then vote 2-1 to restrict Larry's authority.

D. Dissolve the partnership by Joseph's express will.

23. A Grouchy Partner.

Oscar and Elmo have a garbage collection business that they operate as a general partnership. For the busy summer season, Elmo wanted to hire a third person. Oscar said no. Elmo hired a helper anyway, to whom he paid $20,000 out of business funds. Oscar filed suit against Elmo for reimbursement of the funds, arguing that Elmo had exceeded his authority.

What is the most likely result of a lawsuit?

Answer:

24. Ken the Contractor.

Ken is a foreman for a local general contractor that does office renovations. Ken would like to strike out on his own but needs a certain amount of capital to purchase tools and a truck, and for working capital. He approaches Banksie, an old friend of his. Banksie agrees to contribute $100,000 to the enterprise. Ken will solicit clients, bid the renovation jobs, and do the work. Ken and Banksie agree that they will split the profits 50/50, but they do not discuss allocations of losses. They shake hands on the deal. One year later, a national pandemic causes many offices to close, and far fewer offices want remodeling. Ken "burns through" the $100,000 investment. He and Banksie agree that the venture is to end. Ken will go back

to working for the large contractor. Banksie asks Ken to pay her $50,000 so that they will "come out even." Ken refuses.

If Banksie sues Ken for $50,000, what is the most likely result?

A. Ken must pay the $50,000 to Banksie because, unless otherwise agreed, partners share the losses in the same proportions as they share the profits.

B. Ken owes nothing to Banksie. While Banksie contributed capital, Ken contributed his labor. As a matter of fairness, Ken should not have to make an additional contribution to cover the partnership's losses.

C. Banksie owes Ken $50,000 because the value of Ken's labor, at his usual rates, to the partnership has a reasonable value far in excess of Banksie's $50,000, to wit, $100,000.

D. Banksie owes Ken $50,000 because Ken's labor cannot be valued higher than Banksie's contribution.

25. Norse Demolition.

Oden, Theo, and Luke collectively own and operate Norse Demolition and Earthmoving. Their business owns a great quantity of heavy equipment (e.g., bulldozers). After years of successfully leading the business, Oden now wishes to cash out his share of the partnership and retire. Oden has informed Theo and Luke about his decision and given notice that his retirement would take effect immediately, but also that he has no problem with the business's continuing if they want it to. Oden just wants cash. Theo and Luke desire to continue the business. The partnership agreement says nothing about retirement or the effect of dissociation of a partner on the partnership.

What is the current legal status of this partnership and the liabilities of the parties to each other?

A. Oden has dissociated as a partner, and as a result, the partnership is dissolved. The partners must now wind up affairs. After winding up, each partner shall get a third of residual profits, if any.

B. Oden has disassociated himself as a partner, and as a result, the partnership is dissolved; however, all three of the partners may waive the dissolution of the partnership and cause Oden's shares to be bought out.

C. Oden's disassociation is wrongful because it is unilateral, so he is not entitled to anything. Moreover, Theo and Luke can sue Oden for any damages to the partnership caused by his disassociation.

D. The partners must comply with the default rules of RUPA and have no authority to vary the default rules now.

26. Two Taverns.

Pat and Mike have a partnership that owns two Irish taverns, one on the North Side, where Pat lives, and one on the South Side, where Mike lives. The taverns are pretty much identical in decor, revenues, expenses, and so on. There are a few other assets (a pickup truck, extra chairs and tables, etc.). Pat and Mike have decided, quite amicably, to go their separate ways. Mike no longer wants to be in the tavern business. On the other hand, Pat wants to continue running the business. Additionally, Pat does not have the cash on hand to buy Mike out. Mike is sympathetic to the situation and Pat's desire to continue, but he needs cash for retirement. Thus, he cannot agree to any outcome that does not put cash in his pocket. They have asked you as mediator to apply the partnership rules effectuating a split-up between them.

How should you resolve this situation?

A. Pat gets the Northside Tavern and Mike gets the Southside Tavern. The other assets will be split equitably between them.

B. Both taverns and the miscellaneous assets are to be sold with the cash proceeds split 50/50.

C. Each partner gets an election to take a tavern or cash.

D. Pat gets the Northside Tavern and Mike gets the Southside Tavern, but the other assets will be sold at auction and the proceeds will be divided equally between them.

27. Breaking Up.

Keith and Belinda are partners who have run a talent agency together for five years. They have paid off all the debts they incurred when they formed the business, except for a $50,000 note payable to Belinda. Belinda has developed an impressive client list, but Keith has only a few clients, mostly B-class character actors. Keith manages the office and their information technology systems. He also performs numerous tasks for Belinda's clients. Keith and Belinda have started bickering. Keith frequently complains about Belinda's extravagant lunches and her multiple country club memberships. Sick of the complaints, Belinda moved her personal items out and set up shop in a new office she rented in another part of town. She began to make money hand over fist, but Keith floundered.

Does Keith have a claim against Belinda?

A. No, not without a partnership agreement. The withdrawal of a partner dissolves the partnership. Such a dissolution is wrongful only if it contravenes some provision of the partnership agreement.

B. Yes. The partnership had an implied term, which was to pay off the debts incurred in its formation. Belinda's dissolution of the partnership prior to that time is wrongful.

C. Yes. A partner at will is not bound to remain in the partnership, but Belinda must exercise her right to withdraw in good faith and consistent with the fiduciary duties partners owe one to another.

D. No, Belinda did not take anything that belonged to Keith.

28. Partnership Departure Planning.

You are at your 10-year law school reunion picnic. It is August. Megan, a former classmate, takes you aside. Megan is a very successful personal injury practitioner in the mid-size law firm of Rose & Rose. In confidence, she tells you that she is going to form her own firm on January 1. She plans on taking two junior partners and one associate attorney with her.

What should Megan do between August and her date of departure?

Answer:

29. Partnership Expulsion.

Pat publicly supported a contentious candidate for U.S. President — frequently, in high profile ways. Many of the partners in Pat's law firm were infuriated by her support of what they deemed to be a loathsome candidate, and they became concerned that Pat's public support would negatively impact the business. In a regularly scheduled partners' meeting, a majority of the partners voted to expel Pat from the partnership. Pat is bewildered and upset.

Can Pat win a suit for wrongful expulsion?

A. No. But her expulsion is an event of dissociation that does not cause the partnership to be dissolved, so she is entitled to her share of partnership assets in its winding up.

B. No. But her expulsion is an event of dissociation that causes the partnership to be dissolved, its business wound up, and terminated.

C. No. Partnerships are consensual arrangements, and an expulsion of a partner is permitted so long as the partners acted consistently with the obligation of good faith and fair dealing.

D. Yes. Any such clause would be void as against public policy if exercised in such a way as to deny a partner her fundamental First Amendment rights.

30. Partnership Finances, Part I.

Paul and Olivia operate a beach equipment rental business as a general partnership. Each partner contributed $5,000 to purchase equipment and supplies, and they agreed to share the profits and losses evenly. They spend their days renting umbrellas, chairs, and canopies to beachgoers. After a month in business, Paul and Olivia have made $5,000 in profit.

What interest do each of the partners have in the $5,000 profits?

A. Each partner is entitled to immediately receive a check from the partnership for $2,500, but this payment will have no effect on the partners' financial interest in the partnership.

B. Each partner is entitled to immediately receive a check from the partnership for $2,500, but this payment will reduce the partners' capital accounts by $2,500.

C. The profits belong to the partnership, not to the partners individually.

D. Each partner has a capital account which should be updated to reflect their share of the profits, but the partners are not entitled to any immediate payment.

31. Partnership Finances, Part II.

Paul and Olivia operate a beach equipment rental business as a general partnership. The partnership has been doing well, and the partners have decided to build a beach shack to house their equipment. The partners have the liquid funds to pay for much of the construction, but they did not anticipate the steep licensing costs to build on the beach. Accordingly, the partnership took out a loan for $30,000. Thereafter, a number of particularly strong hurricanes came through, and then a migration of jellyfish deterred the usual crowds from coming to the beach. After several months of impacted business, the partners were out of money and realized they could no longer operate the business. They had to shut down, but even after they liquidated all partnership property, they still owed $20,000 on the loan.

What are the partners' obligations as to the repayment of the loan?

A. None. This is the partnership's obligation, not the obligation of the partners.

B. Each partner is only liable to pay half the debt, $10,000.

C. As between the partners, each partner is liable to pay half the debt, but each partner is jointly and severally liable to the lender for the full amount of the debt.

D. Each partner is jointly and severally liable for the full debt.

32. Partnership Finances, Part III.

Paul and Olivia operate a beach equipment rental business as a general partnership, and they have agreed to share the profits and losses evenly. At the end of the year, the partnership had earned an impressive $10,000 in profit.

How should the $10,000 profit be handled for purposes of federal income tax liability?

A. The partnership is responsible for the federal income tax liability.

B. Each partner is individually responsible for half of the federal income tax liability, and each partner's capital account should be credited with half of the profit.

C. No partner is responsible for any of the federal income tax liability unless they have received a distribution, and then, the partner bears the federal income tax liability for the distribution they have received.

D. Each partner is individually responsible for half of the federal income tax liability, but this does not impact the partner's financial interest in the partnership.

33. Landscaping Liability.

Foster and McGee operate a landscaping business as a general partnership. One day, while in the ordinary course of the partnership's business, Foster negligently caused injury to a bystander at a landscaping job. The bystander incurred serious injury and desires to sue for damages.

Against whom may the bystander file suit?

A. Foster only

B. The partnership only

C. The partnership and Foster, but not McGee

D. The partnership, Foster, and McGee

LLCs and Other Unincorporated Associations

Assume that each of the following questions involves facts arising in a jurisdiction that has implemented the Revised Uniform Partnership Act (RUPA), the Revised Uniform Limited Partnership Act (RULPA), and the Revised Uniform Limited Liability Company Act (RULLCA), and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency.

34. Investment Actors.

Three former child actors, Knight, Plumb, and Lookinland, recently reconnected at a reunion. They are all now fairly wealthy and have high-paying jobs. At the reunion, they discussed pooling some cash to invest in real estate. Knight suggested that he could lead them in a real estate investment venture. Plumb expressed concerns that she could not participate in management since she lives abroad in South Korea. Knight and Lookinland live in the United States. Lookinland does not want to handle most of the day-to-day affairs, but he does want to be involved with the interior design. Knight located a 60-unit townhouse apartment complex. The complex needs some repairs and cosmetic improvement, but it is available at a very reasonable price of six times the gross rentals. The actors decided to make a near full-price offer on the property. They seek your advice on the form of business they should set up before making their bid or, in the alternative, once their bid is accepted.

What kind of business association should the actors form?

A. They should form a general partnership (either at will or for a term of years). That way they can all participate in the management of the complex, choosing the color of paint for the units, and so on.

B. They should form a corporation. The tenants will be raucous undergraduates who will, from time to time, injure themselves. You have to have liability insurance, but the limited liability a corporation would afford would give added protection and peace of mind to the investors.

C. They should form a limited partnership. Knight will be the general partner, and the other two actors will be the limited partners.

D. They should form a limited liability company.

35. Partnership Participation.

A group of six unrelated people — Aaron, Burt, Cathy, Doug, Ellie, and Felice — want to invest in real estate. They decide to purchase, renovate, and operate a senior living facility. Aaron plans to supervise day-to-day operations, but he does not want to be personally liable for harms occurring on the property. Burt and Cathy, who are interior designers by profession, want to review all decisions regarding interior decorations (curtain styles, paint colors, cabinets designs, countertops materials, etc.) and to have a veto right regarding any decision they do not prefer. Doug and Ellie wish to be passive investors. Felice, who is an accountant, wants to require that her signature be on all checks, in addition to Aaron's.

Is a limited partnership the best organization for this business?

A. Yes, because the limited partnership will limit all the partners' liability.

B. No, because Burt and Cathy will be personally liable for poor interior design choices.

C. No, because Felice will be personally liable for any financial problems.

D. No, because a limited liability company provides more guarantees of limited liability where members are engaged in business decisions.

36. General Partnerships vs. Limited Liability Companies.

List three key distinctions between general partnerships and limited liability companies.

Answer:

37. "Antique Store, LLC."

Brother and Sister desired to open a business to buy and sell antique goods. Because they were concerned about their personal exposure to the business's liability, the siblings decided that it would be best to operate the business as a limited liability company. The siblings, however, wanted to keep startup costs low and decided not to consult with an attorney about structuring the business. Brother and Sister each contributed $20,000 to the business, and they deposited the funds into a bank account under Sister's name. Without taking any further action or filing any documentation with the government office in the jurisdiction responsible for business filings, Brother and Sister began operating "Antique Store, LLC." Several months into the venture, as a result of an employee's negligence, Customer fell in the store and sustained serious injuries. Customer filed suit against "Antique Store, LLC" and against Brother and Sister. Brother and Sister filed motions to dismiss the lawsuit as to themselves.

How should the court rule on the motions to dismiss?

A. The court should grant the motions to dismiss. By operating the business as a limited liability company, Brother and Sister shielded themselves from any personal liability incurred as in connection with business operations.

B. The court should grant the motions to dismiss. The injury was the result of an employee's negligence, not any wrongful act or omission by Brother or Sister.

C. The court should deny the motions to dismiss. Brother and Sister failed to properly form the limited liability company, and so they are not entitled to the protection of a liability shield.

D. The Court should deny the motions to dismiss. Members of a limited liability company are jointly and severally liable for all the company's obligations in contract, tort, and otherwise.

38. Cashing Out.

Your friend Evelyn is a law librarian who, over the years, has been a persistent real estate investor. She does not own real estate directly. Rather, she has purchased units of participation in limited partnerships that, in turn, purchased a number of commercial and multifamily real estate developments. Evelyn has decided to take early retirement. She intends to move to the Rockies and become a professional snowboarder as soon as possible. She wishes to cash out her units of participation to raise cash to purchase a Hummer and a condominium.

Evelyn seeks your legal advice on how to quickly cash out her stake in various limited partnerships. What do you tell her?

Answer:

39. Myron's Estate.

Myron has had a vineyard and winery for 20 years. He has built up the business from near nothing to a probable market value of $7 to $10 million (an exact valuation is difficult to pin down). He produces Pinot Noir wines that have won many gold and silver medals and are served in fine restaurants up and down the West Coast. Myron has four children, all grown. None is too far away, but none works in the winery, at present. At age 59, Myron has begun to think about his mortality. The value of his winery is spiraling upward, he is thinking of expansion which will increase the value even more, and he wishes the winery to be preserved intact because one or two of his sons or daughters very well might take it over upon Myron's death or retirement. He worries about federal estate taxes, the payment of which might force the sale of the winery.

In what form of entity should he put the winery?

A. General partnership

B. Limited partnership

C. Corporation

D. Limited liability company

40. Limited Liability.

North, South, and West are the only members and only employees of Builders, LLC. Builders, LLC, is a manager-managed LLC, and North is the only manager. One day, South was working at one of the LLC's job sites on a construction project for which the LLC had been hired when she negligently caused damage to an adjacent home. Neither North nor West were present at the time. Assume that no member has received an improper distribution.

Against whom may the homeowner commence suit for damages caused by South's negligence?

A. The LLC, but not North, South, or West

B. The LLC and South, but not North or West

C. The LLC, South, and North, but not West

D. The homeowner may not sue anyone.

41. Members and Managers.

Baseball, LLC, is a family-owned custom athletic apparel company, and it hosts a youth sports competition every year. Although there are seven members of the LLC, only two are actively involved in managing the day-to-day activities of the business. Because of the passivity of most of the members, the two active members want to structure the LLC so that they, and only they, are the only people who may deal with third parties on behalf of the company and sign contracts on the LLC's behalf.

Is such a structure possible?

A. Yes, and it is the default statutory system.

B. Yes, but the LLC's certificate of organization must state that the LLC is to be manager-managed.

C. Yes, but the LLC's operating agreement must state that the LLC is to be manager-managed.

D. No, because all members of an LLC are agents of the LLC and therefore have apparent authority to bind the LLC in contract.

42. A Canceled Concert.

Fernado, LLC, is a manager-managed limited liability company that sells merchandise for sporting and entertainment events. Walter has been appointed as the only manager. In anticipation of an upcoming concert, Walter ordered and paid for 10,000 custom t-shirts for the LLC to sell that listed both the date and city of the concert venue. This order was consistent with orders Walter usually places for similarly-sized events. Unfortunately, and unexpectedly, one of the lead members of the band had become ill, and the concert was canceled. Walter was unable to sell any of the shirts or receive refunds from the vendors who printed the shirts. In total, the LLC suffered a loss of $50,000. The LLC operating agreement does not vary the default rules relating to a manager's fiduciary duty.

Is Walter liable for breach of fiduciary duty to the LLC and the members of the LLC by ordering the 10,000 custom t-shirts?

A. No. Walter does not owe any fiduciary duty to the LLC or to the members of the LLC.

B. No. Although Walter owes fiduciary duties of care and loyalty to the LLC, he has not breached either.

C. Yes. Walter breached his duty of care to the LLC and the members of the LLC.

D. Yes, Walter breached his duty of loyalty to the LLC and the members of the LLC.

43. Competition at the Gym.

Pump You Up, LLC, is a member-managed LLC that owns and operates a line of fitness studios. One of the members of the LLC, Kylar, also owns a fitness apparel business. Without first discussing it with the other members, Kylar set up a booth in the lobby of one of the studios to sell various pieces of apparel that Kylar had produced through work with the other business. The apparel featured the "Pump You Up" logo and colors. This proved quite lucrative, and Kylar quickly made $5,000 of profit through the sales. Kylar kept the money and did not share it with the LLC or the other members of the LLC. The LLC operating agreement does not vary the default rules relating to a member's fiduciary duty.

Has Kylar breached any fiduciary duty owed to the LLC and the other members of the LLC?

A. No. As a member, Kylar does not owe any fiduciary duty to the LLC or the other members of the LLC.

B. No. As a member, Kylar owed the fiduciary duties of loyalty and care to the LLC and the other members of the LLC, but he has not violated either of those duties through the conduct here.

C. Yes. Kylar has breached the duty of care owed to the LLC and the other members of the LLC.

D. Yes. Kylar has breached the duty of loyalty owed to the LLC and the other members of the LLC.

44. Exit via Transfer.

A group of five friends organized Cloister, LLC. Each of the friends became a member of the LLC with rights equal to one another. The LLC operated successfully for several years. Recently, Beta has become frustrated with decisions made by the other members. While the LLC has not made any illegal decision, Beta feels that the LLC is moving in a new direction and that now would be a good time to get out. Beta has been discussing the prospect of selling their membership interest to Foxtrot, someone who has been unassociated with the LLC but is interested in the business venture and is willing to buy Beta out. Beta has not shared their intent to transfer their interest to Foxtrot with any of the other members of the LLC. The LLC operating agreement does not vary the default rules relating to transfer of membership interest.

May Beta transfer their interest in Cloister, LLC, to Foxtrot?

A. Beta may transfer only their financial interest in the LLC to Foxtrot, but this will not result in Foxtrot's becoming a member of the LLC.

B. Beta may transfer their financial interest in the LLC to Foxtrot, and as a result, Foxtrot will become a member of the LLC.

C. Beta may not transfer any interest in the LLC to Foxtrot.

D. Beta's transfer of an interest will result in the dissolution and winding up of the LLC.

45. Stuck in the LLC.

PalmQuest, LLC, has eight members and has operated profitably for the past five years. Recently, one member, Delano, has been experiencing financial success in other ventures. In fact, Delano has been doing so well that continued association with PalmQuest has become burdensome. Delano wishes to withdraw from the LLC and has consulted with an attorney about an "exit strategy." The attorney has reviewed the PalmQuest operating agreement and came across the following clause: "No member has an absolute right to withdraw by express will from the company prior to dissolution and completion of winding up of the company."

Is the clause in the operating agreement enforceable?

A. No. A member has an absolute right to withdraw from an LLC at any time by express will, and an operating agreement may not limit such dissociation.

B. No. A prohibition of withdrawal by express will is manifestly unreasonable.

C. Yes, and this is consistent with the default rules under RULLCA.

D. Yes. This is a permissible and enforceable variance from the default rules.

46. Jumping Ship.

Milo is a member of Turmoil, LLC, which has recently fallen on hard times. Frustrated with the decisions the other members have made — and concerned that the other members have engaged in some shady financial transactions — Milo wants out. Milo delivered proper notice of his withdrawal to the other members. The LLC's operating agreement permits a member to withdraw, and Milo has satisfied the procedural requirements. Three months after Milo's withdrawal, the remaining members approved an interim distribution for $5,000 to each member under the procedure established in the operating agreement. The operating agreement expressly permits interim distributions upon a majority vote of the members, but it otherwise is consistent with all default rules. Assume that the distribution does not render the LLC insolvent and that the LLC is still able to pay its debts as they come due in the ordinary course of the LLC's business.

Is Milo entitled to receive a distribution?

A. Yes, Milo is entitled to a distribution in equal shares with the other members and dissociated members.

B. No, Milo is not entitled to any distribution approved after his dissociation.

C. No. Interim distributions are not permitted.

D. Yes, but only after the LLC is dissolved and wound up.

47. Law Firm Form.

The law firm of Greene, Egge, and Hamme has been operating as a general partnership for 10 years. Now the founding partners wish to promote some of their long-term associates to partners, but they are concerned about liability. The founders approach you and ask you to reorganize the firm.

What is the best choice of business entity for this law firm?

A. Corporation

B. Limited liability company

C. Partnership

D. Limited liability partnership

48. Cabbage Analytics.

Bok, Danish, and Green decide to start a business that provides analytics to cabbage farmers throughout the United States. Bok is a Chinese citizen and resident of Guizhou Province in southwest China. Danish lives in Copenhagen and is a citizen of Denmark. Green is a U.S. citizen who resides full time in Missouri. Together, they have enough money to start and run the business, and they do not plan to invite anyone else to invest in their business.

They want to distribute business profits to themselves monthly, since they will not otherwise earn any salary. They come to your office seeking counsel on what type of entity they should form.

What type of business association should Bak, Danish, and Green form?

A. Corporation

B. Limited liability company

C. Partnership

D. Limited liability partnership

49. Fishmongers I.

Bluegill, Catfish, and Drum own and operate a small business called Fishmongers, LLC, that sells raw fish. Fishmongers, LLC, is a member-managed limited liability company. To keep fish fresh, Fishmongers, LLC, must keep its fish in refrigerators. One day when Drum is alone in the shop, the main refrigerator stops functioning. To prevent $10,000 worth of fresh fish from spoiling, Drum goes to a local department store and purchases a large refrigerator for $1,000, using his personal credit card. When his credit card statement comes due, Drum demands that Fishmongers, LLC, reimburse him for the cost of the refrigerator. Bluegill and Catfish refuse on the ground that Fishmongers, LLC, did not make profits this month.

Is Drum entitled to reimbursement from Fishmongers, LLC, for what he spent on the refrigerator?

A. Yes, because Fishmongers, LLC, must indemnify its members for liability incurred in the ordinary course of business.

B. Yes, because Fishmongers, LLC, is obligated to reimburse members for any payments made in the course of the member's activities for the company.

C. No. Because Fishmongers, LLC, did not earn profits this month, its owners are entitled only to flow-through losses.

D. No, because a majority of the members of a member-managed limited liability company must elect to make distribution, and only one-third of Fishmonger, LLC's members voted for a distribution here.

50. Fishmongers II.

Bluegill is a member and one-third owner of a small business called Fishmongers, LLC, a member-managed limited liability company that resells fish. At a meeting of the members, the members decide that Fishmongers, LLC, should begin selling sushi-grade tuna. Bluegill offers to loan the company $100,000 to purchase three metric tons of whole bluefin tuna from the international market. The other members agree. The company promptly sells the fish at a

substantial profit. Three months later, Bluegill demands repayment of his loan, plus five percent interest per annum. During this same period, the rate of inflation was six percent.

Does Fishmongers, LLC, owe interest to Bluegill?

A. Yes, because loans by members which give rise to limited liability company obligations accrue interest.

B. Yes, because limited liability companies owe imputed interest to their members.

C. No, because Bluegill made a contribution to his capital account, not a loan.

D. No, because members cannot demand interest on loans made to companies they own.

Corporate Incorporation

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

51. Exotic Food.

Roy Bean and his sister Gail, both well-to-do dentists, own a store they operate as Bean's Exotic Food Supplies. Gail has also become the host of a popular cooking show on local television. Bean's food store, after three years of losses, has become profitable, at least in the busy months of the year. In the coming year, they plan to lease premises and open three new stores in the southeastern part of the country. The leases will have seven- to eight-year terms. The business plan, which they prepared for the bank, shows the new stores breaking even in the fourth year. As they embark upon this expansion, they consult you, their attorney, for advice.

Which of the following provides the best advice for Roy and Gail?

A. Do nothing. They can save money on legal fees and filing costs by continuing to operate as a general partnership.

B. Form a corporation and elect subchapter S status under the Internal Revenue Code.

C. Hire counsel in Wilmington and form a Delaware corporation.

D. Hire you to draft a detailed partnership agreement.

52. Six Lawyers.

Six lawyers practice as partners in a boutique litigation firm. Last year, a client brought a malpractice claim against one partner, and the settlement amount exceeded the group's malpractice policy limits. Each partner had to chip in $40,000. They do not wish to see that happen again.

What alternatives do they have?

A. Remain a general partnership because the Rules of Professional Conduct require it.

B. Form a corporation and elect subchapter S status under the Internal Revenue Code.

C. Form a professional service corporation.

D. Form a limited partnership with one lawyer as the general partner and the rest as limited partners.

53. Buddy's State of Formation.

Buddy wishes to incorporate his luxury used car business and, as his lawyer, you concur. Buddy, his business, and you are all located in the State of Peace (a fictional U.S. jurisdiction that has adopted the MBCA).

Buddy should form his corporation by filing articles of incorporation with the Secretary of State (or similar official) in

A. Peace.

B. Nevada.

C. Delaware.

D. An offshore location (Cayman Islands, Bermuda, the Bahamas, or the Netherlands Antilles).

54. Incorporation Process, Part I.

You are a partner in a law firm. A junior associate you mentored several times comes to you and says, "Another partner has asked me to incorporate a client's new business. I never took business associations in law school. What should I do first?" In your firm, the first step of corporate formation is to create the corporate legal entity and verify it exists.

Explain the document you need to draft, and what should be done with this document, to cause a corporation to legally come into existence.

Answer:

55. Incorporation Process, Part II.

You are a partner in a law firm who recently mentored a junior associate on what is the first step in legally forming a corporation. The junior associate completed the task and returned with a file-stamped copy of the relevant document and a "certificate of good standing" signed by the secretary of state. The junior associate asks, "What do I do next?"

Explain what are the next steps in incorporation after the corporation is formed. What documents should you draft, what events should you hold, and what is their purpose?

Answer:

56. A Narrow Purpose.

Musicians Flaunce and Posh have formed a corporation to produce their music. Posh is concerned that Flaunce, if given the chance, will use corporate resources to open a nightclub as a venue for her performances. In their preliminary meeting with their attorney, Posh voices her concerns, and Flaunce agrees to any reasonable measure that would rein in or check her expansionary desires.

What is the simplest way for the attorney to implement Flaunce's and Posh's meeting of the minds?

A. Draft a hold harmless agreement making Flaunce responsible for any losses occasioned by unauthorized expansion of the corporation's business.

B. Do the same in an employment agreement that outlines Flaunce's responsibilities.

C. Draft a narrow purpose article in the articles of incorporation.

D. Have Flaunce post a bond, with a commercial surety thereon.

57. ET McDonalds.

Ernst Thompson came upon some commercial property for rent and decided that the location would be an ideal spot for a new McDonalds restaurant. Ernst negotiated face to face with the landlord while wearing a McDonalds polo shirt. When the landlord offered Ernst a lease, he accepted by signing, "ET McDonalds, Inc." Ernst then applied to McDonalds for a franchise. When McDonalds denied Ernst's application, Ernst decided not to file incorporation documents and so never formed ET McDonalds, Inc. Ernst then called the landlord and repudiated the commercial lease.

Is Ernst liable for the lease?

A. No, because a non-existent corporation may not act.

B. No, because Ernst is protected by corporate limited liability.

C. Yes, because Ernst committed fraud.

D. Yes, because Ernst is subject to promoter liability.

58. Avoiding Promoter Liability.

A promoter inadvertently enters into a contract with a seller on behalf of a to-be-formed corporation.

How can the promoter avoid liability for that contract?

A. No action is required. The promoter is protected by corporate limited liability.

B. Hold a board of directors meeting where the corporation agrees to indemnify and hold harmless the promoter.

C. Agree between the promoter, the seller, and the corporation to a novation after the corporation comes into existence.

D. Agree with the seller that the promoter is protected by limited liability.

59. Failed Start.

A commercial airline pilot quits his job working for a large national airline to start his own charter air service. The pilot hires a lawyer to incorporate a corporation on his behalf. The lawyer tells the pilot that the corporation is created and sends the pilot a bill for related legal services, which the pilot pays. Acting for the corporation, the pilot then contacts Learjet and orders a Learjet 70 for $3 million on credit, with the initial payment due in 30 days. Four weeks later, the lawyer calls the pilot and says that the corporation was not actually formed because a business with the same name already exists in that state. The pilot failed to make the first payment to Learjet, and Learjet sues the pilot personally.

What is the pilot's best defense?

A. The corporation has de jure corporate status.

B. The pilot is shielded by de facto corporate existence.

C. The pilot is shielded by promoter liability.

D. The pilot lacked knowledge that the corporation had not been formed.

60. Corporate Restart.

An entrepreneur formed a corporation properly while residing at a certain address. The entrepreneur later moved away and forgot to update his corporate mailing address with the secretary of state. As a result, the entrepreneur never received mail from the state regarding requirements for annual reports, franchise taxes, and other requirements. After two years of missed filings, the secretary of state dissolved the corporation administratively. The entrepreneur, unaware of this dissolution, continued to act for the corporation by entering into business contracts.

Is the entrepreneur personally liable for contracts entered into after the corporation was dissolved? If so, is there a way to cut off liability?

Answer:

Piercing the Corporate Veil

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Revised Uniform Limited Liability Company Act (RULLCA) and Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

61. Introduction to Piercing the Corporate Veil.

What does it mean to "pierce the corporate veil"?

Answer:

62. Piercing Factors.

Courts must engage in a fact-intensive inquiry when considering whether to pierce a corporation's liability shield. What factors must a court consider?

Answer:

63. Dram Shop Liability.

Melba, as sole shareholder, formed CE, Inc., for the purpose of acquiring the assets of a neighborhood pub. Melba capitalized CE, Inc., for $10,000, in return for common stock. She then used CE, Inc., to enter into an asset purchase agreement to purchase the pub for $50,000, payable as follows: $7,500 cash down payment and a promissory note for $42,500 to the sellers. Later, CE, Inc., borrowed $42,500 from Bank to pay off the purchase of the pub, but Bank required Melba to personally guarantee the loan. CE, Inc., purchased a $100,000 liability insurance policy. Months into the venture, when Melba was working at the pub, a customer left in an inebriated condition and got into a wreck that resulted in serious injury to a pedestrian. The jurisdiction allows anyone injured by an inebriated driver to also bring suit against the owner of the pub and anyone who actually served the driver alcohol. The pedestrian brought suit against the driver, CE, Inc., and Melba individually.

Is there a basis for the court to hold Melba personally liable for the pedestrian's injuries?

A. Yes. The court should disregard the corporate liability shield because CE, Inc., only has one shareholder and that shareholder is heavily involved in the day-to-day activities of the corporation.

B. Yes. The court should disregard the corporate liability shield because CE, Inc., only acquired minimal liability insurance and is under-capitalized considering the potential risk.

C. No, Melba should not be held liable because CE, Inc.'s capital is adequate and there is no indication that Melba was using CE, Inc., as an alter ego.

D. No. Melba cannot be personally liable for any obligation arising from CE, Inc.'s activities.

64. Parent–Subsidiary.

Kenyon owns a warehouse and a manufacturing facility, which he has leased for 20 years to AgriPac, Inc. AgriPac enters bankruptcy. Back East, Inc. (BEI), a billion-dollar company, has an interest in expanding to Kenyon's area. It forms a subsidiary corporation, AgriEast, Inc., to acquire the assets and assume some of the contracts of AgriPac out of bankruptcy. BEI puts in its own officers as directors and officers of subsidiary AgriEast. Within a year, all of the managers of AgriEast have been dismissed, their functions assumed by BEI under a "services agreement" under which AgriEast pays its parent corporation $1 million plus 40 percent of earnings before taxes, interest, depreciation, and amortization. Soon AgriEast's top customers are being billed by BEI. Correspondence with AgriEast's top customers and bankers often is on BEI stationery, and signed by BEI managers. After two years, BEI fires everyone at AgriEast and closes shop. All the top AgriEast customers are now BEI customers. BEI capitalized AgriEast with only $1,000 of its own money, causing AgriEast to borrow $70 million to operate. Kenyon now has an empty warehouse and manufacturing facility, with 15 years left on the lease. He has been unable to rent the facility. He calculates that he is losing over $1.5 million per year. Kenyon has filed a complaint alleging breach of contract against insolvent AgriEast.

Kenyon should amend his complaint to

A. allege personal liability of BEI's officers and directors.

B. pierce the corporate veil to reach the assets of BEI.

C. add allegations of a conspiracy to defraud, naming BEI's officers, BEI, and AgriEast as co-conspirators.

D. seek the intervention of the state attorney general because BEI abused the corporate form when it formed AgriEast as a corporation and capitalized it for only $1,000.

65. Enterprise Liability.

BigGasCo operates a fleet of oil tankers. Captain of one of the supertankers became intoxicated while on duty and left First Mate in charge of the ship while in shallow water. First Mate, who had less training than Captain, drove the giant ship aground, ripping open its hull and spilling millions of gallons of crude oil. The damages to the environment and to the local fishing community totaled $15–20 billion. Evidence at trial established that Captain and First Mate were both negligent and that BigGasCo was aware of Captain's propensity to "drink and boat" and to leave the untrained First Mate in charge. Discovery reveals, though, that this supertanker, and every other tanker in the BigGasCo fleet, is owned and staffed by an individual corporation, and this supertanker was owned by Transportation Co. Transportation Co. also hired and supervised Captain and First Mate. BigGasCo, however, owns each of the brother-sister (sibling) corporations, including Transportation Co.

What is the best argument for holding BigGasCo liable for the damage?

A. BigGasCo should be liable because it commissioned the shipment.

B. Even though BigGasCo and Transportation Co. are technically separate entities, they operate as one single enterprise.

C. Transportation Co. is an agent of BigGasCo, and therefore Transportation Co.'s negligence should be attributed to BigGasCo.

D. BigGasCo should be liable because a third party would be unaware that the supertanker was owned by Transportation Co.

66. Piercing the LLC Veil.

Although a doctrine in corporate law, piercing the corporate veil can also be applied to limited liability companies. How would a court's analysis differ in considering whether to pierce the liability shield of an LLC as opposed to the liability shield of a corporation?

Answer:

Corporate Finance

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

67. Racing Capitalization.

Beau, Luke, and Jesse are starting a stock car racing company. They formed a corporation named Duke Racing, Inc., and now have to set up its capital structure. Beau and Luke are each going to put in $15,000. Jesse will contribute the racecar and the lowboy trailer they use to haul around the car. The parties are not exactly sure how much the racecar and trailer are worth. All three parties want to share profits equally, and they each want an equal say regarding who should be director of the corporation.

What is the best capital structure for Duke Racing, Inc.?

A. Common stock for Beau and Luke and preferred stock for Jesse

B. Common stock for Beau and Luke and a loan by Jesse

C. All common stock

D. All preferred stock

68. Racing Reissuance.

The articles of incorporation of Duke Racing, Inc., authorize issuance of up to 400 shares. At the corporation's organizational meeting, 300 shares are issued to its three founders: 100 to Beau, 100 to Luke, and 100 to Jesse. The shareholders elect Luke to serve as the sole director of the corporation. Two years later, Jesse retires, and the corporation buys back Jesse's 100 shares. Beau and Luke then decide to sell some shares of stock to raise some cash.

How many shares can Duke Racing, Inc., sell without amending its articles of incorporation?

A. 400

B. 200

C. 100

D. 0

69. Racing Distribution.

Beau, Luke, and Jesse have formed Duke Racing, Inc., and had some racing success. In the last year, they have garnered $200,000 in prizes against $30,000 in expenses. They have put much of their winnings into spare parts (extra engines, tires, etc.), a backup racecar, and a used Winnebago motor home. They also wish to each cash out $10,000 from the corporation to spend on a vacation.

Can the shareholders take cash out of Duke Racing, Inc? If so, explain how and how much.

Answer:

70. Xtra Capitalization.

Vin, Michelle, and Paul decide to form a racing team that will compete in the stock car division. They incorporate as Xtra, Inc. Paul is contributing a 2002 Mitsubishi LS sedan that is worth no more than $2,200, and a VR6 engine, two turbochargers, and an exhaust kit he claims are worth at least $10,000. Michelle is contributing $30,000 cash, and she wants to be paid back on schedule. Vin, a mechanic with his own shop, will install all the parts and serve as mechanic and driver in return for his stock. Paul will handle promoting and marketing the team. Vin and Paul plan to split profits equally once they pay back Michelle.

What is the best capital structure for Xtra, Inc.?

A. Common stock for Vin and Paul and preferred stock for Michelle

B. Common stock for Vin and Paul and a loan by Michelle

C. All common stock

D. All preferred stock

71. Soccer Capitalization.

Uma, Vicky, and Wanda were on their college soccer team together. Now Uma is a professional soccer player, Vicky is an attorney who manages her wealthy family's small fortune, and Wanda is completing her MBA. The three entrepreneurs are going to form a company named UVW Sports, Inc., that makes a new sports drink. Uma will contribute $5,000 to pay for startup legal fees and promote the company's products in return for a "fair share" of profits from the company. Vicky will invest $2 million and expects to have the right to invest more as the company scales. Wanda will work full time as the company's CEO in exchange for "sweat equity" plus a small salary.

What is the best capital structure for UVW Sports Inc.?

A. Common stock for Wanda and Uma, and preferred stock for Vicky

B. A loan by Vicky and common stock for Wanda and Uma

C. Common stock for Uma and Vicky. Wanda is an employee with stock options.

D. All common stock

72. DataMine Capitalization.

You represent venture capital investment firms. One of your clients, Accel Ventures, meets with you about an investment they want to make into a company named DataMine, Inc., that produces database software. The company has previously received funding from its founders and their friends and family, and now it seeks $10 million in venture funds. Accel will invest $8 million as the "lead investor," and a consortium of smaller investors known as "follow-on investors" will contribute the rest.

What is the best capital structure for DataMine, Inc.?

A. Common stock for the lead investor and preferred stock for the follow-on investors

B. Preferred stock for the lead investor and common stock for the follow-on investors

C. All common stock

D. All preferred stock

73. BBB Repurchase.

Bill, Bob, & Bart Broadcasting, Inc. (BBB) has radio stations in three mid-sized markets and has been quite successful. The founding shareholder, Bill, owns 40 percent of the company. Bill's son, Bobby, and his college roommate, Bart, own 30 percent each. Bill decided to retire and wants to cash out his shares. Bobby and Bart are willing to cause the corporation to repurchase Bill's shares for a price of $4.5 million, to be paid over 15 years, with 8 percent interest per annum.

Are there any corporate law issues that must be resolved before BBB can repurchase Bill's shares?

A. No. A long-term repurchase of shares is an unregulated transaction in which the parties are free to engage.

B. No. But BBB must require Bill to return his share certificate before paying him the first installment payment.

C. Yes. The repurchase of shares at such a high price is bound to be a violation of the fiduciary duties Bobby and Bart owe to the corporation.

D. Yes. The transaction is a distribution and therefore must be tested for legality using the statutory tests for distributions.

74. Accounting for Distributions.

A profitable corporation has three shareholders. They decide to issue a $1 million dividend to each of the three shareholders and ask you, the lawyer, to handle the paperwork. During your diligence, you review the corporation's current balance sheet. When you subtract the total liabilities from the total assets, the balance sheet reveals that the corporation's net worth is only $1 million.

Is this distribution statutorily permissible?

Answer:

Closely-Held Corporations

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

75. An Easier Way.

The seven shareholders of the Winchester Co., a closely-held corporation, are scattered widely around the world. The bylaws provide that the annual meeting of the shareholders is to be held at the corporation's office on the first Monday in September; however, only two shareholders live near the headquarters, and it would impose tremendous cost on the other shareholders to travel to the annual meeting. Fortunately, the shareholders get along well and are in agreement that the two local shareholders should be elected as the corporation's two directors. The chair of the board has inquired of the corporation's attorney whether there is an easier way to conduct the business that would not require the shareholders to travel or involve the complications of appointing proxies to vote, particularly considering that all the shareholders are in agreement.

If you were the attorney, how would you advise the chair of the board of directors?

A. Although action by written consent in lieu of a meeting is permitted in emergency situations, costs alone do not justify foregoing a meeting.

B. Action by written consent is permitted in lieu of a meeting if the shareholders' consents are unanimous.

C. Action by written consent is permitted in lieu of a meeting only for special meetings.

D. The corporation is required to hold an annual meeting as proscribed by the bylaws, and the shares have to be voted at the meeting, whether by the shareholders in person or through proxy.

76. A Tight Deadline.

On January 30, Arctic Travel, Inc. (AT), a corporation owned by 20 equal shareholders, received a merger proposal from Happy Holidays, Inc. (HH), through which HH would acquire AT. The proposal, which the board has determined to be in AT's best interest and

properly voted to adopt, stated that the offer would expire if not accepted by 5:00 p.m. on February 28. Under AT's bylaws, the corporation's annual meeting of shareholders is to be held on the first Monday of March each year. The chair of AT's board has attempted to negotiate a deadline extension with HH, but HH has insisted on the February 28 deadline.

What, if anything, may the board do to arrange for a shareholder vote on the merger proposal?

A. Call a special meeting of the shareholders for mid-February to take action on the merger proposal.

B. Wait until the annual meeting in March to vote on the merger proposal.

C. Agree to the merger proposal without first taking a shareholder vote.

D. Pass on the merger proposal because it is impossible to schedule a shareholder vote.

77. Missing the Meeting.

Shareholder of Pride, Inc., a closely-held corporation, is planning a big trip to the Scottish highlands; however, the travel itinerary will require them to miss the corporation's annual meeting of the shareholders. Pride, Inc.'s shares are held by a small number of people, and if Shareholder cannot participate in the meeting, there will not be a quorum.

May Shareholder still participate in the meeting even though they cannot attend in-person?

A. No. In-person attendance and participation at the meeting is required. If Shareholder can't attend, they can't vote their shares.

B. Yes. Shareholder has the right to appoint a proxy to vote at the meeting on their behalf at the meeting.

C. Yes. Shareholder may cast an absentee ballot to be counted at the meeting.

D. Yes. Shareholder must create a voting trust with another shareholder to allow a trustee to vote their shares at the meeting.

78. Preserving the Power.

The Whaler Corporation, a closely-held corporation, has proposed acquiring the Jonah Corporation, another closely-held corporation, in a friendly merger. The Jonah Corporation shareholders are hesitating, however, because after the merger, they will own only 25 percent of the stock of the new corporation. They fear that they will be "swallowed up" in the merger. To address — and hopefully resolve — these concerns, the Whaler shareholders have agreed to a bylaw "supermajority" provision that the new corporation will have an 80 percent quorum and voting requirement for shareholders' meetings (to wit, no director can be elected or matter can be approved by the shareholders unless it receives an 80 percent vote in favor of it).

Does the Whaler shareholders' offer address and resolve the Jonah shareholders' concerns about being "swallowed up"?

A. No. The default statutory rule is that "majority wins," and any agreement to the contrary is void and unenforceable.

B. No. Supermajority requirements must be established in the articles of incorporation, not in the bylaws.

C. Yes. The Whaler shareholders' offer will provide the Jonah shareholders with "negative control" by establishing higher quorum and voting requirements for shareholders' meetings.

D. Yes, but the Jonah shareholders should also insist on a bylaw provision requiring that any vote to repeal supermajority requirements be approved by a supermajority vote. Otherwise, the default rule is that supermajority requirements may be repealed by the vote of a simple majority.

79. Counting to Quorum.

The board of directors of Delano Corp., a closely-held corporation, has noticed a special meeting of the shareholders to be held to vote on a board-approved plan of merger. Dentist, who holds 30 percent of the outstanding shares, has considered the plan of merger and has decided to vote against it. While en route to the special meeting, Dentist receives a text message that only about 20 percent of the shareholders (not counting Dentist) will be present in-person or by proxy. As a result, it is unlikely that a quorum would be present to vote on the plan of merger.

Should Dentist attend the special meeting?

A. No. Dentist should not attend the meeting so that their shares will not be counted toward establishing a quorum.

B. Yes. As a shareholder, Dentist has a fiduciary duty to attend the meeting, either in-person or by proxy.

C. Yes. But if a quorum is present and it seems that a vote in favor of the plan of merger is likely, Dentist should leave before voting commences.

D. Yes, but only to make a "special appearance" to protest the lack of a quorum.

80. Late to the Party.

Baker is a shareholder of Figaro, Inc., a closely-held corporation. As part of their retirement planning, Baker has agreed to sell their shares in Figaro to Nurse. Unbeknownst to Baker and Nurse, on January 30, the Figaro board had discussed calling a special meeting of the shareholders to discuss a merger proposal. On February 1, the board of directors called a special meeting to be held February 28 and sent notice to all shareholders of record as of the

close of business on January 31. The notice did not specify any "record date" for determination of eligibility to vote, and the bylaws do not specify any such record date. On February 20, Baker and Nurse closed on their deal and Baker transferred their shares to Nurse. The same day, Baker notified the secretary of the corporation of their transfer of shares to Nurse, and the secretary of the corporation updated the record of shareholders accordingly. As a new shareholder, Nurse is opposed to the merger and desires to vote against it. Assume that there are no transfer restrictions that would prevent this transfer and that Baker has complied with the procedure set forth in the bylaws for transfer of shares.

Is Nurse entitled, in their capacity as a shareholder as of February 20, to vote at the February 28 special meeting?

A. Nurse is not entitled to vote as a shareholder at the meeting because they acquired their shares after the close of business on the day before the date on which the board of directors gave notice of the special meeting.

B. Nurse is not entitled to vote as a shareholder because they acquired the shares after the board of directors gave notice of the special meeting.

C. Nurse is entitled to vote as a shareholder because Baker has transferred their shares to Nurse and has complied with the corporation's procedures for transfer of shares.

D. Nurse is entitled to vote as a shareholder because Baker has transferred their shares to Nurse before the special meeting was called to order.

81. Let's Vote Together.

Phoenix, Inc., is a closely-held corporation with a three-member board of directors, elected annually. The corporation is privately held by two shareholder groups subject to shareholder agreements requiring them to vote their shares together as a block: the Mirage shareholders, who own 600 of collectively own 1,000 shares, and the Veridian shareholders, who collectively own the other 400 shares. Phoenix, Inc., has included a provision in its articles of incorporation permitting cumulative voting for the election of directors. Four candidates are being considered for the board, three of whom are preferred by the Mirage shareholders and one of whom is preferred by the Veridian shareholders. The annual meeting is quickly approaching, and the notice of meeting stated that cumulative voting will be authorized for the election of the directors.

Assuming they vote as a block as required by their shareholder agreement, do the Veridian shareholders mathematically have the votes to elect their preferred candidate to one of the seats on the board of directors?

A. No. The Veridian shareholders are the minority shareholder group, and the Mirage shareholders will be able to elect all three of their preferred candidates to fill the board of directors to the exclusion of the Veridian-preferred candidate.

B. No. The Veridian shareholders will only be able to cast 400 votes for their preferred candidate, which can be defeated by the Mirage shareholder's 800 votes for the position.

C. Yes. The Veridian shareholders have the cumulative votes to elect their preferred candidate to one of the positions on the board, but they do not have the votes to prevent Mirage-preferred candidates from being elected to the other two positions.

D. Yes, under a cumulative voting scheme, the Veridian shareholders both have the mathematical ability to elect their preferred candidate and to block the Mirage-preferred candidates.

82. Staggered Boards.

The articles of incorporation for Farmart, Inc., a closely-held corporation, provide for a "staggered" board of six directors. The board is divided into three classes of two directors each, each class to be elected for three-year terms. The annual meeting of the shareholders is coming up next month.

How many directors will be up for election at the annual meeting of the shareholders?

A. All six. Once elected, a director serves for a term of one-year and their term automatically expires at the next annual meeting. Directors may be reelected by the shareholders.

B. Two. Only one class of two directors will be up for election at the meeting, but the other four directors will continue serving.

C. Three. One director from each of the three classes must be elected by the shareholders at the meeting.

D. None. When a board is "staggered," the directors are not elected by the shareholders.

83. We're Going to Meet, One Way or the Other.

Wheelhouse, Inc., is a closely-held corporation. Although Uncle founded the company and was, at one point, the only shareholder, he has since given away much of the stock to the second and third generations of the family. Uncle now owns only 40 percent of the outstanding shares of stock. Nevertheless, he continues to rule with an iron fist. Uncle signs everything on behalf of the company without consulting any other shareholder, and he has not accepted advice or held a meeting in ten years. Nobody other than the board of directors is authorized by the articles of incorporation or bylaws to call a special meeting. Niece, who now owns five percent of the outstanding shares of stock, desires a forum in which she and the other shareholders may confront Uncle and discuss the status of the corporate affairs. Both she and other members of the family have attempted many times over the past several years to talk to Uncle about the state of the corporation, but Uncle has consistently refused to engage in any discussion, take any phone calls, or respond to any written communications. As of right now, no shareholder other than Niece is willing to engage in confrontation with Uncle.

What option would best accomplish Niece's desire to establish a forum for discussion?

A. Niece, as a shareholder who owns five percent of the outstanding shares of stock, may herself call a special meeting of the shareholders for the purpose of removing Uncle as a director.

B. Niece may demand that Uncle call a special meeting of the shareholders.

C. Niece may seek a court order compelling the corporation to hold a meeting of the shareholders.

D. Niece has no recourse here other than to sell her stock.

84. Keeping It in the Family.

Siblings Indiana and Carolina have each acquired a 30 percent interest in Family, Inc., a closely-held corporation. Through their combined ownership, they control the board of directors. Indiana has recently been presented with an opportunity to go on a three-year archaeological dig in a remote area where it will be virtually impossible to communicate with him. This presents a problem for the siblings because, without Indiana's votes, the other shareholders have the votes to control outcomes. Indiana is happy to let Carolina handle everything at least for the next three years without further input from him, and Carolina is quite willing to vote Indiana's shares for him so as to retain the majority vote; however, she wants the ability to make all decisions without the need to consult with Indiana on each vote, and she wants to prevent Indiana from showing up unexpectedly during the next three years and undermining her decisions. At the same time, Indiana wishes to retain all financial rights and does not desire to transfer ownership of the shares to Carolina.

What voting device is best suited to simultaneously accomplish both siblings' goals?

A. A proxy, with Indiana as the proxy giver and Carolina as the proxy holder

B. A proxy styled as "irrevocable"

C. A shareholder's voting agreement (a.k.a. a "pooling agreement")

D. A voting trust with the trusted family lawyer as the trustee

Corporate Governance

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

85. Ambush by Quorum.

Two of the directors of Bank, Inc., Donnell and Barnham, are unhappy with the performance of the CEO, Nelson, who is also a director. There are five directors in total, but the two other directors are elderly and, by and large, inactive. Because of their absence, the other directors have signed a valid waiver of notice for special meetings. Donnell and Barnham have decided that they want to remove Nelson from the position of CEO. One day, when Nelson is in the office, Donnell and Barnham arrive with the hope of confronting Nelson. Nelson, seeing out his office window that Donnell and Barnham are entering the building, slips out the back door. The next day, Donnell and Barnham approach Nelson when he is in line at a coffee shop. Donnell says: "Three directors are a quorum. I vote to remove you as CEO." Nelson responds: "This is ridiculous. You don't have any grounds to remove me. I vote no!" But then Barnham quickly adds: "I concur. You're out." Bank, Inc.'s bylaws do not vary any relevant default rule.

Has Nelson been removed as CEO of Bank, Inc.?

A. Yes. There was a quorum at a special meeting of the board of directors.

B. No, because the special meeting was not properly noticed.

C. Yes, but he was actually removed when Donnell and Barnham agreed that he should be removed.

D. No, because there was no notice to the other two directors.

86. Flooding and Director Negligence.

Dorren, Thompson, and Grumberg are the three directors of Small, Inc. The board has recently acquired a parcel of real estate that it plans to develop into a commercial space. The development will require a significant amount of grading to flatten it to a point where it will be safe to build upon. Dorren, acting on her behalf and without giving notice to the other directors, decided that she would rent a skid steer for a day and that she would go out and get

a head start on the grading work. She hoped that this would save the corporation money. On the rental agreement, she signed, "Dorren, director of Small, Inc." After spending a solid ten hours at the job site, Dorren called it a day. Unfortunately, that night there was a heavy rainstorm. As a result of Dorren's grading, the waterflow path was changed, causing substantial damage to a neighborhood downhill from the development. The neighbors consulted with an expert who concluded that the flooding was a direct result of Dorren's grading work.

Is the corporation vicariously liable for Dorren's negligent conduct?

A. Yes. Dorren is a director of Small, Inc., and so Small, Inc., is vicariously liable for her conduct.

B. Yes, because the board had approved the grading project and so ratified the conduct that caused the flooding.

C. No, because Dorren acted in her own capacity and was not an agent of Small, Inc.

D. No, because the board of directors had no notice that Dorren was going to do grading work.

87. An Imminent Proposal.

Stewart is one of seven directors of a large corporation that owns a string of car dealerships. Stewart is part of a contingent of three directors on the board who are against expansion, especially into lower priced new automobiles. This contingent believes it best to stick to top-of-the-line dealerships. Fred's two allies in this regard are absent from the March regular meeting of the board, which is held at the time and place specified in the bylaws. Four directors attend. As the meeting continues, it appears to Stewart that a vote on expansion is imminent and that the other three directors present are likely to vote in favor of an expansion proposal. Stewart did not anticipate that this issue would be addressed at this meeting. The corporation's bylaws do not vary the default rules for voting and quorum at board meetings.

What can Stewart do, if anything, to stop the measure from passing and becoming an action of the board?

A. Nothing. The meeting is underway, and a quorum has already been established.

B. Stewart should immediately leave the meeting and deprive the board of a quorum for voting on any additional matters.

C. Stewart doesn't need to do anything because only three directors (less than a majority of all the directors) will vote in favor of the measure, and so it will fail for lack of majority.

D. Stewart should object that there was no notice that the board would be voting on an expansion proposal and insist that the matter be tabled until a future board meeting when the other two members of the anti-expansion contingent can be present.

88. How Big a Board?

Running Co., which started as a family business but has decided to go public after its great success, is in the process of preparing for its Initial Public Offering. Prolong, one of the directors of Running Co. as well as its CEO, has inquired of the corporation's attorney as to how many directors should be included on the board of the public corporation and whether the current directors should continue to serve. Currently, the board has four directors, including Prolong's brother and two "independent" directors, a local track coach and a lawyer. Prolong and his brother also serve as the corporation's CEO and CFO, respectively, hold a significant block of shares in the corporation, and receive a salary from the corporation for their services.

What advice should the lawyer give Prolong about the size of the board?

A. The current slate of four directors is sufficient, both logistically and legally.

B. Public corporations must have at least seven directors, three of whom must be "independent."

C. Typically, public corporations have 8 to 12 directors, but whatever the number, the board of a public corporation must include a majority of "independent" directors.

D. Public corporations should have 24 directors but run most things through an executive committee of 3 members.

89. Governance by Committee.

Linkus, Inc., a closely-held corporation that will soon become a publicly-traded corporation, has 13 directors serving on the board. As they were preparing for the initial public offering, the directors were discussing the amount of work for which the board was responsible. One director mentioned that "it would certainly be easier and more efficient if we could break up into smaller groups — maybe include some people with subject matter expertise — and break this work up into smaller pieces."

Is the director's suggestion valid?

A. No. The board of directors is solely responsible to manage and oversee the business and affairs of the corporation, and they may not divide or delegate that responsibility.

B. Yes. Public corporations may, but are not required to, have committees handle all or part of overseeing the corporation's business and affairs.

C. Yes. Public corporations are required to have certain committees and may appoint additional committees for most, but not all, responsibilities.

D. Yes. Public corporations may appoint advisory committees, but they may not delegate decision-making authority to the committees.

90. Removal as Retaliation.

Stoneham owns a plurality (35 percent) of the outstanding shares of a minor league baseball team, the Reading Retrievers. The field manager, McGraw, owns eight percent. A local judge, Wettick, has recently purchased another 8 percent. The three of them, representing 51 percent, sign a contract providing that each will use their best efforts to keep the others in office as a director of the corporation, which has a five-person board. The contract provides further that, as directors, the signatories will use their efforts to keep Stoneham in as president, McGraw as vice-president, and Wettick as secretary-treasurer. Wettick repeatedly catches Stoneham wrongfully accessing corporate funds. He instructs employees that, under no circumstances, are they to permit Stoneham access to any cash. In retaliation, Stoneham rallies McGraw and one other director. The three directors vote to fire Wettick and remove him as a director. Wettick, who wants to be restored to the board of directors and reappointed as an officer, has consulted with you about options.

What recourse is available to Wettick under these circumstances?

A. Wettick retains the seat on the board but does not have a right to be reappointed as an officer.

B. Wettick has a right to seek a court order enjoining their removal as a director and an officer.

C. Nothing. Wettick is out of both positions.

D. Wettick has a right to remain an officer, but not to remain on the board.

91. Firing an Officer.

The board of Farfalle, Inc., a publicly-held corporation, desired to expand its operations into a new geographic area. Accordingly, the board appointed Telfine as "Feasibility Officer" to undertake a feasibility study. The board approved an employment agreement in which Telfine would serve in the position for eight months, and the position would terminate at the next annual meeting of the shareholders. Telfine accepted the appointment and hired a consulting firm to begin conducting market research. Two months into the process, after incurring some unexpected expenses, the board decided that it no longer had the capacity to expand and that the investigation should be abandoned. The chair of the board informed both Telfine and the consulting firm that the project was canceled and that their services would no longer be needed. Telfine protested that, as an officer of the corporation, they could only be removed by a shareholder vote or at the next annual meeting of the shareholders as provided in the employment agreement.

Is Telfine correct that they can only be removed by a shareholder vote or consistent with the terms of the employment agreement?

A. No. The board appointed Telfine as an officer and can remove Telfine as an officer at any time for any reason not otherwise prohibited by law.

B. No, but only because the position of "Feasibility Officer" was established by the board and not the bylaws.

C. No. Because of the employment agreement, Telfine is guaranteed to serve as an officer until the shareholders' meeting.

D. Yes, because an officer can only be removed from their position by a shareholder vote.

92. Personal Backlash.

Rob, Bill, and Sally form Tree Top, Inc., a closely-held corporation that sells and services various manufacturers' products in the Pacific Northwest, and they are the only three shareholders. They "rep" products used in the orchard industry. They sign a contract providing that Rob will devote half of his time as CEO and interface with the various manufacturers; Bill will work half time as Vice President of Administration and Secretary Treasurer; and Sally will work full time as Vice President of Sales, traveling 30–35 weeks per year and selling equipment to orchardists throughout the Northwest. Rob and Bill are each to receive $50,000 in annual compensation plus 2 percent of sales. Sally is to receive $70,000 plus 4 percent of sales. The company succeeds, mostly because Sally excels at her job, but Bill has a falling out with Sally. At a board meeting, Rob and Bill vote to dismiss her as VP Sales. Sally is in a panic. As with many small companies, her primary livelihood will come not from her investment as a shareholder but from her employment as a corporate officer/employee.

Does Sally have any hope of getting her job back?

A. No, because the directors may remove an officer at any time, for any reason.

B. No, but Sally may have a claim against the corporation for breach of employment contract.

C. Yes, because the directors breached their fiduciary duty in terminating her.

D. Yes, because all the shareholders are parties to the contract requiring that each of the shareholders be appointed as an officer.

93. A Lifelong Contract.

Vice President of Sales of Harbor, Inc., has just delivered one of the most profitable quarters in the corporation's history. Impressed with Vice President's performance, the board of directors desires to reward Vice President with a lifetime, irrevocable appointment to her officer position. The chair of the board of directors has contacted your law firm to confirm the legality of the arrangement and draw up the necessary paperwork.

What advice do you give the chair?

A. Lifetime contracts for anything are never valid.

B. This may be an impermissible abdication by the board of its power and future boards' power.

C. Rather than a lifetime appointment, the board may execute a long-term contract with Vice President, but this will not prevent a future board from removing Vice President as an officer at any time.

D. The proposed course of action is entirely in line with the board's authority.

94. Consulting Services.

Shoehorn, Inc., a publicly-held corporation with 570 shareholders, has become enormously successful. Although started by three friends, who all serve as the only three directors on the board and occupy the top three officers' positions, Shoehorn has a presence throughout the world. To comply with federal law, Shoehorn has engaged Big Accounting Firm (BAF) to audit the corporation's annual financial statements. Now, two of the three friends/officers have decided that they've done enough and are ready to retire. BAF offers to fill the gap in the services they have been providing by covering human resources, bookkeeping, accounting, information systems, legal, marketing, employee benefits, actuarial, valuation, and general management services to the corporation under a 10-year contract, with renewals by mutual agreement for five-year terms thereafter.

Is BAF's proposal acceptable?

A. Yes, this sounds like an efficient use of resources.

B. No, BAF does not have the expertise to do this.

C. No, this is too broad of a delegation to an unelected organization.

D. No, this is too broad of a delegation to an unelected organization and a violation of federal law.

95. Executive Committees.

A large, publicly-held movie production company, Serve US, Inc., has three directors (Wayne, Martin, and Lamour) who dominate its seven-member board. These three directors convince the rest of the board to create an executive committee, appoint them as the three members of the committee, and delegate to it all powers of the full board of directors, except declaring dividends and recommending mergers to shareholders. A dissident director, Knott, consults you about challenging this arrangement.

What advice do you give?

A. Any challenge would fail because the decision to delegate is protected by the business judgment rule.

B. A court would likely uphold the delegation to the committee as an efficient process for managing the corporation.

C. Any delegation of authority to a committee violates the rule that the business and affairs of the corporation shall be managed by the board of directors.

D. This particular delegation is too broad and exceeds the scope of what is statutorily permitted.

96. Shareholder Proposals, Part I.

LandCrest, Inc., is a publicly-held garden-implement manufacturer with approximately 400 shareholders, many of whom live in the community in which LandCrest is located. The corporation has done well, but the last several quarters failed to meet analysts' projections by a few pennies per share. The board of directors therefore fired the CEO, Stewart. Stewart has been extremely popular, both at LandCrest and in the community. He has served as a youth coach, as a scout leader, and on the boards of several community organizations. He personally knows and is friends with a number of the corporation's rank-and-file shareholders. At the annual shareholders' meeting, a shareholder steps to the microphone, propounding two resolutions:

1. That by resolution the shareholders hereby resoundingly voice their praise and affection for CEO Stewart for all the great work he has done at LandCrest and in the community.

2. The shareholders move that Stewart be re-hired as the CEO of LandCrest, Inc.

You are corporate counsel, seated on the dais next to the board chair, who is presiding over the meeting. The chair leans over and whispers to you, "What should I do?"

A. These are not appropriate matters for shareholder proposals. Personnel matters and appointment of corporate officers are part of the corporation's business and affairs and are, thus, matters to be decided by the board of directors.

B. Allow discussion of both resolutions, but allow a vote only on resolution 1, which is purely advisory, and rule resolution 2 "out of order" because it is a business decision.

C. Allow discussion of and voting on both resolutions which, even if passed, are purely advisory and not "out of order."

D. Same as Answer (C), but only if resolution 2 is rephrased in advisory or precatory language (i.e., "The shareholders recommend that the board of directors rehire Stewart as the CEO").

97. Shareholder Proposals, Part II.

Suppose that rather than presenting the proposals at the shareholders' meeting, the shareholder timely submitted the proposals, in the proper form, to the board of directors to be included on the proxy solicitation.

Must the board of directors include the shareholder proposals on the proxy solicitation?

A. Yes, the board must include all timely and properly submitted shareholder proposals in the proxy solicitation.

B. Yes, the board must include any proposal desired to be included by the shareholder in the proxy solicitation.

C. No, the board does not have to include a proposal that relates to personal claim or grievance or ordinary business matters.

D. No, the board does not have to include a proposal that it does not support.

98. Clowning Around.

Clowns, Inc., is a closely-held corporation of fun-loving shareholders, directors, and employees. They wish to have the following (and only the following) officer positions: "Joker in Chief," "Sidekick," "Collector," and "Bookworm." Their bylaws will describe the respective responsibilities of each.

Is Clowns, Inc.'s list of officers and titles permissible?

A. No. Clowns, Inc., may have the officers as desired, but it must also have officers specifically identified as "president" and "secretary."

B. No. Corporations are only permitted to have officers designated as "president," "vice president," "secretary," and "treasurer."

C. Yes. Corporations must have at least two officers, but they may designate officers by whatever title they desire.

D. Yes. Corporations may have as many officers as they desire with whatever titles they wish, so long as the board designates at least one officer to prepare minutes of directors' and shareholders' meetings and to maintain and authenticate records of the corporation.

99. Removal of a Director.

Lake, Moon, and River occupy the three seats on the board of directors of Grover, Inc., a closely-held corporation with 15 shareholders. Lake and Moon are angry with director River and wish to remove him from the Grover board. The difficulty is that River is "squeaky clean," and Lake and Moon have no cause to remove him. He attends every board meeting, contributes to the board's functioning, and has long and well chaired the corporation's audit committee.

What can Lake and Moon do to remove River as a director?

A. Nothing. Directors may only be removed for cause.

B. Removal is by a plurality of a shareholder vote "with or without cause." Lake and Moon can have River removed if they can get the votes.

C. Lake and Moon may call a special meeting of the shareholders and give notice that the purpose of the meeting is to consider removal of River as a director, and River can be removed by a plurality of a shareholder vote "with or without cause."

D. Because they constitute a majority of the board, they can vote to remove River at the next board meeting.

100. Stuck with a Director.

Lake, Moon, and River occupy the three seats on the board of directors of Grover, Inc., a closely-held corporation with 15 shareholders. Lake and Moon have become aware of troubling behavior by River. River has been missing board meetings, harassing employees, misappropriating funds, and frequently comes to the office inebriated. Lake and Moon have had enough and wish to remove River from the Grover board. The difficulty is that River holds 15 percent of the outstanding stock and his close friends collectively hold 45 percent of the stock. Lake and Moon believe that River and his friends will vote against River's removal and will again elect him at the next annual meeting.

What options, if any, do Lake and Moon have?

A. They may go to state court and seek his removal on grounds that "the director engaged in fraudulent conduct with respect to the corporation or its shareholders, grossly abused the position of director, or intentionally inflicted harm on the corporation."

B. Under the Sarbanes-Oxley Act, Lake and River may obtain a "lifetime ban" forbidding his service as a director or officer.

C. They are stuck with River, but perhaps they can get an injunction limiting the harm that he can do.

D. They should cause the corporation to sue River for breach of fiduciary duty.

101. Proof of Officer Authority.

Malloy is a contractor who has just signed a contract with a major Fortune 1000 company to build a new 700,000-square-foot manufacturing facility. It is a fixed-price $19.4 million contract. Malloy's attorney asked her what kind of documentation she got from the corporation. Malloy replied, "The chief executive officer (CEO) signed the contract."

What additional information or document does Malloy's attorney need to ensure that Malloy's contract will be binding on the corporation?

A. None. The contract is signed by the CEO, who is authorized through their appointment as CEO as an agent to bind the corporation in contract.

B. The articles of incorporation. The articles of incorporation must identify the corporate officers and describe their authority.

C. The bylaws. The bylaws must identify the corporate officers and describe their authority.

D. A board resolution appointing the CEO and confirming the CEO's authority to bind the corporation in contract.

102. Cheers Indemnification.

Sam Malone is a director of Cheers, Ltd., a pub chain. A customer slipped and fell on wet tiles in the bathroom in one of the Cheers pubs. Sam was in that pub when the customer fell. The customer sued Sam personally for negligence, and Sam settled. Sam asks Cheers to pay his $100,000 legal bill.

What is Sam's best argument for why Cheers should indemnify his legal expenses?

A. Sam is entitled to mandatory indemnification if he has been "wholly successful on the merits."

B. Directors are agents of the corporation, and Sam acted within his scope of agency.

C. The corporation's directors' and officers' insurance policy has a low deductible.

D. The corporation's articles permit insurance for directors acting "in good faith."

103. Guarding Against Takeovers.

Concerned about a recent trend of hostile takeovers in the industry, the board of Lockdown, Inc., a publicly-held corporation, has been examining its vulnerability to such takeover attempts. The board is concerned that if one activist shareholder acquires enough shares in the corporation, they may be able to exert disproportional control over the corporation without paying a respective premium for that control. One director has recommended the adoption of a "shareholder rights plan," which would cause the issuance of additional securities and then allow existing shareholders to purchase those additional securities on favorable terms, if any one shareholder acquires more than 10 percent of the outstanding shares of stock.

Which of the following strategies would ensure that the "shareholder rights plan" functions effectively to prevent a hostile takeover?

A. Make the plan a "dead hand" plan which may only be deactivated by directors who were in office at the time the plan was adopted.

B. Make it a "no hand" plan which simply cannot be deactivated by anyone (old or new directors) until six months have passed from the plan's being triggered.

C. Combine the plan with a staggered board and a removal-for-cause requirement.

D. The mere existence of the plan is as good a defense as the board can accomplish.

104. A Selfish Board.

The bylaws of Boatworth, Inc., a publicly-held corporation, provide that the annual shareholders' meeting will be held on the first Monday in March, unless the board of directors otherwise decides. Likewise, the bylaws provide that shareholders' meetings are to be held at its West Coast headquarters, but another provision gives the board the right to designate the place of the annual meeting as anywhere in the world. Boatworth learns in July that Suretrust, an investment firm renowned for combative posturing and waging proxy contests, has acquired a large block of Boatworth stock and is in the process of negotiating two more "block" purchases. If these transactions were to be completed, Suretrust would become Boatworth's majority shareholder. Motivated by concerns that Suretrust would attempt to wage a combative and costly proxy contest if it were able to acquire additional shares of stock before the annual meeting in March, the directors take two steps: first, they advance the annual meeting date to the last week of December, and second, they designate the place of the meeting to be on a remote island off the coast of Maine that is accessible only by ferry. The board hopes that these moves will prevent Suretrust from organizing a proxy contest before proxy solicitations are sent out and that the remote location will prevent Suretrust from appearing in person at the meeting. Suretrust has filed suit to enjoin the rescheduled shareholders' meeting and to compel Boatworth to hold the meeting at the time and place specified in the bylaws.

How should the court rule?

A. Advancing the meeting date is permissible, but the relocation to a remote island is not. The court should order the meeting to be held at the corporate headquarters as provided by the bylaws.

B. The meeting can stay on the remote island, but the court should order that the annual meeting must be held in March as provided by the bylaws.

C. The court should affirm the board's decision to advance the meeting to December and to hold the meeting on the remote island.

D. Although both actions by the board are technically lawful, the court should enjoin the actions because the Boatworth board acted inequitably for the purpose of preventing Suretrust from waging a proxy contest.

105. Remote Participation.

A prominent shareholder of Veridian Corp., a public corporation, has to be away at his daughter's wedding when the annual meeting of the shareholders is scheduled to occur. Although he cannot attend in person, he still wants to participate in real time.

Is this permissible?

A. No, only in-person attendance is permitted. If the shareholder can't attend, he may vote by proxy.

B. Yes, but only if the board of directors has authorized remote participation for the class of share that the shareholder holds.

C. Yes. The shareholder has an absolute right to participate remotely.

D. Yes, but only if the board grants the shareholder special permission.

Corporate Fiduciary Duty

Assume, unless otherwise noted, that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

106. Introduction to Corporate Fiduciary Duty.

What fiduciary duties do corporate directors owe to the corporation and to the shareholders?

Answer:

107. A Bad New Idea.

The directors of New Idea, Inc., a publicly-held corporation incorporated under Delaware law, have recently been exploring expanding into new lines of business. After conducting standard due diligence, the directors have just approved a contract with a food manufacturer for the exclusive rights to manufacture frozen meat in the mid-Atlantic region of the country. To carry out this endeavor, the directors also approved the acquisition of a distribution center. Unfortunately, six months after approving the contract, public health officials announced that a new disease strain had been discovered in recent weeks in several of the products manufactured by the food manufacturer. As a result, stores in the mid-Atlantic region refused to purchase or sell the food product. New Idea, Inc., was able to resell the distribution center, but at a significantly lower price than for what it was acquired. New Idea, Inc., suffered a $3 million loss as a result of the contract and sale of the distribution center.

Have the directors of New Idea, Inc., breached their duty of care?

A. Yes, because the corporation lost $3 million as a result of the directors' poor decision.

B. Yes, because the directors should never have entered into this contract or acquired the distribution center.

C. No, because the directors made a reasonable business decision based on standard due diligence.

D. No, because directors never owe liability for a business loss.

108. The Business Judgment Rule.

The board of Missed Opportunity, Inc., a public corporation incorporated under Delaware law, had noted that the corporation had on hand excess cash of $500 million. Desiring to lie low for a year, after a quick canvas of the markets, the board directed the CFO to invest the cash in tax-free municipal bonds earning five percent interest. Uncertainty in the markets soon thereafter pushed interest rates to 16 percent in the short-term bond market. With all of that excess cash, Missed Opportunity could have earned considerably more in the high-yield bond market. A shareholder has sued the board, seeking to hold liable its members for the decision they made. The board files a motion for summary judgment. The judge asks you, his law clerk, what decision he should make on the motion and why.

You recommend that the judge should do which of the following?

A. Grant the motion. The law charges boards of directors, not judges, with management of the corporation's business.

B. Grant the motion. Courts will not second guess business decisions made in good faith by duly elected corporate officials.

C. Grant the motion. The board decision is protected by the "business judgment rule."

D. Deny the motion. The board of directors failed to comply with the business judgment rule.

109. Failure to Monitor.

Old Line Insurance Co. ("Old Line") is a public corporation incorporated under Delaware law that operates as a regional medical malpractice insurance carrier. The directors of Old Line never discussed or otherwise inquired into the adequacy of Old Line's cash reserves, nor was there any reporting system in place to draw the board's attention to the cash reserve status. When malpractice claims increased, and the payout per claim also increased, Old Line had insufficient reserves to carry it through the tough times. When Old Line began to fail, the state insurance commissioner put the corporation into receivership. The shareholders lost the entire value of their investment.

Which of the following best describes the board's breach of fiduciary duty?

A. Simple negligence in breach of the duty of care

B. Intentional or knowing violation of law in breach of the duty of care

C. Sustained and systematic failure to exercise oversight in breach of the duty of loyalty

D. A conflict-of-interest transaction in breach of the duty of loyalty

110. Who's to Blame? Part I.

The directors of Old Line include an actuary who practices her profession through her own actuarial firm and a corporate lawyer from a large multi-service metropolitan law firm. The board also includes the son and daughter of the controlling shareholder, who is the CEO. The daughter is a senior in college. The son is a third-year law student. Neither the son nor the daughter attended board or committee meetings regularly, nor did they do anything to familiarize themselves with the insurance industry, with Old Line, or with the current issues it faced.

If you had to assess the prospects of liability for a board decision, which of the following would be your best estimate?

A. The actuary and the attorney may well be liable, but the son and daughter would not.

B. The son and daughter would be liable, but the lawyer and actuary would not.

C. None would face liability.

D. All four would face liability.

111. Who's to Blame? Part II.

Two other Old Line directors defend on other grounds. Tipton was a former CEO of Big Time Insurance. He now lives most of the year at his farmhouse in Vermont. What meetings he participates in, he participates by conference call. In his deposition, he testifies that he allowed his name to be added to the Old Line board to enhance Old Line's prestige. Pont, a retired university administrator and coach in Bloomington, Indiana, attends meetings, but only when they concern the company's business in Indiana. He testifies that he was added to the board to help it drum up and service business in the Hoosier State.

Are these valid defenses?

A. No. Each and every director must bring their abilities to bear on the full range of issues the board confronts or should confront.

B. Yes. In its judgment the board may add members to the board of directors based upon their prestige value.

C. Yes. Companies that do business over a broad geographical area need to allocate directors' seats geographically.

D. No. Directors who fail to attend all, or most, of the board's meetings will be liable for violation of their duty of care.

112. An Extravagant Deficiency.

Cambridge Bank is an old-fashioned bank. It has one office, three tellers, a cashier, a president who is responsible for day-to-day bank operations, and a seven-person board of directors, which meets quarterly, but after the bank has closed for the day. Cambridge Bank also has no computers. All recordkeeping is done by hand. The cashier takes slips from the tellers, makes entries in the journal and ledgers by hand, and counts the cash at the end of each day. The cashier is a young fellow who, after working for two years, has arrived at work in a brand-new convertible. He has also recently taken to wearing expensive suits. Likewise, though in the last three years the bank has seemed very busy, deposits have continued to drop. Finally the outside auditors call in all of the depositors' passbooks. The passbooks show deposits exceeding those recorded in the ledger by over $250,000 annually. Deposits actually have increased, but the cash is gone. Upon interrogation, the cashier breaks down and confesses. Alas, he has spent all the money, and the bank is now defunct. Disgruntled shareholders sue the cashier, the president, and the directors.

Who has breached their fiduciary duty to the corporation and the shareholders?

A. The cashier

B. The directors

C. The president

D. The directors and the president

113. A Sick Director.

Aged director Veeck has been on the board of Ruckers, Inc., for 15 years. The Ruckers board meets monthly. Veeck has been troubled by a persistent lung infection. In September, he decides that he would rather not face the cold winter. He leases a home on Siesta Key, below Sarasota, Florida. After the October board meeting, Veeck journeys down to Sarasota. He misses the November meeting. He participates by conference call in December. In addition, each month the Ruckers corporate secretary federal expresses a "board packet" (trial financial statements, minutes of previous meeting, reports, etc.) to Veeck, which he takes great care to review. He also misses the January meeting. Still not well, Veeck decides to stay in Florida until April or May. He seeks your advice about what he should do with regard to his Ruckers board commitment.

What is your advice?

A. Directors have an affirmative duty to attend board meetings, and so he needs to attend despite his health issues.

B. Veeck is likely already consciously disregarding his duties, so he should resign now.

C. If Veeck misses another meeting, he should resign then.

D. A director's duty is to keep informed, and so he should try as best he can to participate by conference call and continue to review carefully his board packets.

114. A Rushed Proposal.

Gherkin is the CEO of a large, publicly-held company who is approaching retirement and holds four million shares of the company. The company, TransWheel, has a share price that has languished in the high $30s for several years, even though the book value of the company is $45 per share. A few months ago, Gherkin had the CFO "run the numbers" on a purchase of the company using its cash flow to service the debt that would be incurred if Gherkin and the other senior managers bought up all the shares currently held by the public. The CFO reported back that a buyout would be feasible at prices up to and slightly beyond $60 per share. There were no third-party buyers at $61–62 per share, so Gherkin went to see a well-known financier, Ghoul. Ghoul offered to buy the company at $55 per share but also insisted upon an option to purchase one million TransWheel shares from TransWheel at $38 per share and a "no shop" clause. Under the latter arrangement, the TransWheel senior management would not be able to test the market to see if a better price could be obtained. All of the foregoing occurred on a Friday and the following Monday. On Tuesday, Gherkin then called a special meeting of the TransWheel board of directors for Friday morning. You are personal counsel to two outside directors of TransWheel. The directors called you during a break in the meeting. Gherkin has asked for approval by the board of the buyout by Ghoul after only an hour-long meeting. He has not even presented them with the documents for the proposed transaction. He has started pounding the conference room table.

What should you tell them to do?

A. Go ahead and vote for the deal. Fifty-five dollars is a good price and the business judgment rule will protect you.

B. Fifty-five dollars may be a good price, but you won't know that for certain until reviewing all the underlying documentation.

C. Gherkin and perhaps other insiders are pushing too hard. Refer the matter to a committee of independent directors.

D. The board should refer this to a committee of independent directors and empower the committee to hire an independent investment banker and independent law firm, meet over several sessions before calling the question, and leave an "out" for the directors should a clearly superior bid surface.

115. Officer Duties.

The board of Shady Pines, Inc., a small public corporation, decided that it would be in the best interest of the corporation to seek to be acquired by a larger corporation. The company, although historically profitable and holding valuable assets, had been operating in a depressed economy and was anticipating low future growth. The board charged two officers, President and Chief Financial Officer (CFO), to solicit bids to purchase the corporation. President and CFO complied and worked with a firm to list the corporation for sale. They received three offers. They quickly rejected the first offer because the acquiring corporation

would not retain them as officers after the acquisition. After the board determined that the remaining two offers were acceptable, President and CFO began the due diligence process with the offerors; however, both failed to fully participate. They missed several deadlines and neglected to provide pertinent information. As a result, one offer was withdrawn and the other was revised to a substantially lower amount. At the annual meeting of the shareholders, the board reported as to the efforts to sell and specifically stated, "We currently have one offer that is far below asking price." Accordingly, the board proposed taking the corporation private instead of selling it. The shareholders voted to approve the privatization; however, one director (also a two percent shareholder), who had voted against the proposal and knew about President and CFO's failure to fully participate in the due diligence process, sued to invalidate the privatization measure because President and CFO breached their fiduciary duties to the corporation. President and CFO have defended by maintaining that their actions were undertaken in their capacities as officers rather than as directors, and thus, they did not owe any fiduciary duty to the corporation.

Are President and CFO correct that they do not owe fiduciary duties to the corporation?

A. Yes. Officers do not owe fiduciary duties to the corporation.

B. Yes. Officers do not owe fiduciary duties to the corporation unless they specifically agreed to undertake such duty by contract.

C. No. Officers owe fiduciary duties to the corporation that are generally the same as those owed by directors.

D. No. Officers owe fiduciary duties to the corporation, but they are substantially less than those owed by directors.

116. Exculpation.

You are an associate in a small "town square" law firm that provides a variety of services to clients. Your supervising attorney primarily practices in personal injury but has looped you in on a business planning matter for a friend of hers. The friend, along with six others, wants to form a corporation to do software development. They also have a handful of investors who want stock in the company. Your supervising attorney, however, recalls the case of *Smith v. Van Gorkum*, and she wants to be sure to avoid that outcome as best as possible. She has instructed you to draft the broadest indemnification provision permissible under current Delaware law.

Which of the following provisions both accomplishes your supervising attorney's instructions and is enforceable under current Delaware law?

A. "The directors and officers are exculpated for all monetary damages arising out of any breach of fiduciary duty."

B. "The directors are exculpated for all monetary damages arising out of any breach of fiduciary duty."

C. "The directors and officers are exculpated for all monetary damages arising out of any breach of duty of care, but not for any intentional or knowing violation of law, breach of fiduciary duty of loyalty, or actions not in good faith."

D. "The directors are exculpated for all monetary damages arising out of any breach of duty of care, but not for any intentional or knowing violation of law, breach of fiduciary duty of loyalty, or actions not in good faith."

117. Play Ball at Night, Part I.

Baron Inc. owns a minor league baseball team that plays its home games at Stadium. Baron's majority shareholder, Laker, a successful local car dealer, fervently believes that "God intended baseball games to be played outdoors in the afternoon." Stadium thus has no lights; it cannot accommodate nighttime baseball. Recently, a celebrated athlete has decided to try his hand at baseball with Baron's team. His presence would triple attendance, that is, if the games were played at night. Instead, Baron continues to lose money each year. Year after year, in attempts to avoid upsetting Laker, the Baron board summarily votes to continue to have the team play day baseball only. Foster is a minority shareholder who has given up on the minor league team. He has sued Laker and the other board members for breach of the duty of care. Foster says that if the directors only conducted the most perfunctory market study they would see that the team could make considerably more money playing nighttime baseball, especially given the presence of the aforesaid celebrated athlete.

Is Foster's suit likely to succeed?

A. Yes, because the directors have not made an *independent* decision or judgment. They have merely rubber stamped the controlling shareholder's decision.

B. No, because absent fraud, directors' decisions are protected from judicial scrutiny by the business judgment rule.

C. No, because the directors have no personal financial stake in the outcome, and therefore, they and their decisions are protected by the business judgment rule.

D. Yes, because the directors failed to comply with the business judgment rule.

118. Play Ball at Night, Part II.

Presume that all the directors of Baron Inc. are pillars of the local business community. None has financial ties to the Barons or its controlling shareholder. They are CEOs and business leaders. Only one or two have social ties to Laker. When confronted by the shareholder demand to consider playing night baseball, the directors hire a consultant, who quickly renders onto the board a written report. The report purports to find a trend back to daytime baseball, at least by minor league teams operating in cities with more than 400,000 inhabitants. The consultant also openly discloses that he is the president of a not-for-profit organization named "Daytime Baseball Boosters, Inc." Following receipt and review of the report, the directors now vote 6-0 to continue playing daytime baseball only.

Would you as a plaintiff's attorney still take the case of the complaining Barons' shareholder?

A. Yes, because the directors have a duty of care. Receipt of one report by a biased consultant, quickly produced, does not measure up to the directors' duty.

B. No, because how much information is enough information is itself a matter of business judgment.

C. Yes, because directors making such a decision have a duty not just of due care but of the utmost care.

D. No, because decisions of independent directors, as here, are unassailable.

119. Political Forgiveness.

Mercury Bell Co., a local communications company, has equipped a state political party with technological resources and support for a campaign drive. Though the political party's candidates win, after the election season ends, the party has a huge $4 million bill which it cannot pay. The political party seeks forgiveness of the debt. Mercury Bell's board of directors deliberates. Forgiveness of the debt might well serve the company's best interests as the party's candidate won the election and the company has several important measures on its legislative agenda. None of the directors has an interest in the subject matter of the decision. The board receives reports from the CFO and the company's attorneys. The CFO opines that forgiveness of the debt will not put the company in any financial strait. But the attorney offers a caveat that the forgiveness of the debt may be construed as an indirect gift to partisan campaigns for political office and, hence, illegal. She indicates that she will do further research on the question. The board, however, is impatient. They decide to vote. They forgive the debt. A week later, the attorney reports back that the debt forgiveness does not run afoul of campaign finance laws.

Is the Mercury Bell board's decision likely to be shielded from judicial scrutiny by the business judgment rule?

A. Yes. The directors made a decision or judgment, they reasonably informed themselves, and they rationally believed the decision made was in the best interests of the corporation.

B. Yes. The directors exercised not only some care, as the rule requires, but due care.

C. Yes. The decision ultimately turned out to be legally permissible.

D. No. The directors did not make the decision in good faith because they had notice that the forgiveness might be illegal.

120. Takeover Threat, Part I.

The board of VideoGame Inc., a publicly-held entertainment company, is concerned over a sudden spike in the trading volume of VideoGame stock. They have reason to believe that several activist hedge fund traders are working in concert to acquire the stock with an eye

toward waging a proxy contest. The VideoGame board has convened a special meeting to consider adoption of a shareholder rights plan that would enable them to ward off any hostile takeover bid. They have asked you, as counsel, to address the board and then guide them through the process of adopting takeover defenses.

Which of the following should you advise them not to do?

A. Ensure that any defense measure "is reasonable in relation to the threat posed."

B. Convene the independent directors in executive session for the final discussion and actual adoption of the defenses.

C. Stagger the board of directors into three classes and resurrect a requirement of removal for cause only.

D. Adopt a scorched earth policy of sorts that prevents any one shareholder from acquiring more than 2 percent of the outstanding stock without board consent.

121. Takeover Threats, Part II.

Presume that the hedge fund files a Schedule 13D with the SEC (a form that must be filed when a person or group acquires more than 5 percent of a voting class of stock, also known as a "beneficial owner report"). The hedge fund announces 15 percent ownership and an intention to make a cash offer for a majority of the VideoGame shares at 30 percent over the market price of $20, or $26 per share. VideoGame convinces a friendly competitor, Firstwave, to make a rival bid at $28 per share. The hedge fund rises to the occasion and bumps its offer to $30. Firstwave matches that bid. The hedge fund then raises its offer to $33. The independent directors of VideoGame board meet, and afterward, the board recommends that shareholders accept the $30 Firstwave bid. The directors themselves will tender to Firstwave. They also have caused VideoGame to issue an option to Firstwave to acquire 2,000 authorized but unissued VideoGame shares equivalent to 25 percent of the VideoGame outstanding shares. One of the reasons the VideoGame board states for favoring the Firstwave offer is that Firstwave has promised to keep all or most of the incumbent VideoGame managers in place. Investor Lynch's mutual fund owns two million shares of VideoGame and is upset that success of the inferior bid will cause him to leave $6 million "on the table."

Does the business judgment rule forestall any meaningful challenge to the action by the VideoGame board?

A. Yes, because the directors carefully examined the competing offers and made a decision or judgment.

B. Yes, because the directors took action that was "reasonable in relation to the threat posed" by the hedge fund's ownership.

C. No, because once it becomes certain that the target company will be sold or broken up, directors cease to be "defenders of the corporate bastion" and must attempt to maximize the short-term value for the shareholders.

D. No, because the directors had a conflict of interest and were more interested in taking care of the incumbent management at VideoGame Co. than in serving shareholders' best interests.

122. Duty of Loyalty.

What types of board or officer conduct will implicate the duty of loyalty?

Answer:

123. A Sneaky Director.

Full Sail, Inc., a public corporation incorporated under Delaware law, is a successful microbrewery that has two product lines: Golden Ale and Amber Lager. The board proposes to sell off a brewery and product line (Golden Ale). Director Birch is interested but believes that if he bids on the proposed Golden Ale "spin-off," he will be "held hostage." Birch is the wealthiest of the directors. Birch, therefore, has his cousin, Porter, form a new corporation. That entity purchases Golden Ale, without ever disclosing its association with Birch. Five years later, Golden Ale has proven to be wildly successful. A Full Sail director, however, learns that Birch has been the one behind the new venture all along. Full Sail has demanded that Birch turn over his stock in the new business.

Should Birch defend or should he attempt to settle?

A. Defend. The new corporation paid an objectively verifiable "fair" price for the Golden Ale line. Full Sail has not been damaged.

B. Defend. Most of the increase in value can be proven to be due to Birch's management effort and expertise. Damages due to Full Sail will be small, if any.

C. Defend, but have Birch resign from the board and make his resignation retroactive.

D. Settle. Birch has breached his duty of loyalty, and he is liable not only for any damage to the corporation but also for an illicit gain.

124. Interlocking Directors.

Earheart sits on the boards of both Aircraft, Ltd., and Overby Corning Composites, Inc. Aircraft has been purchasing composite wing assemblies from Overby for its new commuter airliner. The Aircraft purchasing department has been purchasing approximately $900,000 worth of wing assemblies per year. Aircraft's annual sales are $100 million. Earheart has discovered these facts.

Does Earheart need to do anything?

A. No. She has no conflict of interest because the transactions are not material as a percentage of Aircraft's sales or profits.

B. No. She has no personal interest in the subject matter other than the "interlocking" directorate position.

C. Yes. She must disclose to the Aircraft board of directors her interest in the transaction and have the disinterested directors approve (or reject) the transaction with Overby.

D. Maybe. She must disclose and receive board approval if she participated in or influenced negotiation of the transaction.

125. All About Fairness.

The Klein and Lauren families own a Delaware corporation which produces designer jeans. Dissatisfied with a lack of bank financing, the Klein family boycotts meetings, concentrating its resources on real estate ventures instead. Determined not to permit a listing ship to capsize, and having a quorum at meetings, the Lauren family approves a loan of personal funds to the corporation at a high rate of interest that reflects the speculative nature of the enterprise. They also cause the corporation to enter into and pay a substantial but justifiable management fee to themselves. Things soon settle, and the enterprise is profitable again. The Kleins, however, sue, alleging that the Laurens have "violated" the interested director statute.

The Lauren family consults you. Is the Klein family's claim a good one?

A. Yes. The law requires full disclosure and the vote of a disinterested decision maker; otherwise, the loan transaction is voidable.

B. No, but the burden will be on the Lauren family to demonstrate why they did not comply with the statute.

C. No. The directors alleged to have had a conflict may always prove the fairness of the transaction.

D. Yes. If directors or shareholders loan funds to the corporation, they must do so at a low interest rate.

126. Biased Directors.

The three directors of the Blue Moon Motel Co., Ltd., together own a parcel of property which they believe to be a prime motel site, located as it is just off a major interstate highway. They have had the property appraised. They now propose to convey to Blue Moon at the appraised value. At the directors' meeting convened to approve the land transaction, one of the directors looks up and says, "A quorum of disinterested directors would be three. There are only two of us without any interest in this transaction. Counsel, what do we do?"

What advice do you give?

A. Because you cannot obtain a quorum, the directors must convene a shareholders' meeting and seek shareholder approval.

B. For quorum purposes, interested directors may be counted.

C. The board is paralyzed and cannot enter into the transaction.

D. If the directors forego shareholder approval, the transaction may be reviewed by a court under the entire fairness standard.

127. All the Facts.

Using his corporation, Tenore, Ltd., Havarotti proposes to purchase a valuable piece of downtown real estate from Three Tenors, Inc. He further proposes to construct a building in which will be housed offices, a rehearsal hall, and prop storage for the city's civic opera. Havarotti will then donate the refurbished building to the local opera. The Three Tenors board approves the conveyance, with Havarotti stepping out during the final board deliberations and abstaining from the vote. Havarotti neglected to disclose that the conveyance by him to the civic opera will be of a life estate in the realty, with the remainder to Havarotti's children. There has been a change in board membership, and the nature of the realty conveyance has also come to light. The new directors, led by Tomingo, are angry. Tomingo seeks your advice about the transaction.

Can the corporation void the transaction?

Answer:

128. Missed Opportunity.

Weldon owns a number of gravel pits personally, but he also is a director and shareholder of a corporation, Pet Rocks, Inc., which owns the second largest gravel pit in the area. Pet Rocks also owns an undivided one-third interest in the largest gravel pit in the area, the Crescent. Pet Rocks has made an offer to the owner of the second of the three interests in the Crescent and has received a counteroffer. As to the third of the three interests, after protracted negotiations to obtain a long-term leasehold, Pet Rocks was unable to close a deal. When he receives this news, Weldon approaches the two other Crescent owners to sell him both the second and the third interests. Weldon breaks the impasse with one of the owners by promising to give the owner's mother, who lives on the property, a life estate in her lot and flower garden. Weldon ends up nearly cornering the gravel market. Pet Rocks's directors are angry that Weldon, their colleague director, got the deal.

Were Weldon's actions appropriate?

A. No. He has usurped (diverted to his own use) a corporate opportunity, in breach of his duty of loyalty.

B. Weldon's actions were inappropriate as to the second interest, but appropriate as to the third because Pet Rocks had made no attempt to obtain the third.

C. No. What Weldon did was not "fair."

D. Weldon's actions were inappropriate, but he could have avoided the trouble if he had resigned before approaching the owners of the other interests in the Crescent.

129. Cellular Licenses.

Brody has her own Delaware corporation — Brody, Ltd. — which has speculated in Federal Communications Commission cellular telephone licenses. She holds licenses for several service areas and sits on the board of the local telephone company, Yelm Bell Co. Yelm is an old-fashioned local service provider with hard wires running from customers' homes and businesses to Yelm's exchanges. Several cellular licenses have come onto the local market, and Brody asks all of her Yelm director colleagues whether Yelm has an interest, but she does so individually rather than at a board meeting. They each say "no," with the CEO adding that Yelm has little cash right now because it has been building out a cable television system. Brody and Brody, Ltd., then sign a contract to purchase the licenses. Before Brody, Ltd., closes on the deal, Firstwave Communications, a full-service telecommunications company (cellular, internet access, cable television, and traditional telephone service) in a neighboring area, announces a merger with Yelm. Firstwave sues Brody and Brody, Ltd.

Is there a corporate opportunity as to Yelm?

A. Yes, because a director may not divert an opportunity that rightfully belongs to the corporation's prospective merger partner.

B. No, because Yelm's line of business did not include cellular licenses, Brody did not learn of it by virtue of her position, and Yelm has no interest or expectancy (indeed, it turned the deal down).

C. Yes, because cellular is a line of business in which Yelm might reasonably be expected to engage.

D. No, because Brody was in this business long before she became a member of the Yelm Telephone board of directors.

130. Brotherly Competition.

Brothers Hector and Ajax operate a successful business that exports scrap metal. Each owns 35 percent. The former manager, Rosen, comes into the office one day. Rosen owns

20 percent. Friends and employees own the remaining 10 percent. Rosen is moving out of the area and inquires whether the corporation will buy back his shares. The brothers confer and respond that the corporation has no interest but that Hector, individually, would give Rosen $5 per share. Rosen departs on friendly terms. Ajax then excuses himself, saying he has an errand to run. He intercepts Rosen in the parking lot. He offers Rosen $12 per share. Rosen accepts. Using his newly acquired majority control, Ajax puts his business associates on the board. They promote Ajax to CEO, at a greatly increased salary. Meanwhile, Hector languishes. His salary increases, but only slightly. He decides to consult you about what he should do.

Has Ajax usurped a corporate opportunity?

Answer:

Shareholder Litigation

Assume, unless otherwise noted, that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

131. Introduction to Derivative Actions.

What is a "derivative" lawsuit?

Answer:

132. Inspecting the Records.

Faulkner believes that Unlimited, Inc., a publicly-held corporation in which she owns shares, has made false or misleading disclosures relating to a merger agreement. To her chagrin, the annual meeting of the shareholders is not due to be held for eight months. In an attempt to bring public attention to this scandal, Faulkner wants to file a lawsuit against the corporation. She has delivered to the board a procedurally proper notice of demand to inspect Unlimited's list of shareholders. As maintained, the list includes the names, numbers of shares held, and contact information for all shareholders. Faulkner explained in the notice that she wanted to see the list so that she could notify the other shareholders of the lawsuit. Unlimited's board believes that Faulkner is requesting the list so that she may solicit other shareholders to join the suit. Accordingly, the board does not want Faulker to get access to the shareholder list. Unlimited's articles of incorporation and bylaws include the default rules for a shareholder's rights of inspection of corporate records.

Is Faulkner entitled to see the list of shareholders?

A. Yes. She has alleged a proper purpose to inspect the shareholder list.

B. No. Faulkner will not be entitled to inspect the list of shareholders until after notice for the next meeting is given.

C. No. This is just a "fishing expedition" to bolster her lawsuit.

D. Yes. Faulkner is entitled, as a matter of absolute right, to see the list of shareholders at any time for any reason.

133. A Disgruntled Shareholder, Part I.

Falconer is a disgruntled shareholder of Roadstar, Inc., a small, publicly-held company with 150 shareholders and a five-person board. Falconer is disgruntled because a vendor just breached a contract for delivery of 1,000 widgets over the next two years. Falconer has learned that the vendor, Drummond Co., is owned by cousins of Manley, Roadstar's CEO and largest shareholder. Manley's brother, Stanley, also sits on the Roadstar board, as does their father, Randley. As a result of the cancellation, Roadstar stands to experience a financial loss for the first time in five years and will be unable to pay dividends this year. The stock value will also certainly decrease. The other two directors, Carlson and Winslow, rarely attend board meetings. Falconer is incensed because the board has done nothing regarding the breach and has allowed it to happen with nary a protest.

Does Falconer have a right to file a lawsuit against the board of directors on behalf of the corporation?

A. No. The business and affairs are managed by the board of directors and only they may commence a lawsuit.

B. No. A shareholder does not have a right to sue a board of directors under any circumstance.

C. No, but Falconer may file a lawsuit on his own behalf against the corporation.

D. Yes, but Falconer will be subject to heightened procedural requirements.

134. A Disgruntled Shareholder, Part II.

Falconer has decided to pursue a lawsuit against the board of directors on behalf of the corporation. Specifically, Falconer believes that the board has breached its duty of loyalty by entering into a conflict-of-interest transaction to the detriment of the corporation and its duty of care by making bad decisions. Falconer has engaged your firm to discuss the steps moving forward and has asked if there is anything he is required to do before filing the lawsuit.

What advice do you give?

A. Falconer can file the lawsuit immediately.

B. Falconer must first make a demand on the board of directors to cure the breach.

C. Falconer must acquire more stock to meet the threshold to have standing to file the suit.

D. Falconer must file a shareholder proposal to authorize the suit to move forward.

135. A Disgruntled Shareholder, Part III.

Before Falconer can even make demand on the board, he obtains more "bad news." At a Roadstar board meeting, the directors declared an extraordinary dividend of $30 per share (the stock sells for $15), payable only to those shareholders who have held shares for five

years or longer. Falconer is one of five shareholders who has held shares in the corporation for less than years. Believing that the dividend payment is in retaliation for Falconer's efforts to commence a lawsuit, he wishes to add to his lawsuit a challenge over the dividend payments.

Is this additional claim a derivative claim on behalf of the corporation?

A. Yes, this is an additional claim that Falconer can assert derivatively on behalf of the corporation.

B. Yes, this is a derivative claim because Falconer is not the only shareholder to have been impacted by the dividend payment.

C. No, this is a claim that Falconer can assert directly, on his own behalf.

D. No, this is a valid exercise of business judgment and so Falconer cannot file a claim at all.

136. A Disgruntled Shareholder, Part IV.

After your initial consultation with Falconer and the troubles at Roadstar, Inc., you have done some research and discovered that the corporation has a six-member board. In addition to Manley, Manley's father, and Manley's brother, three other members sit on the board: an accountant, a lawyer, and a real estate agent. You reviewed their social media pages and discovered that the lawyer appears to be a close friend of the Manleys and frequently vacations with them. In your investigation, it seems that the accountant and the real estate agent run in the same social circles as the Manleys, but you cannot find any direct evidence that they are particularly close. You are preparing a letter to Falconer to advise him as to whether you believe a court would excuse demand in this case as futile. Assume that Delaware law applies.

What advice do you give to Falconer?

A. Demand is likely to be excused as futile because three members of the board (the Manleys) are self-interested in the challenged transaction and thus conflicted.

B. Demand is likely to be excused as futile because four members of the board (the Manleys and the attorney) are self-interested in the challenged transaction and thus conflicted.

C. Demand is likely to be excused as futile because all six members of the board are self-interested in the challenged transaction and thus conflicted.

D. Demand is not likely to be excused as futile.

137. A Disgruntled Shareholder, Part V.

You are sitting down to meet with Falconer to discuss litigation strategy. You've discussed the pros and cons of making a demand as well as your views on whether you believe the court is likely to excuse demand as futile. Falconer responds, "I hear what you're saying.

To be safe, why not just make a demand. That way we don't have to worry about any of this stuff." Assume that Delaware law applies.

How will you respond?

Answer:

138. A Disgruntled Shareholder, Part VI.

Assume now that you represent the six-member board of Roadstar, Inc., and that you have received Falconer's demand to sue or cure the breach of fiduciary duty of loyalty relating to the alleged conflict-of-interest transaction. You advise the board that at least three, maybe four, of the directors have a conflict of interest in the transaction, and thus, the court is likely to permit the lawsuit to progress even if the board rejects the demand. Assume Delaware law applies.

What advice should you offer the board to best ensure the lawsuit will be quickly dismissed?

Answer:

139. A Disgruntled Shareholder, Part VII.

Falconer decided to proceed with the derivative lawsuit without first making a demand on the board. After receiving service of the lawsuit, the board appointed and referred the matter to a special litigation committee made up of the accountant and the real estate agent. The committee hired outside counsel to review the lawsuit and make a recommendation. Outside counsel issued a written opinion to the committee advising that Falconer's lawsuit was not in the best interest of the corporation and should be dismissed. Accordingly, the special litigation committee voted that the lawsuit should be dismissed, and it noted that its decision was final and not subject to the review of the other directors. Consistent with this report, the board filed a motion with the court to dismiss the lawsuit. Assume that Delaware law applies.

How should the court rule?

A. The court should deny the motion because Falconer was correct to file the lawsuit without first making a demand on the board of directors.

B. The court should deny the motion because it should make its own determination as to whether the lawsuit is in the best interest of the corporation.

C. The court should grant the motion because the special litigation committee was independent, acted in good faith, and made a reasonable recommendation.

D. The court should grant the motion because the special litigation committee was independent, acted in good faith, and made a reasonable recommendation, but only if the court believes in its own independent business judgment that the lawsuit should be dismissed.

140. Shareholder Incentives.

If a shareholder does not stand to receive any recovery from a derivative suit because the recovery flows to the corporation, what incentive does a shareholder have to bring a derivative suit?

Answer:

Mergers and Acquisitions

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

141. Preemptive Rights.

Which of the following is a "preemptive right" that preferred stockholders might bargain for?

A. Right of first refusal

B. Right of first sale

C. Information rights

D. Liquidation rights

142. Fabulous Defense.

Fabulous Foods, Inc., is a confectionery company whose common stock is traded on the New York Stock Exchange (symbol: FAB). An inner circle of shareholders, which holds about 15 percent of the common stock, consists of the third generation of the company's founders and the company's long-time top managers. The inner circle and Fabulous's management are worried about a hostile takeover. Fabulous has no debt, ranks number two or three in every market in which it has products, and has $100 million in cash or cash equivalents. There has also been much recent consolidation in the food industry, not only through friendly mergers but also by hostile takeovers. The FAB board of directors is conducting its annual "fly away" board retreat at a resort in Vermont. The board has asked the founding family members to join the board for an afternoon. The board has also asked you to advise them on a takeover defense they could quickly implement.

Advise the directors on how you could implement a "super voting stock" defense to protect FAB from hostile takeovers.

Answer:

143. Preemptive IPO.

A successful corporation decides to go public and hires you as its attorney for this transaction. You review its articles of incorporation and discover that the shareholders have preemptive rights.

Is it necessary and proper to amend the articles of incorporation to remove the preemptive rights before going public?

A. Although preemptive rights prevent a corporation from going public, no, it is not proper to remove them because they are important and valuable property rights vested in the corporation's shareholders.

B. Yes. Preemptive rights are problematic when going public, and they should be removed by a vote by a majority of shareholders.

C. No. A public offering under the Securities Act of 1933 automatically eliminates preemptive rights.

D. No. The MBCA does not recognize preemptive rights.

144. Buy–Sell Agreement.

Seven Springs is a small ski resort, opened in the late 1940s by two families who enjoyed skiing. Over the years, Seven Springs has acquired additional property, added new ski lifts, and opened a hotel and restaurant. Through gifts and bequests, the number of shareholders has increased to 34, though all are members of several extended families: the Steep and Deep families on the one hand, and the Groomed and Gradual families on the other. Many years ago, the shareholders all signed a "buy–sell" agreement. The agreement provided that before any shareholder could sell, she had first to offer her shares to the other shareholders, on the same terms as the third party was willing to agree to. The existence of the agreement is conspicuously noted in the margin of each Seven Springs share certificate. Now the entire Steep and Deep clan proposes to sell. They wish to sell to a larger company, Vail Ski Corp. The Groomed and Gradual families oppose this. They invoke the buy–sell agreement. The Steeps and the Deeps reply, "This is not a sale, it is a merger, and we have you outvoted (19–15)."

What is the legal result?

A. A merger occurs by operation of the law (filing articles of merger after the requisite shareholder vote has been obtained) and is not a sale. The agreement does not apply.

B. In effect, the shareholders "sell" their shares when they vote on the merger, which will result in their receipt of Vail Ski Corp. shares. The agreement applies.

C. The buy-sell agreement is invalid because it is a restraint on alienation.

D. Their refusal to abide by the agreement constitutes fraud.

145. Alaska–Hawaii.

On and off over the years, Alaska Airlines, Inc., and Hawaii Airlines, Inc., have discussed combining forces. They operate the same type of aircraft. Their route systems are contiguous yet with little overlap, such that combining them will provide synergistic cost savings. The CEOs of both companies met and conferred. They agreed on a term sheet, which they presented to their respective boards, who then voted to retain a lawyer to assist with moving forward toward this deal. You get the call from Alaska's board chair, who asks you, "How do corporate combinations typically proceed?"

Describe the typical steps and some common deal structures.

Answer:

146. Acquirer–Target, Part I.

Two corporations, Acquirer and Target, decide to combine. Acquirer desires Target's intellectual property and real property, but Acquirer wishes to avoid Target's tort liability for harms caused by its products. Acquirer wishes to preserve as much of its cash as possible.

Which deal structure best meet's Acquirer's objectives?

A. Statutory merger

B. Cash for assets

C. Stock for assets

D. Stock tender offer

147. Acquirer–Target, Part II.

Two corporations, Acquirer and Target, decide to combine. Acquirer desires Target's FCC broadcaster license, but FCC broadcaster licenses must be continuously held by the original licensee.

Which deal structure allows Acquirer and Target to combine such that the combined entity may continue holding the FCC broadcaster license?

A. Statutory merger

B. Stock for assets transaction

C. Reverse triangular merger

D. It cannot be done

148. Acquirer–Target, Part III.

The board of directors and the CEO of Acquirer, a very large publicly-traded corporation, decide to purchase Target, a small but rapidly growing technology startup, for $5 million. However, it would cost nearly that much to hold a special shareholders' meeting and solicit proxies to hold a vote about this acquisition. For this deal to be economical, the structure must permit Acquirer to avoid its shareholder vote.

Which deal structure allows Acquirer to purchase Target without requiring a vote by Acquirer's shareholders?

A. Reincorporate Acquirer in a jurisdiction with a small-scale merger statute and then perform a small-scale merger.

B. Perform a triangular merger.

C. Perform a cash merger.

D. Perform a tender offer.

149. Acquirer–Target, Part IV.

The board of directors and the CEO of Acquirer, a very large publicly-traded corporation, decide to purchase Target, a small but rapidly growing technology startup. The CEO of Acquirer offers terms to acquire Target, but Target's board does not accept them. To purchase Target, Acquirer will need to identify a deal structure that does not require Target's board's approval.

Which deal structure allows Acquirer to purchase Target without requiring approval by Target's board?

A. Proxy contest

B. Takeover bid

C. Stock tender offer

D. This transaction cannot be done without target board approval.

150. Dinosaur Classified Board.

Dinosaur Oil, Inc., is a publicly-traded corporation that owns and operates deep sea oil mining rigs. The corporation has been very profitable for over a decade, but last year its profits and stock price fell sharply after a rig caught on fire. The directors are concerned that a shareholder activist will attempt a proxy contest to oust the current director while public sentiment is against the corporation. To prevent this, the directors classified the board into three groups, each serving a staggered three-year term, and installed a requirement that shareholders could remove directors "only for cause."

Can Dinosaur Oil's board defend against a potential proxy contest by classifying the board?

A. Yes. Board classification schemes are permitted by statutes.

B. Probably. Under the business judgment rule, boards are generally permitted to install antitakeover devices.

C. Probably not. The court will review the defenses and their adoption very closely, applying a duty of loyalty analysis that will strike down a defense if the primary motivation behind adoption was entrenchment of the current board and management.

D. No. The court will strike down the board classification scheme, as it clearly is an entrenchment device.

151. Dinosaur Crown Jewel.

Dinosaur Oil, Inc., a publicly-traded corporation, has a staggered board that is notably opposed to takeover offers. Takeover specialist Picken decided to attempt a hostile takeover via a cash tender offer. Picken filed a Form 13D with the SEC disclosing he owns 12 percent of Dinosaur Oil. Dinosaur's directors hold an emergency meeting where they elect to grant their chief competitor, Cambrian Oil, an option to purchase over half of their oil fields at a favorable price. This option, which amounts to Dinosaur Oil's offering up the "crown jewel" of its enterprise, sours the deal for Picken. Picken sues for a preliminary injunction that prevents Dinosaur Oil from offering its oil fields to Cambrian Oil.

Will Picken's challenge prevail in court?

A. No. Dinosaur's directors are permitted to offer the crown jewel option under the business judgment rule.

B. No. Dinosaur's directors are permitted to offer the crown jewel option so long they do not stand to personally profit from the transaction.

C. Yes. Dinosaur Oil's directors failed to get shareholder approval of the option they offered to Cambrian Oil.

D. Yes. The granting of the crown jewel option, especially at such a preliminary stage, is "disproportionate to the threat posed" and will be struck down.

152. Dinosaur Duties.

Dinosaur Oil, Inc., a publicly-traded corporation, is responding to a cash tender offer by takeover specialist Picken, who filed a Form 13D with the SEC disclosing he owns 12 percent of Dinosaur Oil and intends to gain control of the corporation. Dinosaur's directors hold an emergency meeting to evaluate their options. You, Dinosaur's corporate counsel, are present to recommend to the board what actions are permitted under corporate law.

Which of the following statements best summarizes the board's obligations when there is an imminent takeover threat?

A. The directors are obligated to take any and all actions reasonably necessary to prevent corporate raiders from taking over the corporation.

B. The directors are protected by the business judgment rule for any corporate decisions taken in response to a takeover threat.

C. The directors' role has changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

D. The directors must ensure that the transaction is entirely fair.

153. Dinosaur Equals.

Dinosaur Oil, Inc., a publicly-traded corporation, is responding to a cash tender offer by takeover specialist Picken, who filed a Form 13D disclosing he owns 12 percent of Dinosaur Oil and intends to gain control of the corporation. Dinosaur's directors hold an emergency meeting and decide to seek a "white knight" buyer. Eventually, Shell Oil, a larger competitor with synergistic assets, offers to buy Dinosaur Oil for a price per share that is 40 percent more than market value for the shares. The directors agree to this deal, which has several "deal protection" measures, including a "no shop" clause that prohibits Dinosaur or its directors from soliciting another bidder, a "no talk" provision that prohibits furnishing any non-public information to any potential bidder, and a termination fee provision under which Dinosaur must pay Shell approximately 5 percent of the value of the transaction if, for any reason, the merger is not consummated.

Has the Dinosaur board of directors violated its duties to shareholders by agreeing to the Shell Oil merger agreement?

A. No. The directors' business decisions are protected by the business judgment rule.

B. No. In a merger of equals (MOE), the parties are free to "just say no" to other bidders, especially when other values, such as preservation of a unique corporate culture, are at stake.

C. Yes. The board of directors is in *Revlon* mode, such that it must conduct an auction to achieve the highest cash value for stockholders.

D. Yes. Deal protections are presumed to breach fiduciary duties, and the directors have not overcome the burden of persuasion by showing these deal protections are entirely fair to stockholders.

Insider Trading

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

154. Inside Information.

MidAmerican Bank is a conservative institution that has, over the years, gained the loyalty of the local farm populace. Approximately 35 individuals own MidAmerican shares. Long-time director Caron contacts the children of the deceased founder of MidAmerican. The children, Barbara and Lynn, are each married with young families. Caron offers Barbara and Lynn $12 per share for their father's stock, 20 percent of the total outstanding, which they inherited. Later, he bids against himself, raising the price to $15. Each daughter then sells, grossing over $200,000 each. Two months later, Floatman's Bank, a larger bank, makes a friendly tender offer (or takeover bid — the terms are used interchangeably) for MidAmerican shares at $30 per share. Barbara and Lynn have learned that Caron went around to several other shareholders buying up as many shares as he could. Barbara and Lynn feel that Caron took advantage of them, likely knowing of Floatman's interest in acquiring the shares.

What course of action should the sisters pursue?

A. A federal claim for insider trading pursuant to SEC Rule 10b-5 and the Securities Exchange Act of 1934

B. A state law claim of breach of fiduciary duty under the "special facts" doctrine

C. Answers (A) and (B) are equally viable.

D. A state law fraud claim

155. Good News Not Shared.

Over the past few years, employees of Good News Gas Co. have been prospecting for natural gas deposits. They drill a test well on one of their leases. The test results show that the well is gangbusters, so much so that it may be the largest natural gas field ever discovered in North America. The employees quickly cap the well and remove the drilling rig. Knowing also that

natural gas prices are approaching an all-time high, two employees, Twitty and Owen, call several stockbrokers and place large (but not overly large and therefore suspicious) orders both for Good News common shares and for call options to purchase such shares. Twitty and Owen then call Good News headquarters and report the drill test results to Robbin, the vice president for development, who tells Twitty and Owen to keep it under their hat for a few days. Robbin then buys up shares and options on shares. Finally, the "good news" is announced at a press conference. Director Husky, who is in attendance, whips out his cell phone. He purchases Good News shares, as does his broker. Within a month the share price has gone from $14 to $40.

Who is liable and for what?

A. They all are liable for the profit made and, in addition, subject to a civil penalty for up to three times the profit made (or the loss forgone, in cases of insiders selling on negative news) and possible criminal penalties.

B. Husky would not be liable. He did not trade (or "tip" his broker to trade) until after the information was disclosed.

C. Only Robbin is liable. He is a corporate officer. Twitty and Owen are just petroleum engineers, rank-and-file employees who owe to no one fiduciary or similar duties.

D. None of them is liable. This kind of trading keeps share markets efficient, moving share prices in the right direction, and is also the very type of incentive-based compensation we wish to encourage.

156. Misappropriation.

Vincent is a financial printer. In the course of his work, he reviews printer's proofs of "offers to purchase" in takeover bids. Drafts of these documents are communicated to Vincent's employer in absolute secrecy and are protected by a strict confidentiality agreement. The name of the target corporation is encrypted until the final press run. The cipher for the target company name, though, has to have the same number of characters as the real name. Also, by reading the narrative, Vincent can uncover much information. For example, he might discover that the target is in the forest products industry, is headquartered in a Midwest city, and has ten characters in its name. After conducting some research, he quickly researches the subject and finds Hammerhill Paper (ten characters) is located in the right area. Vincent buys the stock, albeit in the modest amounts his financial circumstances permit. Vincent has done this eight times, amassing $80,000. Then the SEC finds out. They bring a civil suit against Vincent in federal district court. In return for getting off with a consent decree, Vincent agrees to disgorge those profits. But eight or nine financial printers have done this. To make an example of him, the SEC refers the case to the U.S. Attorney, who prosecutes Vincent criminally. You are defense counsel.

Will a defense that Vincent did not occupy an "inside" fiduciary relationship work here?

A. No. There's no insider trading, but there may be a breach of contract.

B. Yes. Inside information comes from a source within the company whose shares are being traded, but this information did not come from "within" the company.

C. No. Vincent misappropriated the information and, thus, engaged in unlawful insider trading.

D. Yes. Vincent occupies no fiduciary or similar position vis-à-vis those with whom he traded. He is a stranger to them and owes them no duties.

157. Lucky Overhearing.

State U football coach Olsen (Coach Olsen) is attending a track meet at a local high school because his daughter is running in the 800-meter race. Coach Olsen sits behind Local Public Company CEO and his spouse. CEO is talking to his spouse about leaving the next day, a Sunday, to travel to New York, where he will be meeting with an investment banking firm, Silverman. In the same conversation, CEO talks about mergers and about XYZ Co. Putting two and two together, Coach Olsen calls a local auto dealer who sponsors Coach Olsen's television show. On Monday, they together purchase 20,000 XYZ shares. Sure enough, on Wednesday, a cash acquisition of XYZ by Local Public Company is announced. The cash merger price is at a 48 percent premium over market. Coach Olsen and friendly auto dealer sell on Friday. Their one-week profits are a whopping $1.9 million. The SEC sues Coach Olsen and the local auto dealer.

What is their best defense?

A. They have none. Coach Olsen is a tippee, and local auto dealer is a remote tippee. Both are liable.

B. Coach is liable, but, as a remote tippee, local auto dealer is not liable.

C. The information is market information rather than inside information so that the "disclose or abstain" prohibition does not apply.

D. The coach is only an eavesdropper, not a tippee, and therefore neither he nor the local auto dealer is liable.

Practice Final Exam: Questions

Practice Final Exam

Assume that each of the following questions involves facts arising in a jurisdiction that has adopted the Revised Uniform Partnership Act (RUPA), the Revised Uniform Limited Liability Company Act (RULLCA), and the Model Business Corporation Act (MBCA) and that has interpreted the law of agency consistently with the interpretations stated in the Restatement (Third) of Agency. To the extent you need to consider case law or litigation risk, apply Delaware law. The U.S. Securities and Exchange Commission is referenced as the "SEC."

Recommended Time Allocation: 1 Hour and 30 Minutes

158. Capital Structure.

Five entrepreneurs are opening a French café. They purchase baked goods and cold sandwiches daily from a bakery downtown, then they sell these foods in the suburb where they live. If the business goes well, in three to four years they may open a second café in an adjoining suburb. They have no plans beyond that. Each entrepreneur has agreed to contribute $10,000 to the corporation, and these funds will be used to purchase equipment, furnishings, and fixtures and for working capital.

What is the best capital structure for this corporation?

A. All common stock, in equal proportions to each entrepreneur's capital contribution

B. A small amount of common stock, along with convertible cumulative preferred shares to each participating entrepreneur

C. Common stock to each and a loan by each, say, $4,000 in stock and a $6,000 promissory note from the corporation to each couple

D. Common stock to each entrepreneur, and authorize cumulative preferred in the articles of incorporation so as to be able to fund any future expansion

159. Activist Shareholders.

Activist shareholders in Northern Pines, Inc., a publicly-held corporation with approximately 900 shareholders, wish to force the corporation to cease the practice known as "clear cutting" on Northern Pines lands and further to present to the shareholders for approval a "forestry stewardship plan." One central component of such a plan would be to provide for selective harvest of trees rather than clear cutting.

Which of the following represents the most cost-effective alternative for the activist shareholders to achieve one or more of their goals?

A. Filing suit against Northern Pines's directors seeking an injunction to stop the practices

B. Enlisting the support of 20 or so institutional investors who own 40 percent of Northern Pines's common shares

C. Filing an SEC Rule 14a-8 proposal requesting that the directors propose an amendment to the articles of incorporation prohibiting clear cutting and requiring periodic forestry stewardship plans

D. Waging a proxy contest seeking votes to remove the incumbent directors and replacing them with a slate of activist shareholders and others who oppose clear cutting

160. Promoter Liability.

Frank has obtained approval for a donut shop franchise. The franchise agreement will have a five-year term. Frank has also located suitable commercial real estate space in which to locate his franchise. The landlord requires a five-year lease. Frank's two friends, Yossi and Zelda, will each contribute $20,000 for a 20 percent interest in Frank's new company. You have advised Frank to wait until you have formed a corporation for him, but Yossi is impatient to sign the lease and the franchise agreement. Frank does not wish to be personally liable on the five-year lease and the franchise agreement.

What should Frank do to avoid personal liability on the lease and franchise agreement?

A. On both the lease and the franchise agreement, he should indicate clearly that the corporation does not yet exist ("a corporation to be formed").

B. He should sign by clearly indicating his representative capacity ("By Frank, Promoter").

C. He should provide for a substitution of the corporation for Yossi when the corporation does come into existence (a future "novation").

D. All of the above.

161. LLC Informality.

Dora Bay LLC operates a longshoring venture in the Pacific Northwest loading logs and other cargo onto ships bound for Asia. The LLC's operating agreement provides that Dora Bay will be a member-managed LLC. The five members of the LLC never have meetings. They rely on word of mouth, one to another. They also have kept very poor records. A tugboat company is suing the LLC and its members personally for unpaid bills.

Should the members be held personally liable?

A. No. LLC statutes contemplate informality, which alone should not be a ground for piercing the veil.

B. Yes. Lack of formalities is a ground for "piercing the veil" and denying members limited liability.

C. Yes, because maintenance of books and records is a statutory requirement which the Dora Bay LLC members have violated.

D. Yes, because LLC members have no limited liability if they permit the LLC to engage in ultrahazardous activities such as longshoring.

162. M&A Defenses.

You represent a publicly-held company whose senior executives feel that the corporation may be vulnerable to a hostile takeover bid. The corporation's eight directors are elected annually.

Which of the following is not a common strategy employed to defend against hostile takeover bids?

A. Staggering the board into classes

B. Giving a competitor an option to purchase the company's most valuable assets

C. Adopting a requirement that directors can be removed only for cause

D. Limiting shareholders' abilities to call special shareholders' meetings.

163. Partnership Professional Responsibility.

Crawley & Morass, LLP, is a 30-lawyer firm. Stephens is a young partner in the firm. She has worked extensively on the Bloomberg account. Over the past few years, she has noted that the supervising partner, Johnson, has inflated the hours billed to Bloomberg, sometimes by a factor of 40 or 50 percent. Eventually, Stephens could take it no longer. In June, she reported the over-billing to the managing partner. In August, two of the management committee partners requested an interview with Stephens. They reported to her that their investigation had uncovered no intentional over-billing of Bloomberg. They also stated that she should begin to look for work elsewhere. Her partnership draw would continue only until December 31.

Can the firm get away with such an injustice?

A. Yes. Partnerships are consensual, so the partners may expel her if the partnership agreement so provides.

B. Maybe. They may expel her but only for cause, so the firm would have to prove that Stephens acted improperly.

C. No. The partnership violated the fiduciary duties partners owe one to another.

D. No. The rules of professional responsibility are implied terms of the partnership agreement, and Stephens had a duty to take reasonable remedial action to avoid the consequences of known violations by another lawyer in the firm.

164. Family Business.

Meyer started a successful automobile parts business named First Gear, Inc. When Meyer died, his children, Nate, Olivia, and Pat, inherited the business, with each receiving one-third of the shares. Nate runs the business back in the Midwest. Nate earns a nice salary, leases a company car, and pays for NBA basketball and NFL football season tickets using corporate funds. He refuses to have the company pay dividends. This has gone on for 12 years. Now Olivia is fed up with what she sees as Nate's exploitation of his position. She is willing to go to court to get comparable benefits for herself. She is not on speaking terms with Nate. Pat is indifferent.

What cause of action might Olivia bring against Nate?

A. A derivative suit against Nate for breach of fiduciary duty

B. A direct suit for breach of fiduciary duty owed her by her brother and by the corporation to her as a shareholder in a closely-held corporation

C. A securities fraud lawsuit in federal court

D. A suit for involuntary dissolution of the corporation on grounds of oppression ("denial of reasonable expectations")

165. Family Conflict.

Sole is a director and the CEO of publicly-held Sunsweet Co. The corporation processes fruit for its own brand of juice and for other labels as well. The corporation has now decided to divest itself of the bottling plant and the vehicle fleet utilized for that particular endeavor. Mott, first cousin and childhood friend of Sole, bids at the appraised market price. Or, more accurately, he bids in the name of a corporation he has formed for the purpose of acquiring the assets.

Does the transaction require any special scrutiny or treatment?

A. No. Doing business with a director's first cousin or with an entity controlled by him is not a defined "conflicting interest" transaction.

B. Yes. A transaction with an entity controlled by a director or officer's cousin involves a conflict of interest. The transaction should receive special scrutiny by the disinterested directors.

C. Yes. Whether this is a conflict of interest is a question of fact that needs to be considered by the board.

D. Yes. Sole has a conflict of interest as a matter of law and the transaction is impermissible.

166. Stealing Information.

Horatio worked at a major bank on a team that analyzed leveraged buyout proposals. After the bank terminated his employment six months ago, Horatio kept his corporate identification, which he wears suspended from his neck. He has a magnetic key card for the elevator. He also long ago befriended the Saturday morning security guard who watches over the building lobby and elevators. The guard believes that Horatio still works for the bank. On Saturday mornings, Horatio buys a coffee "to go," passes through the lobby, greets the security guard, and rides the elevator to the 40th floor, where he rifles in the desks of his former co-workers. In this way, he has identified nine LBO targets, eight of which have gone forward. With some uncles, cousins, and college friends, Horatio has an "investment club" that has invested heavily in LBO target company shares. The club has made $2.3 million in profits. Horatio receives 30 percent.

Horatio is liable for insider trading, but in what capacity?

A. Insider

B. Temporary insider

C. Tippee

D. Thief (or misappropriator)

167. Dividend Issuance.

Bill, Pauline, and Steve each own one-third of the stock of a software company, Pear, Inc. Pear has been quite successful in selling its products. Pear has $100,000 in cash and $300,000 in accounts payable. Pear also has $1,000,000 in current accounts receivable. Pear's other assets and liabilities are negligible, at least on the balance sheet. Pauline and Steve have made offers on new houses that have been accepted. They wish to have the corporation declare a dividend of $200,000 each, $600,000 in all, to help them make the down payments on their new homes. A prospective venture capital investor requests that Bill, Pauline, and Steve obtain a letter of opinion from their counsel (you) that the distribution (dividend) is legal. Pear is incorporated in a jurisdiction that has a "double insolvency test" for distributions to shareholders.

What is the best argument for why Pear cannot issue this dividend?

A. Paying this dividend will cause an "impairment of capital."

B. Giving effect to the payment, Pear will be insolvent in the equity sense, although not in the balance sheet sense.

C. Giving effect to the payment, Pear will be insolvent in the balance sheet sense but not in the equity sense.

D. Giving effect to the payment, Pear will be insolvent in the balance sheet sense and in the equity sense.

168. Partridge Proxies.

Partridge developed a very successful foods product company, Partridge Orchards, Inc. When he died, his six children inherited the shares and now own the company. The siblings are young, inexperienced in business, and cannot agree regarding determination of corporate policy or who should be on the board. They fight all of the time. When they can agree to have meetings to discuss corporate affairs, which is seldom, they are at each other's throats within five minutes.

What is a potential solution to this closely-held corporate governance predicament?

A. Draft 5- or 10-year irrevocable proxies running to the eldest sibling, who is 23 years of age.

B. Implement a voting trust arrangement with the trusted family business adviser as trustee.

C. Have the six siblings enter into a shareholders' voting (pooling) agreement under which all six agree to vote as a majority of them (four) may agree.

D. Have the six siblings enter into a shareholders' voting (pooling) agreement under which, failing to agree unanimously, they appoint the trusted family business adviser to vote their shares.

169. Ultra Vires.

Lumber Company, Inc. (LCI), agreed to furnish plumbing supplies to your client, Mitchell Plumbing, at very advantageous prices (15–20 percent below what Mitchell had been paying for supplies). Open market prices for plumbing supplies then rose dramatically. LCI refused to furnish the supplies or otherwise honor the contract. Mitchell was forced to "cover" in the open market, paying 20 percent more than it had been paying and 40 percent more than the contract with LCI had provided. In the meanwhile, relying on its contract with LCI, Mitchell had bid on a number of jobs. Mitchell was the low bidder on all of them. Mitchell has completed the work but has suffered significant losses on each job, all due to the inflated price of plumbing supplies. Mitchell has sued LCI. LCI's counsel attempts to dismiss Mitchell's claim by responding that the LCI's promise to Mitchell, even if made, is unauthorized. LCI provides its articles, which show that LCI's purpose is limited to "sales of lumber and plywood products."

Should Mitchell's claim be dismissed?

A. No. LCI will be unjustly enriched if Mitchell is stuck with the losses.

B. No. Lumber and plywood are building products as are plumbing supplies. Hence, LCI had implied power to agree to furnish plumbing supplies.

C. No. The MBCA estops the corporation itself (as opposed to a shareholder) from raising lack of power or capacity in dealings with third parties.

D. No. Ultra vires cannot be raised in a case in which one side has partly performed.

170. Entity Choice — Golf Course.

Stuart, Vijay, and Fred are golf professionals. They propose to develop a championship-caliber golf course in the foothills of a nearby mountain range. They propose to sell 100 memberships for $75,000 each.

Which of the following is the best corporate structure for this business venture?

A. Limited liability partnership

B. Corporation

C. Limited liability company

D. General partnership

171. Takeover Defenses.

The senior executives of ENIX, Inc., a publicly-traded company, notice that, in recent weeks, the average daily trading volume in ENIX shares has tripled. Later that day, ENIX executives are notified by an SEC Schedule 13D filing that Goldman, a known corporate takeover specialist, has acquired over 12 percent of ENIX shares. ENIX's senior executives propose to give an option to purchase ENIX's new state-of-the-art manufacturing facility to a friendly "white knight" investor, McDuffy. McDuffy already owns 15 percent of ENIX shares.

What should the ENIX directors do before approving (or not approving) management's proposed "crown jewel option" defense strategy?

A. Do nothing apart from ensuring that the business judgment rule safe harbor protects them and any decision they may make.

B. Conduct an investigation to determine if a credible threat exists to ENIX's means of doing business.

C. Conduct an investigation and also ensure that the defense is proportionate to the threat posed.

D. Conduct an investigation and adopt an irreversible poison pill takeover defense.

172. Partnership Contract Liability.

Abe and Betty are law students at State University Law School. They each contributed $10,000 to their business venture. The business plan is to purchase computer hardware and then rent the equipment to their fellow law students. In the first month, however, Abe ordered over $20,000 worth of hardware on credit. Betty does not want to be personally liable for more than she contributed to the business.

What advice do you give Betty to avoid personal liability?

A. Betty should notify all computer hardware manufacturers that Abe is no longer authorized to place orders.

B. Betty should file a notice with the secretary of state to the effect that she does not take personal liability for Abe's purchases.

C. Betty should dissolve their partnership.

D. Betty should sue Abe for breach of fiduciary duty.

173. Settling a Derivative Action.

Shareholder filed a derivative action against Yesteryear, Inc., a public corporation. The court denied the corporation's motion to dismiss for failure to state a claim. Shortly after the court denied the motion to dismiss, the directors determined that the lawsuit was too expensive to maintain and authorized a settlement with Shareholder. Yesteryear's counsel called Shareholder's counsel to discuss the settlement, and ultimately, Shareholder accepted the offer.

What procedural requirements must be completed?

A. Shareholder and Yesteryear may file a notice of dismissal with the court.

B. The court must approve the settlement.

C. A derivative suit cannot be settled. The case must proceed to trial.

D. Shareholder must withdraw the complaint.

174. Pepsi-Cola.

Loft, Inc., a Delaware corporation, is an ice cream parlor and soda fountain company. The directors and senior executives are seeking ways to cut costs. For years, the corporation has bought syrup for its soda fountain soft drinks from Coca-Cola. Coca-Cola, however, will not negotiate a price reduction, despite Loft's volume purchases. The board, therefore, directs the CEO, Guth, to explore alternatives to Coca-Cola. In his market research, Guth discovers a little company with a cheaper product that has recently declared bankruptcy. Its name is Pepsi-Cola. Guth knows a good deal when he sees one and forms a company in his wife's maiden name. Using that company, he purchases the secret formula and the trade name to develop Pepsi Cola out of bankruptcy. A year into that process, Guth quietly resigns his position with Loft. Five years later, the Loft board of directors learns of what Guth has done. They sue him.

What result?

A. Guth is not liable because the corporation had no "interest or expectancy" in the Pepsi Cola opportunity.

B. Guth is liable because the opportunity is in a "line of business" in which the corporation is engaged or might reasonably be expected to be engaged, but he is liable only for the value of the opportunity at the time it was diverted.

C. Guth is liable, and a court will place a constructive trust on the stock of his new company because the opportunity should have gone to Loft.

D. Guth is not liable because his wife owns the stock.

175. Share Transfer Restrictions.

Four doctors form a professional service corporation in which each invests $750,000 in exchange for one-quarter of its shares. The corporation uses the funds to purchase state-of-the-art diagnostic equipment. From the outset, all four want to preserve their proportionate ownership interests by limiting the ability of a majority to issue additional shares, which would have the effect of diluting any shareholder's interest in the corporation.

Which of the following legal strategies is the best approach to achieve the shareholder's goal?

A. Draft a share transfer restriction (buy-sell) agreement.

B. Include preemptive rights in the corporate articles that govern issuances by the corporation.

C. Opt in to the preemptive rights provision of the MBCA.

D. All of the above.

176. Bad Director.

Xavier owns one-third of the shares in XYZ Corp. He used his entire vote allocation in cumulative voting to elect himself to one of three director positions on the board of directors. Thereafter, Xavier sexually harassed various employees of the company, and he once threatened to start a fistfight at a board meeting. You are counsel to XYZ. Shareholders, directors, and senior managers have all insisted that "Xavier must go."

How do you get rid of him?

A. Convene a special shareholders' meeting to remove him as a director by majority vote, with or without cause.

B. Go to court, alleging that he has grossly abused his position and that his removal would be "in the best interests" of the corporation.

C. Nothing. Xavier was elected by the shareholders and will serve his term until the next election.

D. Allege cause (probably required by articles or bylaws), convene a special shareholders' meeting, and remove him as a director by majority vote.

177. Mistakes in Formation.

Three people, Georgia, Hector, and Indigo, decide to start a business together. Georgia and Hector want to be silent partners, meaning that they will contribute $1 million each but will not actively run the business. Indigo plans to manage the business and invest business funds to purchase an antique car collection that the business will rent out to movie and television production companies for use in period pieces. Indigo hires her lawyer to set up the business as a corporation, but the lawyer forgets to pay the filing fee, so the corporation is not legally formed. Meanwhile, Indigo wins an auction to purchase an antique car collection for $2 million. But when the seller seeks payment for the cars, Indigo realizes that her lawyer never formed a corporation, and she refuses to pay for them. The seller sues Georgia and Hector in their personal capacity for the amount due on the contract for the cars.

What is the best legal defense for Georgia and Hector?

A. Invoke the de facto corporation doctrine.

B. Argue Georgie and Hector are not liable because they had no knowledge of the failure to form the corporation.

C. Argue that Georgia and Hector are not liable because they never purported to act on behalf of a corporation, only Indigo did.

D. There is no defense. Either a corporation exists for all purposes ("de jure") or it does not exist. It is an either/or proposition. Try to settle the case.

178. Poison Pill.

The senior executives of XINE, Inc., a publicly-traded company, notice that, in recent weeks, the average daily trading volume in XINE shares has tripled. Later that day, XINE executives are notified by an SEC Schedule 13D filing that Goldberg, a known corporate takeover specialist, has acquired over 13 percent of XINE shares. XINE's board holds an emergency meeting where they adopt a poison pill takeover defense. In response, Goldberg publicly disavows the takeover plans he had announced earlier. The price of XINE shares, which had climbed on the prospect of a possible takeover, drops. Goldberg silently sells the shares he has already acquired, pushing the XINE share price down further. A XINE shareholder files a suit against XINE and its directors, alleging breaches of the duty of care and loyalty. You are the litigator hired to defend the directors.

What should be your early responses to the suit?

A. Recommend expansion of the XINE board of directors and creation of a special litigation committee (SLC). Request an adjournment of the court proceedings while the SLC investigates the shareholder's allegations.

B. Recommend expansion of the XINE board of directors and hire a reputable independent counsel (who has done no work for the corporation or its directors in the past) to represent the SLC.

C. Let the suit proceed and file a motion for summary judgment on business judgment rule grounds after the facts have been developed through discovery.

D. File a motion to dismiss on grounds that demand was required and has not been made.

179. Can't Take It On.

Celeste is vice president of Hemlock, Inc., a forest products company incorporated in Delaware that has recently fallen on hard financial times and is scaling back its operations. While at a fundraiser for the school her children attend, Celeste is approached by Barbar, who describes a process he has developed for recycling used lumber into wood chips. The breakthrough is that the process removes nails and other impurities. Celeste telephones several acquaintances in the industry. They are extremely skeptical that it can be done, but they emphasize the potential if it can. Celeste also speaks with a banker about financing. She has one additional conversation with Barbar. Celeste resigns from Hemlock. She and Barbar form a new corporation, obtain a loan from the bank, and build a prototype. In no time, they are licensing the technology to all the major forest products and paper producing companies, except Hemlock. Hemlock hauls Celeste into court. You are defending.

What is the theory of your defense?

A. Recycling used lumber is neither in the line of business of a major forest products company nor in any line of business that such a company is likely to pursue.

B. Hemlock had no "interest or expectancy" in the opportunity.

C. Hemlock was having financial difficulties and, therefore, would not have had the wherewithal to pursue the technology. Hence, the opportunity was not a corporate opportunity.

D. Celeste breached no duty to Hemlock because, upon forming a resolve to develop the technology, she promptly resigned.

180. Shareholder Ratification.

Sam and Dave's, Inc., a clothing manufacturing company, lost money by investing significant sums in Sam's cousin's nightclub and then failing to monitor the club's (lack of) progress. Two shareholders, Lamont and Grady, who each own 10 percent of the shares, are implacable in their anger over the losses due to the ill-fated nightclub diversification. Sam asks if it can be fixed at the annual shareholders' meeting in two weeks.

Can Sam and Dave obtain protection by a favorable shareholder vote?

A. No. "Waste" of corporate assets is not ratifiable.

B. Yes. Just include a standard resolution ratifying all acts of the past year.

C. Yes, if specific disclosure is made concerning the investment and the ensuing losses and a majority of the shareholders approve.

D. No. Fiduciary duties are duties that are owed to each and every shareholder. A breach of those duties may only be ratified by a unanimous shareholder vote.

181. Film Projects.

Walter owns the movie rights to "Teenage Mutants." Sizemore asks Walter to join the Sterling Productions Co. board of directors, and Walter accepts. Shortly thereafter, the Sterling board discusses another property, "Nail Polish," but declines the movie rights. Walter then acquires "Nail Polish" and forms his own production company, Sparkling Walter, Inc., employing his children, Rickey and Victoria. They successfully produce "Mutants" and "Polish." Walter then has a falling out with Sizemore and resigns from the Sterling board. Sizemore demands a cut of Sparkling Waters's profits for the Sterling treasury.

Does Sizemore have a valid claim?

A. No. A director may compete with the corporation and, of the two properties, Sterling had no rights in one and turned down the other.

B. Yes. A director may not compete with the corporation under the "line of business" test.

C. Yes. Sterling may seek profits of "Polish" but not of "Mutants." Sterling never gave Walter permission to take up the "Polish" opportunity.

D. No. It is outlandish to think that a director may not pursue his own business interests.

182. Director Protections.

Sybil, the wealthy mother of your law school classmate Sylvia, wishes to join the board of Old Squirrel Savings and Loan, a publicly-held regional thrift institution corporation. Old Squirrel has had a history of making bad investments (loans), and its directors have been sued for breach of the fiduciary duty of care in the past. Now, however, Old Squirrel seems mostly clear from legal troubles. The derivative suits various shareholders have filed have all been settled or otherwise disposed of. Sylvia has sought to dissuade her mother from joining the Old Squirrel board of directors and, alternatively, has urged her mother to delay so that the picture can clarify even more. Sybil, however, is insistent. She feels this is her window of opportunity. On her mother's behalf, Sylvia seeks your advice on how Sybil may best be able to protect herself and her assets, which are considerable.

What advice do you give Sylvia regarding protecting Sybil?

A. Purchase a significant amount of stock in Old Squirrel so that you have a say in removing (or not slating for reelection) underperforming directors.

B. Do not join the board unless Old Squirrel has directors' and officers' (D&O) liability insurance.

C. Negotiate a contract with Old Squirrel on Sybil's behalf with multiple protections (e.g., indemnification, insurance, other funding sources for indemnification, exculpatory charter provisions) that will shield Sybil regardless of a change of control, a falling out, or subsequent charter amendments.

D. Review carefully the statutory indemnification provisions and determine whether the corporation has implemented them. Insist on implementation if the authority to indemnify granted by the statute has not been fully, or largely, implemented.

183. Martha's Troubles.

Martha is a television celebrity, known as a home decorating and lifestyle guru. She is a weekend house guest at the home of Peter Finch, the fabled stock picker. While going through the linen drawer in Finch's house, Martha finds a list of stocks labeled "Magellan — recommended purchases." She memorizes all the stock symbols (15 in all), and, when she gets home, she buys all 15 stocks, 14 of which turn out to be big winners. Her profits exceed $15 million.

In what capacity can Martha be prosecuted in federal court?

A. Insider, or temporary insider

B. Tippee

C. None

D. Misappropriator

184. CHC Oppression.

The Zook brothers, Zach and Jack, own a collection of movie theater properties. For tax reasons, the brothers hold the real property 50/50 through a series of limited partnerships. When the father and family patriarch died, he left 51 percent of the shares in the operating company, Silver Screens, Inc., to the younger and more educated Zach, and 49 percent to the older and less educated Jack. Immediately thereafter, Zach began recommending, and the board of directors approved, a series of substantial salary increases for Zach, the CEO. Jack got only small raises. Zach upgraded his company car to a luxury model, while Jack did not get a company car. Zach frequently forgot to give Jack notice of board and other meetings. At the meetings Jack did attend, Zach frequently shouted Jack down or told him he was "out of order" and to "keep his mouth shut." When Jack protested to other board members, he was moved to a small office at the end of the hallway, adjacent to the door leading to the garbage dumpsters. It has been three years since their father died. Nothing Jack has tried seems to work. He has become completely isolated from Silver Screens, his brother Zach, and other managers and board members. He wants to take action.

What legal action can Jack take to obtain more control over the corporation?

A. File suit for dissolution of the corporation on the ground that Jack has been "oppressed," and allege that the majority shareholder and the corporation have been "highly prejudicial" to Jack.

B. File suit for dissolution of the corporation on the ground that Jack has been "oppressed," and allege that the actions of Zach and the board have been "unduly harsh and burdensome."

C. File a suit in the name of the corporation alleging that the increased salary and perks Zach has received result from a breach of fiduciary duty and should be paid back to the corporation.

D. File suit and allege only that, as a substantial minority shareholder in Silver Screens, Jack has been denied his reasonable expectations and is therefore oppressed and entitled to the involuntary dissolution remedy.

185. SOX.

A publicly-traded corporation that operates throughout the United States has had several accounting irregularities that forced it to restate its earnings. Many items that should have been listed as expenses were falsely recorded as "capital expenditures," to be deducted over five years rather than one year. The result of these misstatements is that corporation shares have dropped 80 percent recently. This is the third company run by this same management team that has needed to restate its earnings in this way. You are the U.S. Attorney for a state impacted by this corporation.

What federal law remedies can you seek in this case?

A. A constructive trust on their stock option profits in favor of the company.

B. Forfeiture of compensation (salary and bonuses) received for the period during which they were in breach of their fiduciary duties.

C. Forfeiture of incentive-based compensation, such as stock option profits, for executives of the corporation.

D. Forfeiture of incentive-based compensation, such as stock option profits, for executives of the corporation, plus a lifetime or similar bar against this corporation's officers or directors from serving as officers or directors of another publicly-held company.

Answers

The Law of Agency

1. Introduction to Agency.

   "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Restatement (Third) of Agency § 1.01.

   This definition is critical for law school and bar exam purposes, and it must be committed to memory.

2. Painting Doctor's Office.

   Answer (D) is the best answer. "Agency is the fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Restatement (Third) of Agency § 1.01. Here, Doctor manifested assent that Painter would perform work for Doctor, on Doctor's behalf and subject to Doctor's control, and Painter consented to act on Doctor's behalf and subject to Doctor's control. Thus, the classic elements for an agency relationship have been established between Doctor and Painter.

   Answer (A) is incorrect. Although many courts have moved away from the vocabulary of "independent contractor" in favor of "agent" and "non-agent," *see* Restatement (Third) of Agency § 1.01, cmt. 2, this terminology still pops up from time to time. The term "independent contractor" is equivocal because it does not resolve the question of whether a principal–agent relationship exists because of the test enumerated in § 1.01. Thus, even if an individual is an independent contractor, they may still be an agent.

   Answer (B) is incorrect because a principal–agent relationship can exist even if the parties to the relationship never used those words and even if the parties did not realize the legal consequence of their actions would be the formation of a principal–agent relationship.

   Answer (C) is incorrect because it simply misstates the rule. The test for a principal–agent relationship is not whether the principal benefits from the agent's actions but rather whether the agent was acting on the principal's behalf and subject to the principal's control.

3. Power Washing.

Answer (B) is the best answer. This question explores the parameters of the classic distinction between employees and independent contractors. Under the Restatement (Second) of Agency, a "master [was] subject to liability for the torts of his servants committed while acting in the scope of their employment." Restatement (Second) of Agency § 219(1). On the other hand, independent contractors were typically not agents of the purported principal. The distinction between a servant (an employee) and an independent contractor turned on a number of factors, including "(1) the control exerted by the employer, (2) whether the one employed is engaged in a distinct occupation, (3) whether the work is normally done under the supervision of an employer, (4) the skill required, (5) whether the employer supplies tools and instrumentalities, (6) the length of time employed, (7) whether payment is by time or by the job, (8) whether the work is in the regular business of the employer, (9) the subjective intent of the parties, and (10) whether the employer is or is not in business." Restatement (Second) Agency § 220(2). The critical element, however, was "the extent of control exercised by the employer." *NLRB v. Friendly Cab Co.*, 512 F.3d 1090, 1096 (9th Cir. 2008). The Restatement (Third) of Agency abandoned the labels "master" and "servant," likely because the terms are outdated, but also because the term "independent contractor" is "equivocal." See Restatement (Third) of Agency § 1.01, cmt. c. Rather, the Restatement (Third) simply uses the terms "agent" and "non-agent" and directs that the ordinary definition of agency define the relationships of the parties. At least one court has recognized that, while the Restatement (Third) of Agency has repackaged the language of the provisions, this does not materially alter the analysis. *See United States v. Bonds*, 608 F.3d 495, 504-05 (9th Cir. 2010). Here, Power Washer certainly seems to meet the traditional definition of an independent contractor. Among other things, they are engaged in a distinct occupation, they supply their own tools and instrumentalities, they set their own schedule and do contract jobs, and they appear to be paid for the job. Thus, under the facts presented, it seems that Neighbor simply has no claim that Homeowner should be liable for Power Washer's conduct. This would change, however, if Homeowner were present and directing Power Washer's activities and giving Power Washer instructions. That would constitute Homeowner's exerting control over Power Washer and would likely place Power Washer in the position of employee under the Restatement (Second) or agent under the Restatement (Third).

Answer (A) is incorrect. Although there are some circumstances under which the purported principal might face liability for negligent hiring, there are simply no facts here to implicate that sort of liability. In fact, Homeowner's unfamiliarity with Power Washer seems to make it clearer that Power Washer would be an independent contractor or non-agent.

Answer (C) is incorrect. Although past work may weigh slightly more in favor of the Power Washer's being an employee rather than an independent contract, this is not likely enough to overcome the other factors that weigh the other way, especially if Homeowner is not exercising any sort of control over Power Washer's activities.

Answer (D) is incorrect. Whether power washing is a low-skill job is irrelevant. This alone does not impact the agent vs. non-agent analysis.

4. Driving the Painting.

Answer (C) is the best answer. Critically, "[a]n agent is subject to liability to a third party harmed by the agent's tortious conduct." Restatement (Third) of Agency § 7.01. Additionally, a principal is directly liable to third parties harmed by an agent's conduct when the agent acts with actual authority and the agent's conduct is tortious. *See* Restatement (Third) of Agency § 7.03. "An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act." Restatement (Third) of Agency § 2.01. Here, Family should assert claims against both Gallery and Driver. Family should assert a claim against Driver because Driver is the tortfeasor whose negligence caused them injury. Driver's liability to Family is not absolved merely because they were working as an agent for Gallery. Additionally, Family should assert a claim against Gallery for Driver's negligence because Driver was Gallery's agent and was acting with actual authority when they committed a tort. Gallery hired Driver to drive the painting, and thus, Driver's authority was to drive the painting for Gallery; therefore, it is as if Gallery itself was driving and injured family.

Answer (A) is incorrect because it overlooks Driver's liability as tortfeasor.

Answer (B) is incorrect because it overlooks Gallery's direct liability for Driver's tortious act while Driver was acting with actual authority.

Answer (D) is incorrect because Family has claims against both Gallery and Driver.

5. Catering the Family Reunion.

Answer (B) is the best answer. This question explores actual authority. "An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act." Restatement (Third) of Agency § 2.01. Actual authority may be express or implied. An agent acts with express actual authority "to take action designated or implied in the principal's manifestations to the agent," and implied actual authority to undertake "acts necessary or incidental to achieving the principal's objectives, as the agent reasonably understands the principal's manifestations and objectives when the agent determines how to act." Restatement (Third) of Agency § 2.02(a). Additionally, when an agent with actual authority makes a contract on behalf of the principal, the agent binds the principal on the contract. *See* Restatement (Third) of Agency § 6.01(1). Finally, the principal has a duty to indemnify (in this context, reimburse) the agent for losses that should fairly be borne by the principal in light of their relationship. *See* Restatement (Third) of Agency § 8.14. Here, Chef's best argument is that, by hiring Chef and instructing Chef to do what it took to get the job done, Family expressly authorized Chef to purchase and prepare the food and refreshment for the family gathering but also impliedly authorized Chef to do whatever was necessary or incidental to achieving the objective — such as hiring staff to help "get the job done." Additionally, to the extent Family's obligation to pay staff may sound in contract law, Chef was acting within the scope of their implied actual

authority when they hired the friends as staff. Accordingly, this would provide a sound basis to compel Family to pay the friends.

Answer (A) is incorrect. "Unjust enrichment is defined as the unjust retention of 'money or benefits which in justice and equity belong to another.'" *Tkachik v. Mandeville*, 790 N.W.2d 260, 48 (Mich. 2010). Unjust enrichment is typically a claim in equity, when there is otherwise no enforceable contract. Here, unjust enrichment may sound like a tempting answer. But consider the following: If Family did not authorize Chef to hire staff, would it truly be unjust for Family to be obligated to pay? Would it be a better argument to say that Chef took on a job they knew was too big for them without negotiating the authority to hire staff? Alternatively, if Chef had the authority to hire staff, it would likely be a better argument to claim that Family's obligation arose under contract law rather than equity. Thus, unjust enrichment is not the best answer here.

Answer (C) is incorrect because it focuses on Chef's dilemma without considering Chef's authority. The better argument here would be that Chef was authorized to hire staff.

Answer (D) is incorrect because Chef likely had authority to hire staff on Family's behalf, and thus, Family must pay the friends.

6. Surgery Gone Wrong.

Answer (C) is the best answer. This question explores apparent authority. "Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations." Restatement (Third) of Agency § 2.03. Critical here is the language "other actor" in the definition. This is to say that, under some circumstances, even a ***non-agent*** may possess apparent authority to bind the principal in tort. *See* Restatement (Third) of Agency § 7.03(b) ("A principal is subject to vicarious liability to a third party harmed by an agent's conduct when . . . the agent commits a tort when acting with apparent authority in dealing with a third party on or purportedly on behalf of the principal."). Always first consider whether the purported agent indeed is an agent acting with actual authority. If you conclude that the purported agent is not an agent, or if you conclude the purported agent is an agent but does not have actual authority, you should then consider apparent authority. Some courts will use the term "apparent agency" to describe circumstances in which a non-agent nevertheless possesses apparent authority to act on the principal's behalf. When the third party relies on the purported principal to select the purported agent, the test for apparent agency is as follows: "(1) the principal held itself out as providing certain services; (2) the plaintiff selected the principal on the basis of its representations; and (3) the plaintiff relied on the principal to select the specific person who performed the services that resulted in the harm complained of by the plaintiff." *Cefaratti v. Aranow*, 141 A.3d 752, 624 (Conn. 2016). When the third party selects the agent, they must show "(1) the principal held the apparent agent or employee out to the public as possessing the authority to engage in the conduct at issue, or knowingly permitted the apparent agent or employee to act as having such authority; (2) the plaintiff knew of these acts by the

principal, and actually and reasonably believed that the agent or employee or apparent agent or employee possessed the necessary authority . . . ; and (3) the plaintiff detrimentally relied on the principal's acts, i.e., the plaintiff would not have dealt with the tortfeasor if the plaintiff had known that the tortfeasor was not the principal's agent or employee." *Id.* Here, Smith did not select the orthopedist; rather, he was referred to the orthopedist by the Hillfield Emergency Room. Thus, even if we were to credit the argument that the orthopedist is not an agent of the hospital, the inquiry continues as to whether the orthopedist had apparent authority. Arguably, she did. Hillfield held itself out to the public as providing medical, and specifically orthopedic, services, and Smith selected Hillfield on that basis. Additionally, Smith relied on Hillfield's recommendation and referral to the orthopedist. All indicators apparent to Smith were that the orthopedist was Hillfield's agent. Thus, Smith can likely argue that the orthopedist's negligence can be attributed to Hillfield.

Answer (A) is incorrect. Even if the statement were factually true, the mere fact that someone is labeled an "independent contractor" does not mean that they are not an agent, or a non-agent with apparent authority, acting on the principal's behalf.

Answer (B) is incorrect. The contract between Hillfield and the orthopedist is irrelevant in determining whether the orthopedist had apparent authority. Additionally, because Smith was not a party to that contract, the contract cannot be used to alter Smith's rights.

Answer (D) is incorrect. This is merely a statement of policy, rather than law. On top of that, the statement of policy is arguable, and reasonable minds may differ on the importance of protecting hospitals under circumstances like this. In any event, it does not answer the question posed.

7. Traveling Salesman.

Answer (D) is the best answer. "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." Restatement (Third) of Agency § 1.01. Even when there is no principal–agent relationship, a non-agent may have the power "to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations." Restatement (Third) of Agency § 2.03. The key word here is ***manifestation***. "A person manifests assent or intention through written or spoken words or other conduct." Restatement (Third) of Agency § 1.03. Significantly here, the question is whether Acme Co. made any manifestations to "Chuck" for "Chuck" to act on its behalf or any manifestations to Lavery that "Chuck" was authorized to act on its behalf. Under the facts presented, the answer is no. There is no indication that Acme Co. ever manifested assent to "Chuck" that "Chuck" may act on its behalf, and so there is no principal–agent relationship between Acme Co. and "Chuck." Likewise, Acme Co.'s only interactions with Lavery occurred after Lavery encountered "Chuck." While "Chuck" claimed to work for Acme Co. and Lavery believed him, these manifestations are not traceable to Acme Co. Accordingly, "Chuck" did

not have apparent authority to act on behalf of Acme Co. Thus, Lavery is simply the victim of a scheme. Acme Co. likely has no liability here.

Answer (A) is incorrect. Under the facts given, there is no basis to conclude that a principal–agent relationship exists between Acme Co. and "Chuck."

Answer (B) is incorrect. This choice seems to offer a factual claim, which may or may not be true. Even crediting it as true, there is no indication that Lavery looked at the website before the encounter with "Chuck," and so the warning (or lack thereof) had no connection to whether Lavery reasonably believed "Chuck" had authority to act on Acme Co.'s behalf.

Answer (C) is incorrect. Although Lavery may have been reckless, the real question is whether Acme Co. made any manifestation to Lavery that "Chuck" was authorized to act on its behalf. There is no such indication here.

8. A Land Transaction.

Answer (C) is the best answer. This question describes a fairly common practice in real estate transactions. A principal is "undisclosed" when "an agent and a third party interact, [but] the third party has no notice that the agent is acting for a principal." Restatement (Third) of Agency § 1.04(2)(b). When an agent acting with actual authority makes a contract on behalf of an undisclosed principal, the parties to the contract are, in fact, the agent, the undisclosed principal, and the third party, even though the third party has no knowledge of the undisclosed principal. *See* Restatement (Third) of Agency § 6.03. It is of no legal consequence that the third party was unaware that they were even dealing with an agent. Here, Big Corp. was an undisclosed principal, and the secret agent was acting with actual authority when they entered into the transaction with Nora. Accordingly, Big Corp. is a party to the contract and Nora has no basis to seek to invalidate the deal.

Answer (A) is incorrect because the transaction is valid, even if Nora did not know she was dealing with Big Corp.

Answer (B) is incorrect because there is no unfair benefit to Big Corp., at least not under law.

Answer (D) is incorrect because, while it rightly states the status of the market, it does not address the legal issues at work.

9. The Title Agent.

Answer (B) is the best answer. The rule is that "an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances." Restatement (Third) of Agency § 8.08. This duty of care derives from tort law, but "an agent's conduct may sometimes be subject to regulation by statutes, administrative rules, or rules of a particular profession." Restatement (Third) of Agency § 8.08, cmt. b. "If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skill or knowledge." Restatement (Third) of Agency § 8.08. Further, when an agent is a member of

a profession, they "may reasonably be expected to know at least the basic rules and practices under which the agency's industry or profession operates." Restatement (Third) of Agency § 8.08, cmt. c. Here, Agent is an attorney and is therefore held to the higher standard of care consistent with Agent's specialized skill and knowledge, even though the work being performed does not have to be done by an attorney. Thus, Answer (B) correctly recognizes that, while a non-attorney agent may not have breached their duty of care in this situation, Agent here was expected to act with the care, competence, and diligence of an attorney.

Answer (A) is incorrect because it states too high a standard — strict liability instead of negligence — for breaching the agent's duty of care.

Answer (C) is incorrect because it fails to account for Agent's specialized skills and knowledge.

Answer (D) is incorrect because, in the absence of a contract, statute, administrative rule, or rule of a profession, *see, e.g.*, RUPA § 404(c) ("A partner's duty of care to the partnership and the other partners . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."), it raises the standard for breaching the duty of care to gross negligence.

10. Family Loyalty.

Answer (D) is the best answer. An agent owes their principal a general fiduciary duty to act in the principal's benefit in all matters connected with the agency relationship. *See* Restatement (Third) of Agency § 8.01. Additionally, an agent has a duty of loyalty to refrain from dealing with the principal on behalf of an adverse party, from competing with the principal, and from using or communicating a principal's confidential information for the agent's own purpose or the purpose of a third party. *See* Restatement (Third) of Agency §§ 8.02 to 8.05. Here, it seems clear that Nephew is in breach of his duties to National Store. He applied for a job without disclosing his relationship to Family Store, and then while on National Store's payroll, he essentially served as a spy. More significantly, he gave light to facts that may not have otherwise become publicly known, seemingly for the purpose of hurting National Store so that Family Store would have a better opportunity to compete. It may well be that Nephew did not divulge strictly "confidential" information, at least in the sense of how information might legally be deemed confidential or privileged, but it seems that this information only came to light because of Nephew's reporting. Accordingly, Nephew is likely liable for breach of fiduciary duty to National Store.

Answer (A) is incorrect because the information only came to light because of Nephew's conduct. Strictly speaking, Nephew may not have revealed "confidential" information, but there are certainly other grounds for claiming that he breached his fiduciary duties.

Answer (B) is incorrect because the mere competitive nature of the marketplace is of no legal consequence. Instead, Nephew occupied a position of trust with National Store, and accordingly, owed National Store a fiduciary duty.

Answer (C) is incorrect because the law does not specifically prohibit an agent from disparaging its principal, but even disparagement aside, there are more grounds here to conclude that Nephew breached his fiduciary duties.

11. So Much Stuff.

Answer (C) is the best answer. An agent's actual authority is terminated by a manifestation of revocation of the agent's authority by the principal. *See* Restatement (Third) of Agency § 3.06(5). Termination of actual authority, however, does not necessarily terminate any apparent authority that the agent may have. An agent has apparent authority so long as a third party reasonably believes that the agent has authority to act with legal consequence for a person and that belief is traceable to manifestations of the person. *See* Restatement (Third) of Agency § 3.03. The termination of actual authority does not terminate the agent's apparent authority, and the agent's apparent authority only terminates when "it is no longer reasonable for the third party with whom an agent deals to believe that the agent continues to act with actual authority." Restatement (Third) of Agency § 3.11(2). Here, the owner terminated Franklin's actual authority when they fired Franklin from her position as manager of Bakery; however, there is no indication that the owner then contacted the vendors to inform them that Franklin had been terminated. Having dealt solely with Franklin for the past seven years, there is no reason why the vendors should have been aware that Franklin had been fired or that Franklin no longer had authority to place orders. Accordingly, the owner is likely on the hook to pay for the products that Franklin ordered after she was terminated.

Answer (A) is incorrect because termination of actual authority does not terminate apparent authority.

Answer (B) is incorrect because there is no reason why the vendors should have suspected that Franklin had been fired or for them to contact the owner.

Answer (D) is incorrect because fairness alone does not resolve this case. Apparent authority does.

General Partnerships

12. Pike Patrol.

Answer (D) is the best answer. Formation of a partnership is defined as "an association of two or more persons to carry on as co-owners a business for profit whether or not the parties intend to form a partnership." RUPA § 202(a). So in many cases we examine all the facts and circumstances to determine whether a partnership was formed. For example, one court delineated eight factors a court must weigh in determining if a partnerships exists: (1) the right and duty to participate in management; (2) the right and duty to act as agent for the other owners; (3) unlimited exposure to liability; (4) participation in profits and in losses; (5) contribution (investment) in the firm; (6) ownership stake in the firm's property; (7) voting rights; and (8) the form which compensation takes. *Serapion v. Martinez*, 119 F.3d 982 (1st Cir. 1997). This is the best answer because it addresses more of these factors than the other answers.

Answer (A) is not the best answer. Under RUPA, intention (or lack thereof) is not dispositive. The parties may have intended nothing in particular (they did not think about it) but a partnership can result.

Answer (B) is not the best answer. Although receiving profits and losses is one factor in determining whether there is a partnership, parties can form a partnership even where some receive different payments than others do. On the other hand, financial benefits determined by taking a percentage of profits may nonetheless be wages. Sharing of profits and losses is just one of many factors in determining whether a partnership exists. Co-ownership does not necessarily imply a partnership.

Answer (C) is not the best answer. Although this fact tends to show that Dooley and Estrada were independent contractors because they were required to purchase their own equipment, standing alone, this fact would not be dispositive.

13. Home State Athletics, Part I.

It appears that the trio have formed a general partnership. More precisely, they have formed a partnership at will. No writing is necessary for the formation of a partnership. All that is necessary for formation of a partnership is "an association of two or more persons to carry on as co-owners a business for profit." RUPA § 202(a). Alternatively, it may be that Ursula is not a partner but a lender to the business. The receipt by a person of a share of profits of a business is prima facie evidence that he is a partner in the business, but no such inference

shall be drawn if such profits were received in payment as interest on a loan, though the amount of payment may vary with the profits of the business. *See* RUPA § 202(3)(i). To solve this ambiguity, while the parties are in your office, the easy solution is to ask them what they intend Ursula's status to be. If they want Ursula to be a partner and not just a lender, you might structure part or all of Ursula's financial contribution as partner's equity.

14. Home State Athletics, Part II.

You should probably draft a partnership agreement for them. You may also have to draft a promissory note from the partnership to Ursula if the parties decide that all, or a portion, of Ursula's contribution is to be structured as a loan. Three salient features of the agreement would be how the partners are to divide the profits, how the partners are to share the losses (if any), and what the duties and responsibilities of each partner will be (for example, who maintains the warehouse and inventory, who will have what sales territory, how much time is to be devoted to sales, who keeps the partnership books, etc.).

15. Home State Athletics, Part III.

If they do not draft a partnership agreement, they are partners at will. The consequences of a partnership at will is that the partners will split the profits equally. Upon dissolution, "[e]ach partner shall be repaid his [or her] contributions whether by way of capital or advances to the partnership property and share equally in the profits and surplus remaining after all liabilities[.]" RUPA § 401(b). So, what happens in the event of dissolution depends on whether there is a surplus of losses. If there is a surplus, Ursula's disproportionate contribution will be repaid in full first, and then the others will share in the remainder. It is the event of losses for which parties tend not to provide and which may cause difficulties in a partnership at will situation. A number of courts have held that in the event of a dissolution in a partnership consisting of a partner who has contributed primarily capital (Ursula) and partners who have contributed primarily services (Sammie and Tyrese), neither party is entitled to a contribution from the other when there are losses. The reasoning is that "where one party contributes money and the other labor, then in the event of loss each would lose his own capital — the one his money and the other his labor." *Kovacik v. Reed*, 315 P.2d 314 (Cal. 1957). A number of jurisdictions follow this rule. *See, e.g.*, *Becker v. Killarney*, 532 N.E.2d 931 (Ill. App. Ct. 1988); *Snellbaker v. Herrmann*, 462 A.2d 713 (Pa. Super. Ct. 1983). This result is bad for Ursula, and it may be unexpected by all because it is counterintuitive. To avoid disputes later, the parties are better off agreeing or at least discussing whether Sammie and Tyrese should in some fashion make monetary contributions in the event of losses.

16. Home State Athletics, Part IV.

Sam and Charlene can just give Dave notice that they are dissolving the partnership. Dissolution is the change in the relation of the partners caused by any partner's ceasing to be associated in the carrying on of the business. In the absence of an agreement to the contrary, dissolution is caused "by the express will of any partner." RUPA § 801(1). So they should check the terms of the partnership agreement, if any. If the partnership agreement is silent,

or there is no partnership agreement, Sam and Charlene may dissolve it by simple notice to Dave, to be followed by a "winding up" of the partnership affairs.

17. Home State Athletics, Part V.

Sammie and Tyrese may or may not have legal rights against Ursula for her absences, for her failure to supervise, and for the losses resulting from her absences and failure to supervise. The key thing is for Sammie and Tyrese to couch their claims in terms of Ursula's fiduciary duties to the partners and their partnership. However, Sammie and Tyrese must show that Ursula was more than merely negligent. RUPA § 404(c) states, "A partner's duty of care to the partnership and the other partners . . . is limited to refraining from or engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law." Unless they can show that Ursula was grossly negligent or worse, Sammie and Tyrese probably do not have a cognizable claim. Under RUPA, they should have been stopping in at the Central City facility periodically in order to assure themselves that Ursula was managing things properly.

18. Joint Microbrewery.

Answer (D) is the best answer. A joint venture is the association of two or more persons or entities in business for a limited purpose, but a joint venture is not a form of business association itself, so it must take some form. In this case, the parties have formed a partnership, which is best understood as a joint venture operation. So the best answer is Answer (D) because this venture is both a partnership and a joint venture.

Answer (A) is not the best answer because it is incomplete. While it is true that the parties formed a partnership by carrying on as co-owners a business for profit, that business has a limited purpose, and so it is also a joint venture.

Answer (B) is not the best answer because it is incomplete. While it is true that the parties formed a business for a limited purpose, they also formed a partnership under RUPA at the same time.

Answer (C) is incorrect because parties cannot form LLCs inadvertently. If, however, the co-venturers (Liam and Clare) take no affirmative steps to form a business organization such as a corporation or an LLC, their joint venture will be a partnership at will ("an association of two or more persons to carry on as co-owners a business for profit[.]" RUPA § 202(a)).

19. The Partnership Lease Renewal.

Answer (D) is the best answer. As you read this fact pattern, you likely thought about the landmark case of *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928), in which then Judge (later Supreme Court Justice) Benjamin Cardozo announced a lofty standard of fiduciary duty. There, Judge Cardozo depicted fiduciary duty as "something stricter than the morals of the market place" and that the standard was that a fiduciary owed "the punctilio of an honor of the most sensitive." *Meinhard* involved what was regarded at the time as a "joint venture,"

which does not line up well with our understanding of general partnerships (such as the one in this fact pattern) today. Thus, Cardozo's views are likely modernly regarded as more aspiration than law, particularly in light of RUPA's articulation of a distinct fiduciary duty standard. RUPA § 404(a) instructs that "[t]he only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care. . . ." A partner's duty of loyalty, owed both to the partnership and to the other partners, is limited to requiring the partner to (1) account to partnership and hold property, profit, or benefit for partnership; (2) refrain from acting with an adverse interest; and (3) refrain from competing with the partnership. *See* RUPA § 404(b). Although the obligations under the statute are not framed explicitly as fiduciary duties, RUPA provides that "[a] partner shall discharge the duties to the partnership and the other partners . . . and exercise any rights consistently with the obligation of good faith and fair dealing." RUPA § 404(d). Answer (D) best reflect the rules of fiduciary duty under RUPA.

Answer (A) is incorrect because it reflects the aspirational standard from *Meinhard* and fails to consider the duties imposed under RUPA § 404(a). Some states have rejected the limiting language in RUPA § 404(a) that the "only" fiduciary duties owed are the duties of care and loyalty, *see, e.g.*, 15 Pa. Cons. Stat. § 8447(a). In these states, courts may find that partners owe a broader fiduciary duty than articulated by the statute and may be more inclined to apply Cardozo's aspirational standard (or something like it).

Answer (B) is incorrect because Developer's conduct does not seem to run afoul of any of the requirements under the duty of loyalty stated in § 404(b).

Answer (C) is incorrect because it misstates the rule. RUPA § 404(a) is clear that a partner owes fiduciary duties to both the partnership and the other partners.

20. Partnership Auto Purchase.

Answer (D) is the best answer because there is no obvious source of authority for this unusual or extraordinary transaction. While it is true that partners can bind the partnership in ordinary affairs ("Every partner is an agent of the partnership for the purpose of its business, and the act of every partner . . . for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership," RUPA § 301), ordering luxury automobiles cannot be said to be carrying on in the usual way the business of a law partnership. The managing partner probably would not have the power to bind the law firm in such an unusual transaction. What a lawyer will advise a client to obtain is "express actual" authority that the agent for the counterparty has the authority to bind the entity (i.e., the partnership, the corporation, the LLC) for which he is acting. A provision in the partnership agreement (or articles or bylaws in the corporate setting) may contain a broad grant of authority to the agent. More probable is that the lawyer will request a resolution from a partnership or board meeting authorizing the partner or corporate official to carry out the transaction.

Answer (A) is incorrect because a careful lawyer should not rely on the vague concept of inherent authority in such a case as this one. It is true that partnerships grant some degree of

inherent authority by vesting offices and titles in a person, but this is limited to the authority possessed by similar agents, with similar titles, and in similar types of businesses. Look to the left, look to the right, see what similar agents in similar corporations actually do. Treasurers sign checks. Purchasing agents purchase automobiles. Purchasing agents, or here, managing partners of medium-sized law firms, do not order luxury automobiles (and in great numbers, to boot). Even if the transaction proposed was arguably in the realm of the managing partner's or other official's inherent authority, before the fact, in a transaction of any size, no reasonable business lawyer would rely on inherent authority. Inherent authority is more suited to smaller or routine transactions or, after the fact, for argument in arbitration or court proceedings that the other party to a contract is bound.

Answer (B) is not the best answer because it is better to get prior authorization of a transaction instead of arguing it existed in a past transaction. A particular agent may have very similar authority through having done the same or similar transactions in the past. This source of authority is called implied actual authority. Again, though, as with inherent authority, implied actual authority is more suited to smaller or routine transactions or, after the fact, for argument in arbitration or court proceedings.

Answer (C) is incorrect. If the principal has created in third parties a reasonable apprehension that the agent has the authority to enter into the transaction, the principal will be bound because the agent is clothed with apparent authority. The principal could do so by provision to the agent of office, stationery, title, and so on, or by having permitted the agent to engage in similar acts in the past and not rescinding them or otherwise objecting. In many cases in which implied actual or inherent authority is present, apparent authority also is present. But, yet again, no transactional lawyer is going to advise a client to enter into a major transaction based upon the apparent authority of a managing partner.

21. A Ponzi Scheme.

Answer (A) is the best answer. A partner is an agent of the partnership, and an action of the partner in the ordinary course of the partnership's business binds the partnership. *See* RUPA § 301(a). On the other hand, "an act of a partner which is not apparently for carrying on in the ordinary course the partnership business . . . binds the partnership only if the act was authorized by the other partners." RUPA § 301(b). Here, the question is whether Turner's scheme was in the ordinary course of the partnership's business. It is clear that Turner did not have actual authority to run this scheme, since his 50/50 partner did not even know it was happening. The question of whether the partnership authorized this actually turns on whether Turner had apparent authority. The question, therefore, is whether a reasonable third party, such as a client like Norma, should expect this conduct to be authorized. And what is common or public understanding does not turn on expert opinion.

Answer (B) is incorrect. There simply is no evidence that Norma was "contributorily negligent."

Answer (C) is not the best answer. This expert testimony does not seem to address what the public would reasonably expect.

Answer (D) is incorrect. The judge should bar the testimony of the bar association president and other leading members of the bar as irrelevant. This is not a toss-up question.

Note: A Ponzi scheme is a prevalent species of fraud. The scheme's promoter promises and pays high rates of return by using funds contributed later (as principal) to pay interest on funds contributed earlier, which have been spent for personal expenses or otherwise squandered. Eventually the scheme collapses when the promoter is unable to attract new investors. The form of fraud takes its name from Carlo Ponzi, who apparently developed this scheme in the 20th century.

22. Can't Stop Shopping.

Answer (D) is the best answer because Joseph must be prepared to dissolve the partnership because there is no effective way to restrict Larry's authority and have that restriction bind third parties. As with the absence of a duty of care among partners, this outcome, too, lends support for the proposition that in a small partnership a partner truly is their sibling's keeper.

Answer (A) is incorrect because Joseph does not have unilateral authority to restrict his 50/50 partner's spending. *See* RUPA § 401(j) ("A difference arising as to a matter in the ordinary course of business of partnership may be decided by a majority of the partners.") Restricting a partner's authority requires a decision by majority vote of the partnership, which is effectively a unanimity requirement where there are just two equal partners.

Answer (B) is incorrect because there is no such thing as a partner's veto in such ordinary matters as ordering office supplies. In a two-person partnership, a majority is 50 percent plus one. If Larry refuses to cooperate, there is no way in which Joseph can vote to restrict Larry's authority.

Answer (C) is incorrect. Joseph cannot associate a new partner because that action requires unanimous consent by the partners. RUPA § 401(i) ("A person may become a partner only with the consent of all the partners."). Thus, Larry could, by withholding his consent, block any attempt to end-run him by expanding the partnership.

23. A Grouchy Partner.

Oscar is likely to win. *See* RUPA § 401(i) ("A person may become a partner only with the consent of all the partners."). The partnership must act for the hire to be enforceable against it. The partnership acts by a majority. A majority of two (50 percent plus 1) is two. Elmo had only one vote (his own). His act was not authorized by the partnership and so he is liable to the partnership for its cost. Accordingly, Elmo did not have authority to hire a helper and will be required to reimburse the partnership.

24. Ken the Contractor.

Answer (B) is the best answer because these facts present a common law exception to a general statutory rule, although not all jurisdictions will follow that exception. The ordinary rule, at least when all partners are contributing capital (property and/or cash), is "[e]ach

partner . . . must contribute towards the losses whether of capital or otherwise, sustained by the partnership according to his share in the profits." RUPA § 401(b). Many states hold that when one partner is a pure capital contributor and the other is a pure talent/labor contributor, they do not share in financial losses. *See , e.g.*, *Kovacik v. Reed*, 315 P.2d 314 (Cal. 1957) ("The rationale of this rule . . . is that where one party contributes money and the other contributes service, then in the event of a loss each would lose his own capital — the one his money and the other his labor.").

Answer (A) is incorrect, though it is a plausible answer because a court could follow the statutory language if a particular jurisdiction does not have higher court precedent that deviates from it, but it reaches a harsh and inequitable result. Courts may also attempt to distinguish the present situation from ones where unequal contributions were equitable, but this is not the best answer because most courts would probably at least consider Ken's claim that he did not expect to share losses.

Answer (C) is incorrect because, absent agreement, a partner is not entitled to remuneration for services to the partnership, so the fair value of those services is irrelevant.

Answer (D) is incorrect because, absent agreement, a partner is not entitled to remuneration for services to the partnership, so the fair value of those services is irrelevant.

Note: Several jurisdictions have case law expressly following the rule in *Kovacik v. Reed*. The ramification for the business lawyer is thus: (1) always discuss with clients how they intend to share losses as well as how they intend to share profits; and (2) memorialize their agreement in the partnership agreement. Unless the parties expressly provide otherwise, at least in the capital versus talent/labor partnership, the somewhat counterintuitive rule of *Kovacik v. Reed* might be applied.

25. Norse Demolition.

Answer (B) is the best answer. Oden's notice of retirement is an event that causes Oden's dissociation from the partnership. RUPA § 601(1). The default rule is that a partner's dissociation by express will is an event of dissociation that causes the partnership to dissolve and requires that its business be wound up. RUPA § 801(1). RUPA, recognizing that the partnership is an entity distinct from the partners, offers a way forward. Thus, "[a]t any time after the dissolution of a partnership and before the winding up of its business is completed, all of the partners, including any dissociating partner other than a wrongfully dissociating partner, may waive the right to have the partnership's business wound up and the partnership terminated." RUPA § 802(b). In such an event, the partnership may continue as if it was never dissolved. The partnership shall cause the dissociated partner's interest to be purchased for a buyout price. *See* RUPA § 701(a). Here, the facts indicate that all the partners, including the dissociated partner (Oden), are agreeable to allowing the partnership to continue even though Oden has dissociated. Accordingly, the partners may waive the right to have the partnership's business wound up, and Theo and Luke shall cause Oden's interest to be purchased. Then, the partnership can continue as if it had never been dissolved, with Theo and Luke at the helm.

Answer (A) is incorrect because, while it states the general rule correctly, it fails to account for the fact that the partners may waive the right to have the business wound up and the partnership terminated.

Answer (C) is incorrect. Dissociation is wrongful only if the partnership agreement is violated by their dissociation. *See* RUPA § 602.

Answer (D) is incorrect. Indeed, the partners may certainly agree to avoid the outcome provided by the default rules of RUPA.

26. Two Taverns.

Answer (B) is the best answer. A partner has a right to dissociate at any time by express will. *See* RUPA § 601(1). There are two general routes once a partner dissociates: either the partnership is dissolved, the business is wound up, and the partnership is terminated, or the partnership continues and causes the interest of the dissociated partner to be bought out. *See* RUPA § 603. The problem here is that there is not enough cash for Pat (or the partnership) to buy Mike out. This complicates things because "[a] partner has no right to receive, and may not be required to accept, a distribution in kind," (i.e., a distribution in the form of partnership property). RUPA § 402. Thus, if Pat or the partnership cannot cause Mike's interest to be bought out, all of the partnership profit must be liquidated and split between the partners according to their right to share in the partnership profits. That's the only route that works here.

Answer (A) is incorrect because Pat cannot force Mike to take an in-kind distribution. Thus, if Pat cannot come up with cash, the only option is to sell everything.

Answer (C) is incorrect because Mike cannot make a unilateral election to sell just one of the taverns. The parties would have to agree on what assets to sell and what to keep.

Answer (D) is incorrect because this would be an in-kind distribution, which Mike will not agree to and cannot be forced to accept.

27. Breaking Up.

Answer (A) is the best answer. Partnerships are consensual in nature. A partner's withdrawal, and the ensuing dissolution of the partnership, is wrongful only if it is in contravention of the partnership agreement. RUPA § 602(b) defines "wrongful" as dissolution that is "in breach of an express provision of the partnership agreement," which implies that anything not in breach of that agreement is not wrongful. Here, we see an unfortunately typical pattern where the stronger partner withdraws in an opportunistic manner, setting up in business alone or with someone else.

Answer (B) is not the best answer because there is no evidence that the partners joined together for a "definite term or particular undertaking" under RUPA § 602(b)(2). While Keith can locate cases finding that partners who intended to continue the partnership for a term were required to allow the partnership to earn sufficient funds to accomplish the objective understood by all the partners, and where paying off startup expenses is a common objective, Keith simply has no evidence to this effect.

Answer (C) is not the best answer because Belinda did not use threat of withdrawal to extract concessions from Keith. Rather, Belinda made a "clean break," where she left without taking partnership property.

Answer (D) is not the best answer because it is incomplete. While it is true that Keith has no claim because Belinda did not take anything that belonged to him or the partnership, if there had been a partnership agreement with a provision protecting Keith from the dissolution, Keith would have a claim against Belinda. Partnership law does not have, as an objective, making all partners equal in all things. There is no perfectly level playing field.

28. Partnership Departure Planning.

Up until the date of departure, Megan should continue to perform her partnership obligations in good faith and in accordance with the letter of the partnership agreement. Your discussion points may include some of the following:

(1) If the agreement requires advance notice of her withdrawal, she should give such notice; otherwise, her withdrawal will be wrongful. Once she gives notice, she may be treated as a pariah, but some discomfort is better than a suit for wrongful withdrawal.

(2) If cases are ripe for settlement, she should settle them. She should not postpone settlement to a date when her own partnership will enjoy the entire fee. She should make reasonable efforts to avoid continuances in her cases and conduct discovery at her normal pace.

(3) She should not use firm resources (copy machine, telephone, and so on) to develop her new partnership.

(4) She should work during normal working hours. She should meet with the architect, the office machine salesperson, and so on, on Saturdays, or after normal working hours.

(5) She may take her clients, and their files, with her, but first she must obtain their consent. The choice of representation is the client's and not the law firm's or the lawyer's. In seeking such consent, she should avoid misrepresentation or puffery. The notice must be "brief, dignified, and not disparaging of the lawyer's former firm." The notice should be sent only to persons with whom the lawyer has an active attorney-client relationship and not to other of the firm's clients.

(6) The law firm may also send to the clients solicitation letters and authorization forms.

(7) If asked, be truthful. Thus, if the firm asks which clients Megan intends to take with her (so the firm may conduct a dueling solicitation), she must provide the information. RUPA § 403(c) provides that a partner has an obligation to render on demand true and full information of all things affecting the partnership and the partner.

(8) The firm associates are employees. She should not offer them employment with the new firm before she has left the old firm. The day after she leaves, she may offer them positions with the new firm.

29. Partnership Expulsion.

Answer (A) is the best answer. A partner's expulsion is an event of dissociation. *See* RUPA § 601(3). But the expulsion of a partner is not an event of dissociation that causes the dissolution of the partnership. *See* RUPA § 801(1). Instead, the partnership shall cause the interest of a dissociated partner to be purchased for a buyout price. *See* RUPA § 701(a). Underscoring their conclusions with observations about the consensual nature of partnerships, courts have upheld such clauses in the face of a number of policy objections. Partners who have been expelled by a vote of their partners because of, for example, their political activities (including actions taken as a state senator), their reporting of their law partners' ethics rules violations, or their former alcoholism, have failed to win damages for wrongful expulsion.

Answer (B) is incorrect because the expulsion of a partner does not cause the partnership to be dissolved.

Answer (C) is not the best answer. Although it correctly states the proposition that partners must "exercise any rights consistently with the obligation of good faith and fair dealing," RUPA § 404(c), it fails to consider what effect the expulsion has on the partnership.

Answer (D) is incorrect. The First Amendment has no applicability because no governmental action is involved.

30. Partnership Finances, Part I.

Answer (D) is the best answer. Partners are not co-owners of partnership property or funds. *See* RUPA § 501. Instead, each partner is deemed to have a "capital account" that is credited with the amount of any contribution the partner has made and the partner's share of the partnership profits, and that is charged the amount distributed to the partner and the partner's share of the partnership losses. *See* RUPA § 401(a). In other words, the capital account fluctuates; however, the partner is not immediately entitled to the balance of their capital account. Additionally, as a matter of default rules, "[e]ach partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner's share of the profits." RUPA § 401(b). Finally, once the partnership has been dissolved and its business wound up, no partner is entitled to a distribution from their capital account until the capital accounts are settled, *see* RUPA § 807(b), but under some circumstances, the partners may agree to pay interim distributions. Here, the $5,000 profit is strictly partnership property, and neither partner is entitled to immediate payment of any profit. Instead, because they share profits evenly, both of their capital accounts will be credited with their share of the profits.

Answer (A) is incorrect because the partners have no individual interest in the partnership profits, nor are they entitled to immediate payment. Additionally, if there were to be

a distribution to the partners, the amount of the distribution would be charged against the partners' capital accounts.

Answer (B) is incorrect because the partners have no individual interest in the partnership profits, nor are they entitled to immediate payment.

Answer (C) is not the best answer because it only states half the rule. While it is true that the profits are partnership property, the capital accounts of the partners should be credited for their share of the profits.

31. Partnership Finances, Part II.

Answer (C) is the best answer. "[A]ll partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law." RUPA § 306(a). After the dissolution of the partnership and the winding up of its business, "[a] partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account." RUPA § 807(b). If any one partner fails to contribute to cover the loss, the other partners are required to do so. *See* RUPA § 807(c). The bottom line is that, when dealing among themselves, the default rule is that partners share equally in the profits and losses of the partnership, and each partner is on the hook for the full extent of the partnership's obligations when it comes to third parties. If there is a disparity, then the partners can settle it among themselves. Here, Answer (C) best reflects the contrast in the obligations among the partners and the obligations of the partners to third parties.

Answer (A) is incorrect. The partners are jointly and severally liable for all of the partnership's obligations.

Answer (B) is incorrect. Although when dealing among themselves, the partners split the profits and losses equally, each is jointly and severally liable to third parties for the obligation.

Answer (D) is incorrect. While this choice correctly states the partners' liability to third parties, it fails to account for how the partners allocate profits and losses among themselves.

32. Partnership Finances, Part III.

Answer (B) is the best answer. The actual calculation of the tax liability is beyond the scope of a traditional Business Associations course, but it is important for lawyers to understand the basic tax framework. A general partnership is a "pass through" entity for purposes of federal income tax liability. That means that each partner is responsible for the federal income tax liability for their respective share of any profits that the partnership experienced, and that each partner may claim their respective share of any partnership losses. The partner's capital account should be credited with their share of the profit or charged for their share of the losses. *See* RUPA § 401(a). The partnership should issue each of the partners an IRS Form K-1 at the end of the tax year to reflect the adjustment of the balance of the partner's capital account. The partnership may file a federal income tax return, but this is informational only. The partnership does not bear any responsibility for the federal income

tax liability. Significantly, the partnership may owe liability for other taxes under federal or state law. Keep in mind, of course, that by default, a partner is not entitled to distributions until the partnership is dissolved, its business is wound up, and the accounts are settled. Even if the partnership agreement provides for interim distributions, or even if the partners themselves desire to make an interim distribution, they may not be able to do so if making the distribution would render the partnership insolvent or unable to pay its debts as the debts come due in the ordinary course. Thus, this exposes the partner to tax liability for profits they may never receive in their own pocket, and this is one of the key considerations that lawyers should talk to clients about when discussing appropriate business entities for the clients' ventures. In this case, the partnership earned $10,000 in profit. Because Paul and Olivia share the profits evenly, each will be responsible for the federal income tax liability for $5,000, and their capital accounts should be credited with the $5,000 profit.

Answer (A) is incorrect. The partnership itself does not bear any responsibility for federal income tax liability.

Answer (C) is incorrect. The partners are responsible for the federal income tax liability, even if they have not received a distribution.

Answer (D) is incorrect. Although this answer choice rightly places the federal income tax liability on the partners, it wrongly states that the partners' financial interest in the partnership will be unaffected. In fact, the partners' capital accounts will be credited for their share of the profits.

33. Landscaping Liability.

Answer (D) is the correct answer. One of the scariest features of the general partnership is that the partners are each jointly and severally liable for all of the obligations of the partnership. *See* RUPA § 306(a). To compound this, "[a] partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with authority of the partnership." RUPA § 305(a). Finally, each partner is an agent of the partnership for the purposes of its business, *see* RUPA § 301(a), and under ordinary principles of agency law, "[a]n agent is subject to liability to a third party harmed by the agent's tortious conduct." Restatement (Third) of Agency § 7.01 Thus, the liability proceeds in three steps. First, the agent/partner is always liable for their own tortious conduct. Second, the partnership is liable for any harm caused by a partner acting in the ordinary course of business. Finally, each partner is jointly and severally liable for the partnership's obligations. Here, the bystander should sue the partnership, Foster, and McGee. The bystander may sue Foster because Foster is the one who negligently caused the injury. Next, the bystander may sue the partnership because the partnership is liable for the injuries caused by Foster's negligence while Foster was acting in the ordinary course of business. Finally, the bystander may sue McGee (and Foster, too) because, as a partner, McGee is jointly and severally liable for the partnership's obligations.

Answer (A) is incorrect because it fails to account for the partnership's liability for Foster's negligence and McGee's (and Foster's) joint and several liability for the partnership's obligations.

Answer (B) is incorrect because it fails to account for Foster's individual liability as the person who negligently caused damage and McGee's (and Foster's) joint and several liability for the partnership's obligations.

Answer (C) is incorrect because it fails to account for McGee's joint and several liability for the partnership's obligations.

LLCs and Other Unincorporated Entities

34. Investment Actors.

Answer (D) is the best answer. A limited liability company provides liability protection for all members, it offers a flexible management structure which allows the members to participate in management (or to be silent partners), and it can be taxed like a partnership.

Answer (A) is a bad answer. A general partnership is not a good idea. The partners would be personally liable on both contract and tort claims against the partnership, which for these purposes is nothing more than an aggregate of the partners. Student tenants who fall off balconies could and would sue the partners personally. General partnership would be well suited only for a small-time investment such as a duplex or small commercial property.

Answer (B) is a poor choice. A corporation would provide the limited liability but not the flow-through tax treatment essential here. While a corporation can make an "S" election, that election is unavailable where one of the shareholders is not a U.S. taxpayer. This corporation would generate paper losses that would accumulate in the corporation, doing no one any good.

Though plausible, **Answer (C) is not the best answer** because LPs have been generally obviated by LLCs in recent years. A limited partnership must have one or more general partners, who remain personally liable. This can be avoided by using a "blocking corporation" as the general partner, but the need for this rigmarole is obviated by using an LLC. The limited partners (sometimes called "sleeping partners") may not undertake active management of the partnership's business and affairs. If they do, they may lose their limited liability. This form offers desirable flow-through tax treatment, but it is not the best way to achieve limited liability at the same time.

35. Partnership Participation.

Answer (D) is the best answer because the actions described are not characteristic of how limited partners should act. Even if the business forms in a RULPA jurisdiction, where there are safe harbors for certain actions, it is unclear whether the actions contemplated here fall within those safe harbors. Moreover, the LLC form is much more obviously suited to a business such as this, making an LLC a better choice than an LP.

Answer (A) is not the best answer. Even in a RULPA jurisdiction, actions such as those described would very likely lead to liability for the acting members. RULPA introduces a number of safe harbors, that is, activities in which limited partners now may be engaged.

Second, it introduces a further requirement of reliance. A limited partner who oversteps the boundary "is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." RULPA § 303(a).

Answer (B) is not the best answer because it does not contemplate Felice's liability, and because it is unclear whether Burt and Cathy would in fact be liable under RULPA, where RULPA does not provide an obvious safe harbor for making business decisions such as these. RULPA permits exercise of a limited partner's "democracy rights." The former includes "being a contractor for or an agent or employee of the limited partnership or of a general partner." RULPA § 303(b)(1). Thus, ironically, under RULPA, while Burt and Cathy probably should not oversee the renovations by an interior decorator, they themselves could contract with the partnership to be the interior decorators. Other permitted business activity includes "consulting with and advising the general partner," acting as surety for or guaranteeing partnership obligations, or winding up the partnership's business and affairs. Democratic rights include attendance at partners' meetings; bringing derivative actions in the name of the partnership; proposing and voting on dissolution, sale, or pledge of substantially all the partnership's assets; incurrence of indebtedness; a change in the nature of the partnership's business; admission or removal of a general partner; and admission or removal of a limited partner.

Answer (C) is not the best answer. At a minimum, it is incomplete, as it does not contemplate Burt's and Cathy's probable liability. But there is also a factual question as to whether Felice has control over partnership funds where her signature is required on the checks. This makes her liability uncertain as well.

36. General Partnerships vs. Limited Liability Companies.

Although limited liability companies are hybrid entities that seek to combine the ease of management and flexibility of general partnerships with the structure and limited liability shield provided under corporate law, general partnerships and limited liability companies may be distinguished in at least three critical ways: First, the organization of an LLC requires an intentional and overt step — the organizers must file a certificate of organization with the governmental office designated for handling business filings (most commonly, the Secretary of State). *See* RULLCA § 201(a). A general partnership, on the other hand, may be formed (sometimes by accident!) merely through the conduct of the partners. *See* RUPA § 202(a). ("[T]he association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership."). Second, LLCs offer the limited liability shield. "The debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise . . . do not become the debts, obligations, or other liabilities of a member or manager solely by reason of the member acting as a member or manager acting as a manager." RULLCA § 304(a)(2). Conversely, "all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law." RUPA § 306(a). Finally, the LLC is designed to endure beyond the dissociation of a member, *see* RULLCA § 701(a),

whereas the default rule is that a partnership is dissolved and must be wound up when a partner dissociates, *see* RUPA § 801(1).

37. "Antique Store, LLC."

Answer (C) is the best answer. The problem here is that, while Brother and Sister desired to form a limited liability company (LLC), they failed to take the legal steps necessary to do so. Accordingly, they cannot claim the limited liability protection that an LLC offers its members and managers. To form an LLC, "one or more persons may act as organizers . . . by signing and delivering to the [Secretary of State] for filing a certificate of organization." RULLCA § 201(a). Generally speaking, an LLC "is formed when the [Secretary of State] has filed the certificate of organization and the company has at least one member." RULLCA § 201(d)(1). Once the LLC is formed, "[t]he debts, obligations, or other liabilities of [an LLC], whether arising in contract, tort, or otherwise . . . are solely the debts, obligations, or other liabilities of the [LLC]; and do not become the debts, obligations, or other liabilities of a member or manager solely by reason of the member acting as a member or a manager acting as a manager." RULLCA § 304(a). Although there may be some equitable principles that would allow a court to treat the business entity as a de facto LLC, *see, e.g.*, *Stone v. Jetmar Properties, LLC*, 733 N.W.2d 480 (Minn. Ct. App. 2007), no such considerations appear present here. As a result, Answer (C) best reflects that no LLC was properly formed and that Brother and Sister are not entitled to any liability shield under RULLCA § 304.

Answer (A) is incorrect because, even had the LLC been properly formed and the liability shield applied, this choice overstates the protections offered by the liability shield. RULLCA § 304(a) protects members from being liable for the LLC's obligations solely because they are members. There may be other reasons for why a member would be liable for the LLC's obligations — for example, if the obligation arose because of their own tortious conduct.

Answer (B) is incorrect. It contains a more accurate description of the liability shield offered by RULLCA § 304, but it is nevertheless incorrect because the LLC was not properly formed.

Answer (D) is incorrect because it misstates the liability shield applicable to members of an LLC and instead states the rule for liability of a partner in a partnership. *See* RUPA § 306(a) ("[A]ll partners are liable jointly and severally for all obligations of the partnership . . . .").

38. Cashing Out.

You should advise Evelyn that limited partnership interests are extremely illiquid, so she will likely have trouble cashing out these investments quickly. There are firms that stand willing to purchase some limited partnership interests, but at a deep discount from probable market value, based on their illiquidity discount. Usually, there is no market in which to sell your interest to another investor. Illiquidity makes partners' dissolution rights doubly important. RULPA § 603 provides that a limited partner may withdraw on six months' notice to the general partner, absent a contrary agreement. Under RULPA § 604, the withdrawing partner must be paid any distributions to which she is entitled and, if not otherwise provided in the agreement, the fair value of her interest in the partnership. Those are the default rules.

Usually (but not always — so it is worth checking each of Evelyn's agreements), the limited partnership agreement "provides otherwise." The agreement may provide for sale of the real estate after a holding of so many years (e.g., 10 years), followed by a distribution. There may also be provision for dissolution by a vote of a majority, or a super majority, of the units of participation. If the partnership is a smaller, local "deal," perhaps Evelyn can procure the requisite vote. Overall, however, you should advise Evelyn that she likely will obtain liquidity only over time.

39. Myron's Estate.

Answer (B) is the best answer. While LLCs have obviated many use cases for LPs, an area of remaining vitality for the LP form of entity is the "family limited partnership." It is a device used to minimize estate taxes upon death and, short of death, gift taxes. The details of family limited partnership tax strategy are beyond the scope of this text, but it is worth noting just that family limited partnerships seem to be the last area of robust vitality for the LP as a form of entity.

Answer (A) is incorrect. A general partnership would not work. The partners would have full rights to participate in the business. They might be in Myron's hair all of the time. Moreover, their control rights would increase the value of what they hold, thereby increasing gift tax payments.

Answer (C) is incorrect. A corporation may not work, at least not without complex and novel machinations such as non-voting stock that divests all potential control from shareholders. Even then, there is no good reason to take the risks and expense associated with using a novel form.

Answer (D) is not the best answer. A limited liability company could be adapted to suit Myron's purposes (manager-managed, etc.). Currently, however, most estate planners utilize the limited partnership form as there are simply more tax rulings and thus more certainty for this traditional form.

40. Limited Liability.

Answer (B) is the best answer. This analysis requires us to ask three questions: First, who is personally liable? Next, is the LLC liable? Finally, is anyone else liable for the LLC's obligations? It is easy to overlook it, but a tortfeasor is always liable to third parties for damages caused by their own torts. *See* Restatement (Third) of Agency § 7.01. Thus, we can quickly identify here that South is the negligent actor, and so the homeowner may sue South for damages. Next, we need to establish whether the LLC is also liable for South's negligence. A member of an LLC is not an agent of the LLC "solely by reason of being a member." RULLCA § 301(a). Still, there may be a different basis to impute liability to the LLC — agency law! "An employer is subject to vicarious liability for a tort committed by its employee acting within the scope of employment." Restatement (Third) of Agency § 7.07. Here, the fact pattern provides that, in addition to her being a member of the LLC, South was also an employee of the LLC acting within the scope of her employment. Accordingly, the LLC

can be held vicariously liable for damages caused by South's negligence here. Finally, under RULLCA, "the debts, obligations, or other liabilities of a limited liability company, whether arising in contract, tort, or otherwise . . . are solely the debts, obligations, or other liabilities of the company; and . . . do not become the debts, obligations, or other liabilities of a member or manager solely by reason of the member acting as a member or manager acting as a manager." RULLCA § 304. Here, North is the manager of the LLC and West is a member. Accordingly, without additional facts that would justify imposing liability on North or West, they cannot be held liable for the LLC's obligations solely because they are members, or in North's case, a manager.

Answer (A) is incorrect because it does not recognize that the homeowner may sue South.

Answer (C) is incorrect because it wrongly extends liability to North.

Answer (D) is incorrect because it does not recognize that the homeowner may sue South.

41. Members and Managers.

Answer (C) is the best answer. Under RULLCA, an LLC may be either "member-managed" or "manager-managed." *See* RULLCA § 407. A member is not an agent of the LLC solely by reason of being a member. *See* RULLCA § 301(a). In a member-managed LLC, "[t]he management and conduct of the company is vested in the members" and "[e]ach member has equal right in the management and conduct of the company's activities." RULLCA § 407(b). In a manager-managed LLC, however, the general rule is that "any matter relating to the activities of the company is decided exclusively by the managers." RULLCA § 407(c)(1). The default rule is that an LLC is "member-managed" unless the LLC's operating agreement states that it is to be managed by managers. *See* RULLCA § 407. Here, it sounds like the best way to set up the active members' desired structure would be to organize the LLC as manager managed. To do so, this needs to be addressed in the operating agreement.

Answer (A) is incorrect because it wrongly states that "manager-managed" is the default rule.

Answer (B) is incorrect because it wrongly states that the certificate of organization, rather than the operating agreement, is needed to establish the LLC as manager-managed.

Answer (D) is incorrect because members of an LLC are not agents of the LLC (nor do they have apparent authority to bind the LLC) solely because they are members.

42. A Canceled Concert.

Answer (B) is the best answer. A manager of a manager-managed LLC owes the fiduciary duties of care and loyalty both to the LLC and to the members of the LLC. *See* RULLCA § 409(g). The duty of loyalty requires a manager "to account to the company and to hold as trustee for it any property, profit, or benefit derived" in the conduct of the LLC business, *see* RULLCA § 409(b)(1); "to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company[,]" *see* RULLCA § 409(b)(2); and "to refrain from competing with the company in

the conduct of the company's activities before the dissolution of the company[,]" *see* RULLCA § 409(b)(3). The duty of care required of a manager "is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company." RULLCA § 409(c). Generally, the standard for breach of the duty of care is gross negligence. Additionally, a manager must discharge their duties to the LLC and the members "consistently with the contractual obligation of good faith and fair dealing." RULLCA § 409(b)(3). Here, Walter's decision to order 10,000 shirts was consistent with prior practice and seems within the scope of his authority as manager. There is nothing to indicate that his decision to place this order was self-motivated, the result of a conflict-of-interest transaction, or a form of competition with the LLC. Accordingly, there is no indication here that Walter breached any fiduciary duty owed to the LLC or to the members of the LLC merely by ordering the 10,000 custom t-shirts when the concert was unexpectedly canceled.

Answer (A) is incorrect because managers most certainly do owe fiduciary duties to the LLC and the members of the LLC.

Answer (C) is incorrect because it wrongfully concludes that Walter breached his duty of care.

Answer (D) is incorrect because it wrongfully concludes that Walter breached his duty of loyalty.

43. Competition at the Gym.

Answer (D) is the best answer. Members of a member-managed LLC owe to the LLC and to the other members of the LLC the fiduciary duties of loyalty and care. *See* RULLCA § 409(a). The duty of loyalty requires a member "to account to the company and to hold as trustee for it any property, profit, or benefit derived" in the conduct of the LLC business, *see* RULLCA § 409(b)(1); "to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company[,]" *see* RULLCA § 409(b)(2); and "to refrain from competing with the company in the conduct of the company's activities before the dissolution of the company[,]" *see* RULLCA § 409(b)(3). The duty of care required of a member "is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company." RULLCA § 409(c). Generally, the standard for breach of the duty of care is gross negligence. Additionally, a member must discharge their duties to the LLC and the members "consistently with the contractual obligation of good faith and fair dealing." RULLCA § 409(b)(3). Here, Kylar's conduct seems to be a fairly textbook example of breach of the duty of loyalty. Arguably, by selling the apparel in the fitness studio and using the "Pump You Up" logo and colors, the LLC is entitled to at least some of the profit of the sales. Likewise, Kylar was acting in furtherance of the interests of the apparel business rather than the LLC by not looping the LLC in on the deal or getting approval from the other members. Finally, this seems like competition; the LLC could have produced and sold its own apparel. On the other hand, this does not quite seem to rise to a level of breach of the duty of care, as the duty is defined by RULLCA. It's hard to see how

Kylar's conduct here would constitute gross negligence. In all likelihood, if this were to go to court, the court could enjoin Kylar from selling any more apparel and could order that Kylar pay all profits earned to the LLC.

Answer (A) is incorrect because it wrongly states that a member does not owe a fiduciary duty.

Answer (B) is incorrect because, as stated, Kylar's conduct is a textbook example of breach of the duty of loyalty.

Answer (C) is incorrect because, although Kylar's conduct is wrong, it likely does not meet the definition of breach of the duty of care.

44. Exit via Transfer.

Answer (A) is the best answer. Broadly speaking, a member's interest in an LLC consists of a voting interest and a financial interest. The voting interest reflects the member's right to participate in the management of the LLC's business and affairs, *see* RULLCA § 407(b), while the financial interest reflects the member's right to receive distributions, *see* RULLCA § 404. The default rule is that a member has a transferable interest in the LLC, and that interest is personal property of the member. *See* RULLCA § 501. A member may transfer to a transferee "the right to receive . . . distributions to which the transferor would otherwise be entitled." RULLCA § 502(b). Such a transfer does not, by itself, cause the member's dissociation from the LLC, nor does it require that the LLC be dissolved and wound up. *See* RULLCA § 502(a)(1)-(2). On the other hand, a member's transfer to a transferee does not entitle the transferee to "participate in the management or conduct of the company's activities [or] . . . have access to records or other information concerning the company's activities." RULLCA § 502(a)(3). In other words, under the default rule, a member may transfer their financial interests in the LLC only, not their voting interests. "[W]hen a member transfers a transferable interest, the transferor retains the rights of a member other than the interest in distributions transferred and retains all duties and obligations of a member." RULLCA § 502(g). Generally speaking, a transferee may only become a member as provided for in the operating agreement or with the consent of all the members. *See* RULLCA § 401(d). This is known as the "pick your partner" rule. Here, applying the default rules, Beta may transfer their financial interests in the LLC to Foxtrot, but Beta may not transfer their voting rights to Foxtrot, and Foxtrot does not become a member of the LLC as a result of the transfer. Foxtrot may be delighted to receive Beta's financial rights, but a transfer here does not accomplish Beta's goal of getting out of the business.

Answer (B) is incorrect because Foxtrot can only become a member of the LLC as provided for in the LLC's operating agreement or with consent of all the members.

Answer (C) is incorrect because the default rules permit Beta to transfer their financial interests in the LLC.

Answer (D) is incorrect because the transfer of a member's transferable interest does not result in the dissociation of the member or in the dissolution and winding up of the LLC.

45. Stuck in the LLC.

Answer (D) is the best answer. An LLC's operating agreement governs "relations among the members as members and between the members and the limited liability company; the rights and duties . . . of a person in the capacity of manager; the activities of the company and the conduct of those activities; and . . . the means and conditions for amending the operating agreement." RULLCA § 110(a). To the extent an operating agreement does not provide for any of these matters, RULLCA provides the default rules. *See* RULLCA § 110(b). LLCs have great leeway in how they structure their governance in the operating agreement, but there are certain things that an operating agreement may not do, *see* RULLCA § 110(c), and other things that an operating agreement may do, so long as it is not manifestly unreasonable, *see* RULLCA § 110(d). Under RULLCA, the default rule for a member's dissociation is that "[a] person has the power to dissociate as a member at any time, rightfully or wrongfully, by withdrawing as a member by express will . . . ." RULLCA § 601(a). Neither RULLCA § 110(c) nor § 110(d) prohibits an operating agreement from varying this default rule. Indeed, it is quite common for LLC operating agreements to prohibit a member from voluntarily dissociating. Thus, here, the provision in the operating agreement is valid, and Delano does not have the right to withdraw by express will from the LLC.

Answer (A) is incorrect because it wrongly states that RULLCA prevents an operating agreement from varying the default rules permitting withdrawal by express will. This is an area where LLCs are distinguishable from general partnerships. In general partnerships, "[a] partner has the power to dissociate at any time[,]" RUPA § 602(a), and a "partnership agreement may not . . . vary the power to dissociate as a partner under Section 602(a), except to require the notice under Section 601(1) to be in writing[,]" RUPA § 103(b)(6). From a policy perspective, it makes sense to permit an operating agreement to limit a member's ability to withdraw from the LLC because a member is not an agent of the LLC and is not liable for the obligations of the LLC solely by reason of being a member of the LLC; the converse is true of general partnerships.

Answer (B) is incorrect for the same reason as Answer (A).

Answer (C) is incorrect because, while permissible, this provision is a variance from the default rules.

46. Jumping Ship.

Answer (A) is the best answer. As a matter of default rules, RULLCA does provide for interim distributions — that is, a distribution before the LLC's dissolution and winding up. RULLCA merely provides that an LLC may not make an interim distribution if, after the distribution, "the company would not be able to pay its debts as they become due in the ordinary course of the company's activities; or . . . the company's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the company were to be dissolved, wound up, and terminated at the time of the distribution, to satisfy the preferential rights upon dissolution, winding up, and termination of members whose preferential rights are superior to those of persons receiving the distribution." RULLCA § 405(a). Significantly, "[a] ny distributions made by a limited liability company before its dissolution and winding up

must be in equal shares among members and dissociated members." RULLCA § 404(a). Nothing prohibits the operating agreement from varying these rules (subject to the general requirement that all members and managers must act consistently with the contractual duty of good faith and fair dealing). *See* RULLCA §§ 110(c)-(h). As an effect of a person's dissociation as a member, "the person's right to participate as a member in the management and conduct of the company's activities terminates." RULLCA § 603(a)(1). Here, Milo had dissociated as a member, and Milo's right to vote on whether the LLC should make an interim distribution had terminated. But this did not impact Milo's financial rights. Milo is still entitled to receive a distribution in equal shares to the other members and dissociated members.

Answer (B) is incorrect because Milo's dissociation has no effect on Milo's right to receive an interim distribution.

Answer (C) is incorrect because, as a general rule, interim distributions are permitted.

Answer (D) is incorrect because an LLC may certainly make distributions before it is dissolved and wound up.

47. Law Firm Form.

Answer (D) is the best answer. Under the Model Rules of Professional Conduct, and predecessor ethics provisions, attorneys must remain professionally and financially responsible for the work they do and for the work they supervise. Therefore, lawyers are not and have never been able to practice using a form of organization that accords them across-the-board limited liability. A law firm, then, may not practice by means of a corporation or a limited liability company.

Answer (A) is incorrect. Although some states allow firms to form as professional corporations, that is distinguishable from the "vanilla" corporation suggested by this answer. A law firm may not usually form as a corporation because the partners are not allowed to protect themselves from their malpractice via corporate limited liability.

Answer (B) is incorrect. Although some states provide for professional limited liability companies, that is distinguishable from the "vanilla" LLC suggested by this answer. A law firm may not usually form as an LLC because the partners are not allowed to protect themselves from malpractice in this way.

Answer (C) is incorrect. The partnership form does not give the firm enough protection from non-professional liabilities, such as the lease on the firm's offices.

Note: The question does not ask how to effectuate this reorganization, but the answer is relatively simple. The firm can reorganize by filing a certificate with a state official such as the secretary of state. They would then draft a partnership agreement for the conduct of their LLP. In most respects, aside from providing for the curtailment of across-the-board professional liability, the LLP statute provides a set of default rules. The drafter of the LLP agreement should consult with the partners to determine whether they want to contract out of the default regime by, for example, prohibiting opportunistic withdrawal.

48. Cabbage Analytics.

Answer (B) is the best answer. An LLC by default is taxed like a partnership, which is a flow-through entity from a federal tax perspective. This means that the partners will be taxed on profits earned just once, not twice, as occurs with corporate taxation. Unlike a partnership, a corporation pays federal taxes on annual profits, and then its shareholders pay tax again on distributions the corporation makes to them. While corporations can make an S election by filing IRS Form 2553, this corporation is ineligible for an S election because some of its shareholders are non-resident aliens, thus disqualifying the corporation from electing flow-through taxation. An LCC, on the other hand, can be taxed as a flow-through entity even where it has non-resident alien owners. Given the founders' desire to distribute business profits monthly, this is the optimal tax structure.

Answer (A) is not the best answer because corporate distribution will be taxed twice: once when the corporation earns profits and again when it distributes those profits to shareholders. Since the business intends to distribute profits regularly, this option produces a sub-optimal tax result. A more efficient tax result will occur if the business is not taxed at the entity level but instead is treated as a flow-through entity. Corporations can sometimes be treated like flow-through entities where they make an election to become a so-called S corporation by filing Form 2553 with the IRS. But this flow-through tax treatment is not possible here because corporations cannot elect to be treated as flow-through entities where any of the shareholders are not U.S. taxpayers. Here, Bok and Danish are not U.S. taxpayers, so their business is ineligible to qualify for S corporation status. Therefore, they cannot obtain a tax-optimal result through the corporate form.

Answer (C) is not the best answer because partners have unlimited liability for partnership debts and torts.

Answer (D) is not the best answer because limited liability partners have liability for professional malpractice. While this form is required in some jurisdictions for specific professions, here, the business does not appear to engage in any restricted profession that requires practitioners to maintain malpractice liability, such as law, medicine, or accounting. There is another form of business association that better suits this client's business needs.

Note: While noting that federal tax law changes separately from the law of business associations per se, lawyers engaged with business associations should generally understand the difference between entity taxation and flow-through taxation. Entity taxation means the business association is a U.S. taxpayer that retains income, losses, deductions, and credits. In a simple example, if a corporation earns net profits, that corporation owes taxes to the Internal Revenue Service. The individual shareholders of that corporation do not, however, owe taxes purely because the corporation they own earns profits. Rather, corporate shareholders owe IRS taxes only when the corporation issues distributions to them. A flow-through entity, on the other hand, is taxed as a partnership, which is a form of disregarded entity from an IRS perspective. Instead of the profitable partnership paying taxes, the partners owe taxes on their share of profits.

49. Fishmongers I.

Answer (B) is the best answer. Under RULLCA § 408(a), "[a] limited liability company shall reimburse a member of a member-managed company or the manager of a manager-managed company for any payment made by the member or manager in the course of the member's or manager's activities on behalf of the company, if the member or manager complied with Sections 405, 407, and 409 in making the payment."

Answer (A) is not the best answer. Under RULLCA § 408(d), as a default, the company may purchase insurance on behalf of its members. This situation, however, does not appear to present an insurance issue. Rather, this is either a payment made by a member on behalf of the company, *see* RULLCA § 408(a), or indemnification of a member with respect to a debt incurred by reason of the member's capacity as member, *see* RULLCA § 408(b). Since this is not an insurance claim, this is not the best answer.

Answer (C) is incorrect. As a matter of default law, limited liability companies must reimburse members for company payments, regardless of whether or not the company earned profits that period. While it is true that members are entitled to flow-through losses, such losses are not usually calculated on a monthly basis.

Answer (D) is incorrect. Unless the company's operating agreement otherwise specifies, default law applies, and the default under limited liability company law is that members are entitled to reimbursement of debts, even if a majority of members do not wish to pay them.

50. Fishmongers II.

Answer (A) is the best answer. Under RULLCA § 407(g), members are specifically entitled to interest on loans they make to the company.

Answer (B) is not the best answer. While the specific amount of interest that the company owes to Bluegill may be said to be imputed because interest terms were not expressed when the loan was made, it is not accurate to say that the interest is owed because it is imputed. This statement would be a tautology. Rather, a better answer is that the company owes interest to its members because, under default law, loans by members to their companies accrue interest. The amount of interest, in turn, may be established by extrinsic evidence such as the prevailing interest rate. In this case, 5 percent interest seems reasonable, given that the inflation rate is higher than that.

Answer (C) is incorrect. The members specifically discussed Bluegill's payment as a loan, not a contribution. RULLCA distinguishes between capital accounts and loans. *See generally* RULLCA § 408. Nothing in these facts suggests that the members could not effectuate Bluegill's payment as a loan, the members specifically termed this payment a loan, and loans are distinguished from contributions to capital accounts, so this is a wrong answer.

Answer (D) is incorrect. RULLCA § 407(g) specifically states that interest shall accrue on loans by members to companies from the date on which the loan is issued. This answer is thus an incorrect statement of the law.

Corporate Incorporation

51. Exotic Food.

Answer (B) is the best answer. Roy and Gail should form a corporation. Once the business has been incorporated and adequately capitalized (see the discussion of veil piercing below), the corporation will afford Roy and Gail limited liability, which does not mean "no liability." It means that Roy and Gail's liability will be limited to the monies and property they convey to the corporation.

Answer (A) is a bad answer because it leaves Roy and Gail with unlimited personal liability for business harms, such as tort liability from food poisoning, and contract liability for leases and amounts payable on goods. This is also a bad answer because Roy and Gail have duties to each other under default rules according to the Alabama partnership statute, even if that is not what they intend.

Answer (C) is not the best answer. Roy and Gail should form their corporation in the state in which they do business. Incorporating in Delaware would entail added expense and is generally inappropriate for small businesses like this one.

Answer (D) is a bad answer, although it is not as bad as doing nothing. The partnership agreement does give Roy and Gail better defined rights and responsibilities as to each other, but it does nothing to protect them from liabilities from business torts and contracts.

Note: An alternative to forming a subchapter "S" corporation is forming an LLC and electing to tax it as a partnership.

52. Six Lawyers.

Answer (C) is the best answer. Beginning in the 1960s, most states adopted professional service corporation acts. Generally, anyone required to be licensed (a physician, lawyer, accountant, cosmetologist, dentist, veterinarian, etc.) incorporates under that act rather than under the general business corporation law. All shareholders and directors must be members in good standing of the same profession (except architects and structural engineers). Two disparate professions (e.g., surgeon and undertaker) cannot combine. The active business of the corporation must be limited to the carrying on of the profession. Passive business investments (e.g., owning real estate or stocks and bonds) are permitted. The incorporated professional or professionals must place a special appellation ("PS" or "PC" are common) after the corporate name. The acts deal with the malpractice liability issue in one of two ways. Some acts provide that with regard to rendition of the professional service there will be no limited

liability. Other acts remain silent, on the theory that if professionals abuse the privilege of incorporation, say, by practicing without malpractice insurance, courts will pierce the corporate veil to hold the professionals personally liable as the owners of the enterprise.

Answer (A) is incorrect. Partners are liable for the acts of every other partner for carrying on in the usual way the business of the partnership. Bar associations used to require complete financial responsibility for each and every lawyer in a group practice. Lawyers did that by practicing law together in a partnership. Today, while lawyers may have to be financially responsible for one another, they may accomplish that in ways other than remaining in a general partnership and being personally liable.

Answer (B) is incorrect. Most states will not permit law firms to operate as general business corporations.

Answer (D) is incorrect. Most states will not permit law firms to operate as limited partnerships because, first, that would imply either that some limited partners are actively participating in the business or that the firm has investors who are not actively participating professionals, and neither scenario is permitted by limited partnership acts on the one hand and professional bar association rules on the other. Second, permitting law firms to operate as limited partnerships would imply that some professional practitioners enjoy limited liability for their own malpractice, which is generally inappropriate.

53. Buddy's State of Formation.

Answer (A) is the best answer because, generally, small business entrepreneurs should incorporate in the state where they operate. The Home State (here, "Peace") vs. Delaware calculus is simplified somewhat because this jurisdiction adopted the Model Business Corporation Act (MBCA). As the name implies, the MBCA is a model statute adopted in at least 35 states. The MBCA is suitable for most corporate business situations.

Answer (B) is not the best answer. While Nevada offers unique corporate law and is sometimes favored by very large private corporations and going-private transactions, Buddy's business seems rather ordinary. There appears to be no need to bear additional expense to incorporate Buddy's business out of state in Nevada.

Answer (C) is not the best answer. While Delaware offers well established corporate law and is sometimes favored by venture-capital investors and high-growth startups, Buddy's business seems unlikely to require frequent resolution by corporate law expert courts. There appears to be no need to bear additional expense to incorporate Buddy's business out of state in Delaware.

Answer (D) is not the best answer. Going offshore offers tax advantages in certain situations, especially those involving intellectual property licensing or substantial operations in Asia, but Buddy's business is unlikely to have any significant income from IP, and he seems unlikely to do any manufacturing.

54. Incorporation Process, Part I.

To legally form a corporation, you first must draft the articles of incorporation and file them with your secretary of state, generally in its division of corporations.

This need not be technically difficult. Most modern statutes provide a form for "plain vanilla" articles of incorporation that fit on a single side of letter paper. For example, MBCA § 2.02(a) requires only that articles state the business name, the number of shares authorized, the name and street address of the registered agent, and the name and address of each incorporator. Under the default rules, corporate duration is assumed to be perpetual. No specific business purpose needs to be stated, as general business corporations are presumed able to perform "any lawful purpose." No other information is required.

However, more provisions are expected in all but the simplest articles/certificates of incorporation. Typically, lawyers may put in a provision opting out of or limiting directors' duty of care liability; provisions for indemnification of directors (see the discussion of protecting directors below); a provision naming the first or initial board of directors; elimination of preemptive rights in further share issuances or creation of preemptive rights (the right to subscribe to further issuances for cash in proportion to one's preexisting proportionate interest, discussed below); authority to issue preferred shares and a description of the relative rights and preferences of the preferred class; restrictions on the transfer of shares (although restrictions usually are set out in a separate "buy–sell" agreement); and so on. Articles/certificates of incorporation generated by lawyers for specific clients are usually five to eight pages long. Complex ones for startups which have enjoyed several rounds of venture capital financings may be dozens of pages because they list many specific rights of many traunched investor groups.

To save the client a trip back to the lawyer's office, the lawyer may sign the articles as incorporator. The lawyer-incorporator then files the document with a check with the secretary of state for the state of incorporation and pays any applicable startup fees. Once the lawyer-incorporator verifies the corporation successfully formed, the lawyer should appoint the client's directors and officers and resign as incorporator.

55. Incorporation Process, Part II.

After filing the articles of incorporation, the lawyer-incorporator should draft bylaws. This is typically a matter of selecting a standard form and modifying it as needed to fit the client's business circumstances. Seldom will anyone draft bylaws from scratch, and they are often rather generic.

Bylaws deal with the frequency and preliminaries for shareholders' and directors' meetings, descriptions of the officers' duties, what their titles will be (president or CEO, treasurer or CFO, secretary, etc.), and other internal arrangements for conduct of the corporation's business. Generally, bar association committees or legal stationers provide stock bylaws that may be adapted by filling in the blanks ("the annual meeting of shareholders will be held on the (third) (Tuesday) of (March)"). Many law firms have their own model bylaws. If bylaws

from those sources are not forthcoming, check with your local law library for some standard forms.

You might also prepare stock certificates for the founders. You can establish a corporation with uncertificated stock, as physical certificates are not strictly necessary, but it is traditional to print these certificates (stamped with any legends that are required by securities regulation or agreement) for signature by the founders at the organizational meeting or when they sign their organizational resolutions by unanimous consent. You should also enter stock information into a spreadsheet, which you should send to your founders with admonitions that they must keep track of all stock issuances (or hire your firm to manage their "cap table").

Third, you should prepare organizational resolutions, which are the startup matters the new board must approve. These organizational resolutions establish directors and officers, empower them to open accounts and file forms on behalf of the corporation, issue founder's stock, etc.

Finally, you should hold the organizational meeting, where you inform all the directors and officers about what you've done to establish the corporation and advise them what they must do to maintain the corporation. You can alternatively do this via email in a process called resolutions by unanimous consent. You should provide signed copies of everything to the new corporate officers and directors. The corporation can thus get up and running accordingly.

After incorporation, some lawyers remain involved in corporate affairs as secretary of board meetings, while others get involved less frequently (such as when the corporation engages in a major transaction or considers litigation).

56. A Narrow Purpose.

Answer (C) is the best answer. Corporations generally have all the powers natural persons have. The applicable statute will list many of those powers. *See, e.g.*, MBCA § 3.02. Corporations may operate "any lawful business"; in fact, the MBCA presumes such a broad purpose. *See* MBCA § 3.01 ("[E]very corporation 'has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation.'"). A corporation may, however, provide for a more limited purpose in the articles of incorporation. Then, if any shareholder or director desires to engage in business outside the purpose, they will have to seek amendment or revision of the article of incorporation. This adds an "extra step" that must be accomplished before extending the corporation's business.

Answer (A) is incorrect because this would not impact the corporation's ability to open the nightclub.

Answer (B) is incorrect for the same reason as Answer (A).

Answer (D) is incorrect because the bond would only become relevant if there was a loss; it would not prevent Flaunce from opening the nightclub.

Note: The outcome would be similar under Delaware law. *See* DGCL §§ 102(a)(3), 121, and 122. Significantly, while the MBCA presumes that a corporation's purpose is for any lawful purpose unless the articles of incorporation state a narrower one, the DGCL requires that the corporation's purpose be stated in the certification of incorporation. *See* DGCL § 102(a)(3).

57. ET McDonalds.

Answer (D) is the best answer because Ernst is subject to promoter liability. There is no precise and universal legal definition of who is, or is not, a promoter, but generally this means the entrepreneur responsible for the corporate project. The promoter is personally liable for "corporate" contracts to the extent that the promoter leads others to believe the corporation exists. Here, by signing for a corporation that does not exist, Ernst implied that it does, and so he likely has promoter's liability for this contract.

Answer (A) is incorrect because it does not address Ernst's liability for the purported action.

Answer (B) is incorrect because the promoter is not protected by corporate limited liability until the corporation is duly formed, and then only enjoys its projection while it validly exists.

Answer (C) is not the best answer because these facts do not indicate that Ernst committed fraud. In particular, nothing suggests he has "scienter," that is, that he has knowing intent to defraud.

58. Avoiding Promoter Liability.

Answer (C) is the best answer. A novation is a three-party transaction in which one obligor is substituted for another on a contract.

Answer (A) is incorrect because limited liability does not apply to pre-incorporation transactions.

Answer (B) is not the best answer because the corporation's indemnification does not prevent the seller from holding the promoter liable for breach of contract.

Answer (D) is incorrect because neither the seller nor the promoter can make the corporation liable to the contract without the corporation's authorization.

59. Failed Start.

Answer (D) is the best answer. "All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting." MBCA § 2.04. Here, the pilot has no actual or constructive knowledge that there was no incorporation, and he was likely reasonable in relying on the lawyer's statement that the corporation was formed. Under that standard, the pilot would likely escape liability.

Answer (A) is incorrect. A de jure corporation is a business that complies with all the requirements of its state incorporation statute. Such a de jure corporation has recognized

existence as a juridical person. This would protect an entrepreneur from liability from all claimants, including the state, but de jure status cannot exist here because the lawyer never made an acceptable filing with the incorporating authority. The lawyer did not comply with all the requirements, so the protection does not exist.

Answer (B) is not the best answer. The defense of de facto corporation has three elements: (1) existence of a statutory scheme permitting incorporation for the purposes stated; (2) good faith attempt to incorporate under that scheme; and (3) purported use of corporate powers or activity as a corporation. These elements appear to be present here. But the MBCA has tried to eliminate this common law defense because the doctrine originally arose when the incorporation process was more difficult and fraught with potential for failure. The thinking now is that incorporation has become so simple that there is no possibility to fail to incorporate in "good faith" — the second prong of the de facto corporation test. Some states have expressly eliminated the doctrine of de facto corporation for this reason. The MBCA seems to redefine the test as related to knowledge instead of good faith.

Answer (C) is incorrect. Promoter liability is not a defense but rather an affirmative basis for rendering the pilot liable for this transaction.

Note: A related doctrine is "corporation by estoppel." If a contract creditor dealt with the entity as though it were a corporation, sending invoices in the corporate name to the corporate address, etc., and if the owners of the business have changed position or otherwise relied in good faith upon their belief that a corporation exists, the creditor may be estopped to deny the corporation's existence. The official comment to MBCA § 2.04 makes clear that estoppel is possible under the statute if, and only if, the owners had no knowledge of the defective corporate existence. This is not presented as an answer choice because the fact pattern does not address whether Learjet thought it was dealing with a corporation.

60. Corporate Restart.

Yes, the entrepreneur has promoter liability for contracts entered into on behalf of the nonexistent corporation after the corporation was administratively dissolved. The way to cut off personal liability and to potentially retroactively reinstate limited liability, including for past contracts, is to follow the state reinstatement procedures. In most states, paying back taxes, interest, and penalties, plus filing the required report form, can reinstate corporate existence. There may, however, be an outside time limit, for example, three years after the date of dissolution, MBCA § 14.22(a). Most statutes also provide that any reinstatement relates back to the date of dissolution. *See, e.g.*, MBCA § 14.22(c). A few do not and a question exists, upon which little authority exists, as to whether a reinstated corporation in such a jurisdiction may have a gap in its corporate existence. Quite a bit of variation exists among jurisdictions, so the best answer is always to check the relevant statute. But, in most cases, the entrepreneur can cut off liability and retroactively reinstate protections by following reinstatement procedures.

Piercing the Corporate Veil

61. Introduction to Piercing the Corporate Veil.

The corporation is a legal fiction with its own legal standing. One of the key features of the corporate form is the separation of ownership (the shareholders) and control (the board of directors). As a legal fiction, a corporation may only act through its board of directors, officers, agents, and employees. Under principles of agency law, however, obligations incurred — whether through tort, contract, or otherwise — may be attributed to the corporation itself. Because of the separation of ownership and control, our law recognizes that the corporate form serves as a liability shield between the corporation and the individual shareholders. That is, the shareholders are generally not personally liable for the obligations of the corporation. The shareholders may lose whatever they have invested in the corporation, but the creditors of the corporation cannot generally reach the shareholders' personal assets to satisfy the corporation's obligations. This "limited liability shield" is one of the most valuable aspects of the corporation. Sometimes, however, the wall between shareholders and the corporation itself may blur when the shareholders fail to observe the separate corporate form and treat it instead as a mere alter ego of themselves. In these circumstances, it would be inequitable for courts to permit a shareholder to hide behind the corporate form when it comes to personal liability for the corporation's obligations. If the shareholder does not consider the corporation a different form, why should anyone else? Thus, as an equitable remedy in extraordinary situations, a court may disregard the corporate liability shield ("pierce the corporate veil"), attribute corporate obligations to the shareholders, and allow creditors of the corporation to reach the personal assets of the shareholders to satisfy those corporate obligations.

62. Piercing Factors.

Jurisdictions have articulated the analysis for piercing the corporate veil in numerous ways. In essence, most courts require a party seeking to pierce the corporate veil to show an overall element of injustice or unfairness. A court may consider factors such as whether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation simply functioned as a facade for the dominant shareholder. No single factor will justify a decision to pierce the corporate veil, but there must be some combination of these factors as well as an overall element of injustice or unfairness.

63. Dram Shop Liability.

Answer (C) is the best answer. This question is based on *Baatz v. Arrow Bar*, 452 N.W.2d 138 (S.D. 1990). When the owners utilize a corporation solely or primarily to evade (an existing) contract, statute, or other obligation imposed by law, the court may disregard the corporation. If the promoters and owners do not abuse that privilege, courts will not pierce the veil. The doctrine does not look to the adequacy of capital with the benefit of hindsight and does not exist to achieve the objective of making tort and contract claimants whole in every case. It exists to prevent or police extreme abuses of the corporate form. Most courts would find the capital here adequate.

Answer (A) is incorrect because the mere fact that there is only one shareholder or that the shareholder is actively involved in the management of the corporation, without any evidence that the shareholder is disregarding or abusing the corporate form, is insufficient to permit a court to disregard the liability shield.

Answer (B) is incorrect because the capitalization here seems appropriate. The mere fact that the pedestrian sustained greater damages than it turned out CE, Inc., had in assets is not itself a basis to pierce the corporate veil.

Answer (D) is incorrect. Law students sometimes forget that an agent of a corporation is always liable for her own torts. If Melba served the drinks to a customer, knowing that the customer was inebriated, she is a tortfeasor, liable directly for her tort.

64. Parent–Subsidiary.

Answer (B) is the best answer. This question presents a "parent–subsidiary" basis for piercing the corporate veil. The idea is that separate existence is so lacking and intermixture of affairs is so complete that the subsidiary has become "the mere instrumentality," "alter ego," or "agent" of the parent. The parent completely dominates the subsidiary's business and affairs. Here, it seems that BEI's attorney, however sophisticated, allowed conduct that would provide a good basis for veil piercing. Courts have held that the mere identity of joint officers and directors in the subsidiary may be relevant evidence, but alone it is not enough to justify veil piercing. Beyond the identity of corporate officials, plaintiff Kenyon can prove grossly thin capitalization of the subsidiary and extensive intermeddling. The conversion (theft of customers), the abdication by AgriEast officers and directors in favor of BEI employees, and the takeover by the parent of the subsidiary's day-to-day affairs all might convince a court to hold BEI liable on veil piercing grounds. In such a case, the separate corporate identity of the subsidiary should be disregarded.

Answer (A) is incorrect because it would require an entirely separate analysis to pierce the veil of BEI to reach the individual officers and directors, and there are not enough facts here to support that.

Answer (C) is incorrect because there is no indication of fraud here, and Kenyon can prevail in this claim even if he cannot prove fraud.

Answer (D) is incorrect because merely capitalizing a corporation for $1,000 is not an abuse of the corporate form.

65. Enterprise Liability.

Answer (B) is the best answer, even though it is not a sure thing that this argument would succeed. This question demonstrates a theory for piercing the corporate veil known as "enterprise liability." Enterprise liability may apply when there exists common control of various corporations and those corporations have contributed to a collective enterprise or endeavor. Facts such as common employees, use of the same parent company logo, use of a central treasury or bank account, undercapitalization, and the like support a finding of enterprise liability. Enterprise liability has been applied when large multinationals have attempted to hide behind subsidiaries' separate existence after torts have been committed by a far-flung subsidiary. This must be balanced against the idea that it is entirely appropriate to organize an enterprise such that riskier segments of a business might be segregated from asset-rich or less-risky segments of the same business, assuming the strategy is not abused. As long as the separation is clear and maintained, capital adequate to "the business to be done or the risks of loss" is provided, and the subsidiary has a measure of functional independence, a business may pursue a segmentation strategy.

Answer (A) is incorrect because merely commissioning a shipment does not expose the commissioner to liability.

Answer (C) is not the best answer because there are no facts here to indicate that Transportation Co. is an agent of BigGasCo.

Answer (D) is incorrect because the perception of a third party is not relevant.

66. Piercing the LLC Veil.

Although the LLCs borrow certain structural aspects from corporate law, they retain the flexibility and ease of management of partnerships. Thus, it undermines the purpose of the LLC to disregard the liability shield where members or managers fail to adhere to stringent corporate formalities. Under RULLCA, "[t]he failure of a limited liability company to observe any particular formalities relating to the exercise of its powers or management of its activities is not a ground for imposing liability on the members or managers for the debts, obligations, or other liabilities of the company." RULLCA § 304(b).

Corporate Finance

67. Racing Capitalization.

Answer (C) is the best answer. Since all three want to share profits equally, and since all three are making equal contributions, the simplest and best way to achieve this is to grant common stock to all of them. They should each receive the same amount of stock. It does not matter that some contributed cash and others contributed property. Doing this will effectively value the racecar and trailer at $15,000, since it is presumed that all shares of founders' stock issued at the same time were issued for the same price.

Answer (A) is not the best answer. In simple, small incorporations such as the one described, attorneys avoid complexity such as multiple classes of stock. Issuing common and preferred stock would be too complicated for this fact scenario.

Answer (B) is incorrect. This is a simple incorporation for a small company with relatively little capital. Issuing a loan would require additional legal work that is not needed here. Moreover, as a creditor, Jesse would not have the control or profit rights that he seeks.

Answer (D) is incorrect. A corporation must issue at least one share of common stock. It cannot issue only preferred stock. Moreover, the concept of preferred stock is deprived of meaning where there is no common stock to compare its preferential treatment to.

Note: There are tax reasons to issue promissory notes to all three shareholders, namely, interest on a debt is an expense to the corporation and therefore deductible, while money paid out as dividends on shares is taxed as profits to the corporation and as income to the shareholders. This is not presented as an answer choice because the tax decision would be based on additional factors including whether this corporation makes a subchapter S tax election, when the corporation expects to earn profits, and additional factors not included in the prompt.

68. Racing Reissuance.

Answer (B) is the best answer. The corporation can issue 200 shares because the MBCA considers reacquired shares to be available for issuance. MBCA § 6.03(a) ("Shares that are issued are outstanding shares until they are reacquired, redeemed, converted, or canceled.").

Answer (A) is incorrect. The corporation authorized 400 shares for issuances. Of those shares, 200 are currently outstanding; therefore, only 200 remain available for issuance.

Answer (C) is incorrect. Statutes older than the MBCA often provided that, when the corporation reacquired, the directors could vote to "retire" the shares, in which case the power to reissue would be lost and the number of authorized shares reduced accordingly. The MBCA abolishes this concept. Moreover, the facts do not indicate that the director intended to retire Jesse's shares. The MBCA does allow the articles to prohibit the reissue of acquired shares. *See* MBCA § 6.31(b).

Answer (D) is incorrect. The corporation has 200 shares at its disposal for issuance. Under MBCA, there are 200 authorized, unissued shares. Under older statutes, there are 100 authorized but unissued shares, which can be issued, and 100 treasury shares, which can be reissued.

69. Racing Distribution.

Yes. Shareholders can take cash out via what the MBCA calls a "distribution" and what Delaware law calls a "dividend." A distribution is payment made "in respect of" shareholdings. It may be in the form of a cash dividend, but it could be in the form of a dividend in kind (e.g., two new tires for each shareholder) or a pro rata repurchase of stock by the corporation. MBCA § 1.40(6) defines "distribution" as follows: "A direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares . . . or otherwise."

Not all corporate payments are distributions or dividends, even when made to shareholders. A payment might be made to, say, shareholder Luke, but with respect to labor performed for the corporation. Or a payment could be made to, say, Beau, but with respect to a loan he made to the corporation. Those payments to shareholders would not be dividends because the corporation did not pay them "in respect of any of its shares." Rather they were wages paid to an employee and principal or interest paid to a lender.

Corporate law regulates distributions. A director who authorizes an "illegal" distribution is "personally liable to the corporation for the amount of the distribution that exceeds what could have been distributed without violating section 6.40(a)." MBCA § 8.33(a). The liability standard is negligence, not strict liability: "[T]he party asserting liability [must establish] that when taking the action the director did not comply with [the statutory duty of care]." *Id.* So, before making a distribution, a corporation should obtain the opinion of an attorney (formal or informal) that the distribution is legal.

MBCA § 6.40 uses "double insolvency" testing for establishing the legality of distributions. After giving effect to the distribution, the corporation must still "be able to pay its debts as they become due in the usual course of the business," that is, it must be solvent in terms of what is known as the "equity" sense. Also, after giving effect to the distribution, the corporation's total assets must also exceed its total liabilities, that is, the corporation must be solvent in what is known as the "bankruptcy" sense.

Here, testing for bankruptcy solvency is easy as the corporation has no liabilities. Giving effect to the distribution, assets minus liabilities equals $70,000. The corporation would be solvent in the bankruptcy, or balance sheet, sense. Testing for equity solvency (or insolvency) is more problematic. Paying a $30,000 dividend will deprive the corporation of all its cash. Thus, it will not be able to pay its debts as they become due (if, in fact, it has any debts). The wise advice may be to pay out only $24,000–$27,000, leaving $3,000–$6,000 cash in the corporation for working capital.

Note: Delaware law addresses dividends in DGCL § 170.

70. Xtra Capitalization.

Answer (B) is the best answer. Michelle's contribution should be treated as a loan and documented with a promissory note. Since Michelle wants to be paid back on schedule, she apparently wants to be in a debtor–creditor relationship with Xtra, Inc. She does not indicate interest in controlling or managing the company, which accords with this relationship because the debt relationship does not confer shareholder rights on its creditor. Vin and Paul, however, indicate they want to be partners in this going-forward co-adventure known as Xtra, Inc. The simplest and best way to achieve this is to grant common stock to Vin and Paul. Each should receive the same amount of stock. It does not matter that Michelle was the only one who contributed cash while the others only contributed property or services. Doing this will effectively value the race car at $15,000, since it is presumed that all shares of founders' stock issued at the same time were issued for the same price.

Answer (A) is not the best answer. Preferred stockholders are usually paid before common stockholders, but they are not paid back on schedule, as Michelle desires. Michelle does not indicate a desire to actively manage the business, and she does not expect profits beyond being paid back. Michelle apparently wants to be a creditor to the corporation, not a shareholder.

Answer (C) is not the best answer. Issuing common stock to all three is uncomplicated, but it does not reflect the fact that Michelle desires a different relationship with the corporation than does Vin and Paul. Michelle should be treated as a creditor, while Vin and Paul should be treated as shareholders.

Answer (D) is incorrect. A corporation must issue at least one share of common stock. It cannot only issue preferred stock. Moreover, the concept of preferred stock is deprived of meaning where there is no common stock to compare its preferential treatment to.

71. Soccer Capitalization.

Answer (A) is the best answer. Vicky should get preferred stock because she is acting like a venture capital investor, someone who typically demands preferred stock because they are willing to pay a premium for the preferences associated with preferred stock. Wanda should receive common stock because she is acting like a typical founding entrepreneur, someone who invests time in the business in exchange for common stock and thus a share in its

profits commonly known as sweat equity. Uma should probably also receive common stock; although she is investing, it is a relatively small amount compared to Vicky's, so it's likely that her "fair share" should come mainly from her efforts in promoting the company going forward and not from what she invested.

Answer (B) is not the best answer. Vicky does not appear to be acting like a creditor who expects to be repaid on a debt. It would be rather foolish to loan $2 million to a startup company with no track record. Instead, Vicky is acting like a venture capital investor, one who takes preferred stock that provides significant financial upside and more business control than a loan would provide.

Answer (C) is not the best answer. Setting up stock options for just one employee is overkill in terms of complexity at this stage. Instead, Wanda should get common stock that vests, meaning the company loses the right to repurchase that stock from her over time as she works for the company. Also, Uma and Vicky are differently situated, so it does not make sense to grant both of them the same kind of stock. Uma plans to be actively engaged in day-to-day business in exchange for her shares, so it makes sense to grant her common stock that vests over time, like Wanda's. Vicky, on the other hand, should get fully vested preferred shares for her large upfront investment in the company.

Answer (D) is not the best answer. Vicky is situated differently than Wanda and Uma. Vicky is acting like an investor, while Wanda is behaving like an entrepreneur. Uma might be categorized as an advisor or part-time employee. At a minimum, Vicky should get preferred stock, and in any case, the three should not all receive the same type of shares.

72. DataMine Capitalization.

Answer (D) is the best answer. Venture capitalists often take convertible preferred stock in companies in which they have made an investment. A preferred stock is "preferred" because the issuing company's articles of incorporation so provide. The stock may be preferred as to dividends (e.g., 7 percent preferred, meaning 7 percent of stated value which often is $100), or preferred upon liquidation (in which case the articles set out a "liquidation preference," say, $110). Often preferred shares are preferred in both ways, but, again, the articles of incorporation have to spell out the preferred's "designations, preferences, limitations and relative rights." *See* MBCA § 6.01(c) & (d).

Answer (A) is incorrect. Venture capitalists rarely take common stock, especially in companies where the founders already received funding from other investors. None of the venture capital investors are likely to take common stock here, and least of all the lead investor, who if anything would negotiate for special preferences like a board seat.

Answer (B) is incorrect. There is no reason for the follow-on investors to take different stock than the lead investor. Venture capital investors generally expect to receive preferred stock in exchange for multimillion dollar investments, and nothing here suggests otherwise.

Answer (C) is not the best answer. While it is possible for venture capital investors to purchase common stock, they or the companies in which they invest millions of dollars are

willing to pay for legal fees that achieve venture capital objectives through specialized capitalization. The reason most small businesses grant common stock is to avoid the complexity associated with multiple classes of preferred stock, but at this stage in the company's lifecycle such complexities are merely a cost of doing business.

Note: Delaware law requires that classes of stock be described in the certificate of incorporation. *See* DGCL § 151(a).

73. BBB Repurchase.

Answer (D) is the best answer. A long-term repurchase is a distribution. It must therefore be tested for legality under MBCA § 6.40.

Answer (A) is incorrect. This transaction is regulated by statutory authority, namely, MBCA § 6.40.

Answer (B) is incorrect. There is no magic regarding the share certificate. By returning it, Bill accepts the promissory note in exchange for his shares, but it is not strictly necessary to collect that document before paying Bill.

Answer (C) is incorrect. The price is not necessarily high just because it is in the millions of dollars. Moreover, this transaction was approved by all the shareholders, so they probably cannot later complain that the board approved the transaction.

Note: Delaware law addresses the legality of dividends in DGCL § 170.

74. Accounting for Distributions.

It depends. A corporation's solvency is not necessarily determined by its balance sheet value. If the balance sheet figures produce ambiguous results, we should either hire an appraiser to value the corporation or not proceed with the transaction. Whatever figures we use, we must pass the MBCA's double insolvency test, which tests for bankruptcy solvency and equity solvency.

The board of directors may base a determination that a distribution is not prohibited under subsection (c) [double insolvency test] either on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances. MBCA § 6.40(d).

The comments to the section make clear that, in revaluing assets, directors are subject to their fiduciary duties. Also, if they undertake a revaluation, directors should not do so on a selective basis. If they write up some assets, they should also write down the value of other assets, if economic reality so dictates.

Equity solvency seems not to be a problem. After giving effect to the $3 million in payments, the corporation has sufficient cash of $3 million.

Balance sheet solvency is more challenging. Under the MBCA, the corporation must have a balance sheet surplus equal to, or greater than, $4.5 million.

The corporation has, however, only $1 million in balance sheet surplus. After giving effect to the distribution, liabilities would exceed assets by $3.5 million. The corporation would be insolvent in the "bankruptcy sense."

But this ambiguous result is based on accounting figures, which are not necessarily in line with real-world values. For example, if this corporation owns real property, it depreciates the accounting value of that property each year. But, if land values are going up and if the property is well maintained, the real value of that property may very well have appreciated over that same time. Instead of relying on accounting information that is not designed to strictly correlate with the real world, the corporation can hire an appraiser who provides a valuation for the corporation. If the appraiser values corporate assets with an accounting or "book" value of $1 to be worth $6 million on the open market, then there is no insolvency problem here.

Note: There is usually a distinction between accounting (e.g., balance sheet) value and the real-world valuation of a corporation. Most corporations, or other business entities for that matter, carry assets on their balance sheet at cost. They may "mark to market" assets they hold for purposes of sale, such as inventory. A securities firm, for example, might revalue the inventory of securities it holds for sale on a daily basis. But most assets (equipment, land and building, and so on) are not held for sale. Instead, a business holds them for their usefulness in producing income. Conservative accounting thus dictates that those assets remain on the books at their historical cost until such time as they actually are sold. Businesses have on their books assets they have held for a long period of time that have appreciated significantly in value (say, commercial real estate in Seattle, Denver, Chicago, or New York City that was acquired many years ago). Especially in periods of inflation, hard assets such as equipment or airplanes may have value much higher than their historical cost. Intangibles, such as patents, licenses, software may have values much higher than their carrying value on the books.

Closely-Held Corporations

75. An Easier Way.

Answer (B) is the best answer. "[A] corporation shall hold a meeting of shareholders annually at a time stated in or fixed in accordance with the bylaws at which directors shall be elected." MBCA § 7.01(a). On the other hand, "[a]ction required or permitted by this Act to be taken at a shareholders' meeting may be taken without a meeting if the action is taken by all the shareholders entitled to vote on the action." MBCA § 7.04(a). Critically, under the MBCA, the default rule is that action by written consent is only permissible when the shareholders unanimously agree to the action. *Id.* As a practical matter, unanimous consent is easier to achieve when there is a smaller number of shareholders; thus, it is unusual (though not theoretically impossible) to see actions by written consent in larger or publicly-held corporations incorporated in an MBCA jurisdiction. The MBCA affords corporations some opportunity to vary this default rule requiring unanimous consent: "[I]f consents in writing setting forth the action so taken are signed by the holders of outstanding shares having not less than the minimum number of votes that would be required to authorize or take the action at a meeting at which all shares entitled to vote on the action were present and voted[.]" MBCA § 7.04(b). If an action by written consent is to be taken by fewer than all voting shareholders, the corporation must give notice to the nonconsenting voting shareholders. MBCA § 7.04(f). If cumulative voting is permitted, only unanimous written consents are permissible. MBCA § 7.04(b). "A consent signed pursuant to the provisions of this section has the effect of a vote taken at a meeting and may be described as such in any document." MBCA § 7.04(d). Here, because there is unanimity among all the shareholders, they may take action by written consent in lieu of a meeting.

Answer (A) is incorrect because there is no rule that action by written consent is only available in emergency situations.

Answer (C) is incorrect because action may be taken by written consent in lieu of either an annual or a special meeting.

Answer (D) is incorrect because no annual meeting is required when an action can be accomplished through written consent.

Note: Answer (B) is also probably the best answer under Delaware law. Action by written consent may be held in lieu of a stockholder meeting, but there is no requirement that the consent be unanimous. *See* DGCL § 228(a). Majority stockholders still must comply with statutory formalities, and non-consenting shareholders must be given prompt notice

of the action. *See* DGCL § 228(e); *Espinoza v. Zuckerberg*, 124 A.3d 47, 65 (Del. Ch. 2015) ("Although minority stockholders have no power to alter a controlling stockholder's binding decisions absent a fiduciary breach, they are entitled to the benefits of the formalities imposed by the DGCL, including prompt notification under Section 228(e).").

76. A Tight Deadline.

Answer (A) is the best answer. Shareholders have the right to exercise control of the corporation by voting. Shareholders generally may exercise their right to vote at meetings, although they also have a right to vote by proxy and some shareholder action may be accomplished through written consent, *see* MBCA § 7.04. There are two types of shareholder meetings: the annual meeting and special meetings. The annual meeting of the shareholders is held "at a time stated in or fixed in accordance with the bylaws." MBCA § 7.01(a). The primary purpose of the annual meeting is to elect directors, but other business can be (and often is) conducted at the annual meeting, even if the notice for the annual meeting did not describe the additional business to be conducted. *See* MBCA § 7.05(b). Special meetings, on the other hand, may be called for by the board of directors, anyone authorized by the articles of incorporation or bylaws to call special meetings, or shareholders holding at least 10 percent of the votes entitled to be cast on an issue. *See* MBCA § 7.02(a). Notice of special meetings must be given at least 10 days prior to the meeting (and no more than 60 days prior to the meeting) and must specify the purpose for which the meeting is being held. *See* MBCA § 7.05(a) & (c); *see also* MBCA § 11.04(d) (describing notice requirements for meetings to approve plans of merger). Only business within the purpose described in the notice of special meeting may be conducted at the special meeting. *See* MBCA § 7.02(d). Mergers involve a two-step process: First, the board of directors considers the plan; if the board approves it, then it votes to adopt the plan of merger. *See* MBCA § 11.04(a). Then, plans of merger generally must be approved by "the shareholders at a meeting at which a quorum exists consisting of a majority of the votes entitled to be cast on the plan." MBCA § 11.04(e). Here, AT's board has voted to approve a plan of merger with HH. Although this plan certainly could be presented to the shareholders at an annual meeting, there is a practical problem here in that AT's next annual meeting will not be until after the deadline for the merger has expired. Thus, the only way AT's board could get shareholder approval of the plan of merger would be to give notice of and hold a special meeting of the shareholders to consider and vote upon the plan of merger. The deadline here is tight, but doable.

Answer (B) is incorrect because the offer will expire before the annual meeting. If the board waited until the annual meeting to obtain shareholder approval, the offer that they had approved as being in AT's best interest would have expired.

Answer (C) is incorrect because shareholder approval of a plan of merger is statutorily required, and a tight deadline does not allow a board to bypass shareholder approval.

Answer (D) is incorrect because the board may call a special meeting for the purpose of obtaining shareholder approval of the plan of merger.

Note: This issue would turn out the same under Delaware law. *See* DGCL §§ 211(d) (authorizing special meetings), 222(a) (describing notice of special meetings, and 251(c) (discussing stockholder approval of agreements of merger).

77. Missing the Meeting.

Answer (B) is the best answer. Shareholders have the right to exercise control of the corporation by voting, and they may do so either in person at a meeting or through a proxy. *See* MBCA § 7.22(a). This is a matter of right, not of grace. Although the word "proxy" tends to be used in everyday parlance to mean a number of different things, the MBCA uses "proxy" to reference a person whom a shareholder appoints as an agent to vote or otherwise act for the shareholder. *See* MBCA § 7.22(b). So, in this context, when a shareholder appoints a proxy, they appoint a person to vote at the meeting on their behalf — most typically in an instructed way. Likewise, when a shareholder participates in a meeting through proxy, they are counted as present for purposes of establishing a quorum. *See* MBCA §§ 7.22(a) & 7.25(b).

Answer (A) is incorrect because it misstates the rule — in-person attendance and participation are simply not required.

Answer (C) is incorrect because voting takes place at the meeting and there is no provision under the MBCA providing for a shareholder to cast an absentee ballot.

Answer (D) is incorrect because the solution to Shareholder's problem does not require a voting trust. A voting trust functions differently from a proxy. When a shareholder creates a voting trust, they "confer[ ] on a trustee the right to vote or otherwise act for them . . . and transfer[ ] their shares to the trustee." MBCA § 7.30(a). Voting trusts are distinct from the appointment of a proxy because the shareholder does not transfer the share to the proxy.

Note: The outcome would be the same under Delaware law. *See* DGCL §§ 212(b) (authorizing stockholders vote through proxy), 216(1) (permitting votes by proxy to establish a quorum), and 218(a) (authorizing voting trusts).

78. Preserving the Power.

Answer (B) is the best answer. Under the MBCA, the default rule is that shareholders exercise their voting power at meetings of the shareholders. The MBCA further provides that "shares representing a majority of the votes entitled to be cast on the matter by the voting group constitutes a quorum of that voting group for action on that matter." MBCA § 7.25(a). In corporate law, supermajority requirements function as protection for minority shareholders by giving them "negative control" or "veto power" over the corporation (i.e., they may not be able to affirmatively accomplish their policy goals, but they can prevent a simple majority from accomplishing their goals by preventing a quorum or withholding votes). Under the MBCA, supermajority voting requirements must be set forth in the articles of incorporation, *see* MBCA § 7.25(d), and must be approved by the same vote percentage that would constitute the supermajority requirement, *see* MBCA § 7.27. Likewise, supermajority requirements can only be repealed by a vote of the supermajority. *Id.*

Answer (A) is incorrect because, while "majority wins" is the default rule, the articles of incorporation may vary this rule by establishing supermajority requirements.

Answer (C) is incorrect because, under the MBCA, supermajority requirements must be established by the articles of incorporation, not the bylaws.

Answer (D) is incorrect for the same reason as (C).

Note: Under Delaware law, Answer (D) would be the best answer. The DGCL allows supermajority requirements to be established either in the certificate of incorporation or the bylaws. DGCL § 216. Supermajority voting requirements may be adopted by a simple majority. Supermajority requirements established in the certificate of incorporation require a vote of the supermajority, *see* DGCL § 242(b)(4), while supermajority requirements established by the bylaws may be amended with a vote of only a simple majority, *see* DGCL § 109 (discussing amendments to bylaws). Thus, the shareholders in this case would either want to enshrine supermajority voting requirements in the certificate of incorporation or ensure that the bylaws also require a vote of the supermajority to repeal the supermajority requirement.

79. Counting to Quorum.

Answer (A) is the best answer. Under the MBCA, "[s]hares entitled to vote as a separate voting group may take action on a matter at a meeting only if a quorum of those shares exists with respect to that matter." MBCA § 7.25(a). The default rule is that a quorum exists when shareholders holding "shares representing a majority of the votes entitled to be cast on the matter by the voting group" participate in the meeting. *Id.* Thus, if Dentist does not attend and participate in the special meeting, shareholders holding only 25 percent of the shares entitled to vote will be present. This falls short of a quorum, and so no business can be voted on at the meeting.

Answer (B) is incorrect. Typically, only corporate directors and officers owe fiduciary duties to the corporation and shareholders. *See, e.g.*, MBCA §§ 8.30 & 8.42. Some courts have held that, at least in some circumstances, majority shareholders owe some form of fiduciary duty to the corporation and minority shareholders. *See, e.g.*, *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 661–62 (Mass. 1976); *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 512 (Mass. 1975). Here, there is no indication that Dentist is a director or officer, and because they only hold 30 percent of the outstanding shares, it is unlikely that a court would find that Dentist owed — much less breached — a fiduciary duty by not attending the meeting. Thus, Dentist likely owes no fiduciary duty to attend the meeting, and their absence from the meeting, which here prevents a quorum, will have the same practical effect as a "no" vote.

Answer (C) is incorrect because "[o]nce a share is represented for any purpose at a meeting, it is deemed present for quorum purposes for the remainder of the meeting and for any adjournment of that meeting." MBCA § 7.25(b). Thus, once a quorum has been established, Dentist cannot then defeat a quorum by leaving the meeting.

Answer (D) is incorrect. A shareholder's attendance at a meeting waives any objection that the shareholder may have as to the sufficiency of the notice of the meeting. *See* MBCA § 7.06(b). A shareholder may only make a "special appearance" to object to the sufficiency of the notice of the meeting or that business is being considered that exceeds the scope of the notice of the meeting. *Id.* Thus, Dentist's attendance here would be self-defeating. If Dentist were to attend the meeting and object to a lack of quorum, they would actually be deemed to have participated in the meeting and their shares would count toward establishing a quorum.

Note: Answer (A) is also the best answer under Delaware law for similar reasons. *See* DGCL § 216 (describing quorum and voting requirements). Of note as it relates to Answer (B), Delaware courts have firmly rejected the imposition of fiduciary duty on non-majority stockholders. *See, e.g.*, *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1344 (Del. 1987) ("Under Delaware law a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation.").

80. Late to the Party.

Answer (A) is the best answer. Shareholders have the right to participate in and vote at annual and special meetings of the shareholders. The bylaws may fix or provide a manner for fixing the "record date" to determine the shareholders entitled to vote at a meeting. *See* MBCA § 7.07(a). A record date is essentially a snapshot of shareholders on a certain date for determining exactly who is entitled to be given notice of the meeting and vote. Record dates help provide certainty and avoid chaos. If the bylaws do not designate a record date, the board of directors may fix the record date. *Id.* Under no circumstances may a record date be more than 70 days in advance of the shareholder vote. *See* MBCA § 7.07(b). If neither provided for by the bylaws nor set by the board of directors, the record date is the close of business "the day before the first notice is delivered to shareholders." MBCA § 7.05(d); *see also* MBCA § 1.40 (defining "record date."). Only shareholders as of the record date are permitted to vote at the meeting. *See* MBCA § 7.07; *see also* MBCA § 1.40 (defining "shareholder" as "record shareholder"). Here, the prompt makes clear that the notice of special meeting did not specify a record date for determining eligibility to vote. Thus, by operation of the MBCA, the "record date" is the close of business the day before the notice of special meeting was sent out — January 31.

Answer (B) is incorrect, although the difference between it and Answer (A) is subtle. The date of the notice was February 1, and so under the MBCA's default rule, the record date would be close of business on January 31.

Answer (C) is incorrect because the fact that the transfer occurred before the special meeting is simply not relevant. Nurse will likely be able to vote at future meetings, assuming that the board does not set a record date that predates Nurse's acquisition of the shares. Of course, Baker is entitled to vote, and nothing would prevent Baker from appointing Nurse as their proxy to vote at the meeting.

Answer (D) is incorrect for the same reason as Answer (C).

Note: The outcome is the same under Delaware law. "[O]nly holders of record of voting stock, as of the record date, are 'entitled . . . to vote at the meeting.'" *Mariner LDC v. Stone Container Corp.*, 729 A.2d 267, 273 (Del. Ch. 1998) (quoting DGCL § 213(a)). The board of directors may fix a record date at least 10, but no more than 60, days before the meeting. "If no record date is fixed by the board of directors, the record date for determining stockholders entitled to notice of and to vote at a meeting of stockholders shall be at the close of business on the day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held." DGCL § 213(a).

81. Let's Vote Together.

Answer (C) is the best answer. Shareholders have the power to exert control over the corporation through voting their shares. The default rule for voting is "one share, one vote," *see* MBCA § 7.21(a), where every share of stock in a class entitles the shareholder to one vote on each matter voted upon — equal to the vote associated with every other share of stock in the class. Typically, matters may be approved by a plurality of the vote (i.e., the largest numbers of votes, even if the number of votes does not equal a majority of the shares entitled to vote on the matter). *See* MBCA § 7.28(a). A corporation may, however, provide in the articles of incorporation for "cumulative" voting. *See* MBCA § 7.28. Cumulative voting permits a shareholder to take the number of shares she has the right to vote (say, 400), multiplied by the number of directors to be elected at the meeting (say, 3), to compute the number of votes she has (here, 1,200), which she may then vote for one candidate, or less than all, of the candidates standing for election. *See* MBCA § 7.28(c). Then the candidates with the most votes are elected to the vacant positions. This is a powerful protection for minority shareholders because, while they may not have the votes to fill all seats on the board of directors with their preferred candidates, they may be able to fill at least one seat, thus ensuring that their interests are represented on the board. Cumulative voting may be contrasted with "straight" voting, in which the majority (or, under today's MBCA, a plurality) at the meeting elects all of the directors. Thus, all shares would be voted once per each vacancy. Almost all publicly-held companies have eliminated cumulative voting. Few state laws mandate it anymore. However, most state laws do provide that corporations may "opt in" to cumulative voting by a provision in their articles of incorporation. *See* MBCA § 7.28(b). Many corporations, and their lawyers, do so to facilitate power-sharing arrangements in small- and medium-sized corporations. As an aside, even if authorized by the articles of incorporation, shareholders may vote cumulatively only when the meeting notice or proxy solicitation states conspicuously that cumulative voting is authorized or a shareholder gives notice of their intent to vote cumulatively. *See* MBCA § 7.28(d). As calculated here, the Veridian shareholders cumulatively have 1,200 votes, whereas the Mirage shareholders have 1,800 votes. Thus, if the Veridian shareholders voted all of their 1,200 votes in favor of their preferred candidate, it would be mathematically impossible for the Mirage shareholders to fill all three positions on the board of directors with their preferred candidates. They would have to vote at least 1,201 votes in favor of three Meridian-preferred candidates to elect them over the Veridian-preferred candidate. They do not have the votes here. Stated differently, even though they are the minority shareholder group, the Veridian shareholders still have the mathematical

ability to elect their one preferred candidate under this cumulative voting scheme. On the other hand, if Phoenix, Inc., followed the default straight voting scheme, the Mirage shareholders would be able to outvote the Veridian shareholders for each of the seats on the board under the "one share, one vote" rule.

Answer (A) is incorrect because it reflects the default "one share, one vote" rule.

Answer (B) is incorrect for the same reason as Answer (A).

Answer (D) is incorrect because it overstates the Veridian shareholders' voting power.

Note: The outcome would be essentially the same in Delaware. The DGCL adopts the same "one share, one vote" default rule. *See* DGCL § 212(a). Cumulative voting may be permitted by the certificate of incorporation, but there is no additional requirement that either the notice of meeting or proxy solicitation state conspicuously that cumulative voting is permitted or that the shareholder needs to give advance notice of their intent to vote cumulatively. *See* DGCL § 214.

82. Staggered Boards.

Answer (B) is the best answer. The default rule is that directors are elected at the annual meeting of the shareholders, *see* MBCA § 8.03(c), and then serve a term that expires at the next annual meeting of the shareholders, *see* MBCA § 8.04(b). A corporation may, however, in its articles of incorporation, provide for the "staggering" of the terms of directors into two or three groups, with each group being up for election every two to three years. *See* MBCA § 8.06. There are several reasons to stagger — or "classify" — a board. It provides for greater consistency and preserves institutional knowledge while also avoiding the pressure and dynamics of having every director up for election every year. Staggered boards also serve as a defense mechanism against hostile takeovers. Although more common in closely-held corporations, it is not extraordinary for a publicly-traded corporation to have a staggered board. Accordingly, if the articles of incorporation provide for a staggered board and divide the directors into three classes of two directors each, only two directors will be standing for election at the upcoming annual meeting of the shareholders, and the directors elected will serve a three-year term until their class is back up for election.

Answer (A) is incorrect because it states the default rule and does not account for MBCA's authorization of staggered boards.

Answer (C) is incorrect because the class of directors will stand for election, not one director from each class.

Answer (D) is incorrect because, even when a board is staggered, the power to elect directors remains with the shareholders and is exercised at the annual meeting.

Note: The outcome is the same under Delaware law. DGCL § 141(d) permits directors to be divided into up to three classes, to stand for elections in staggered years. Of note, the DGCL permits the authorization of a staggered board to be set forth in either the certificate of incorporation or the bylaws. *See id.*

83. We're Going to Meet, One Way or the Other.

Answer (C) is the best answer. The list of things that a corporation is statutorily required to do is quite short, but the corporation is required to "hold a meeting of the shareholders annually." MBCA § 7.01(a). In addition to annual meetings, a corporation may hold special meetings of the shareholders. *See* MBCA § 7.02(a). A special meeting may be called by the board of directors or by any other person authorized to do so by the articles of incorporation or the corporation's bylaws. The board of directors must call a special meeting upon receipt of written demand from one or more shareholders who own at least 10 percent of the outstanding shares of stock entitled to vote. If a corporation fails (or refuses) to hold a meeting, a shareholder may seek an order from a court requiring the corporation to hold a meeting if (1) the corporation has not held an annual meeting "within the earlier of six months after the end of the corporation's fiscal year or 15 months after its last annual meeting," MBCA § 7.03(a)(1); or (2) shareholders holding 10 percent of the outstanding shares of stock entitled to vote have made written demand to the corporation for a special meeting and then the corporation either did not, within 30 days of receiving the demand, give notice of a special meeting or did not hold a special meeting in accordance with the notice, *see* MBCA § 7.03(a)(2). Under these circumstances, the court has broad discretion in ordering the meeting and may itself give notice of the meeting and set the time, place, and quorum requirements for the meeting. *See* MBCA § 7.03(b). Here, Wheelhouse is plainly due to have an annual meeting. Indeed, it is questionable whether anyone has authority to conduct the corporation's business or to call a meeting. It seems a safe bet that, under these circumstances, a court would likely order that the corporation hold a meeting. Niece, however, lacks the power to herself call the meeting, and similarly, does not have enough shares alone to make demand of the corporation to hold the meeting. Thus, if she wants the corporation to have a meeting, her only option is likely to go to a court and seek an order compelling the corporation to hold an annual meeting because the corporation has not held an annual meeting in the past 10 years.

Answer (A) is incorrect because Niece is not authorized by the MBCA, the articles of incorporation, or the bylaws to call a meeting.

Answer (B) is incorrect because Niece only owns 5 percent of the outstanding stock — not enough to entitle her alone to demand the corporation hold a special meeting.

Answer (D) is incorrect because Niece has more recourse than simply selling her shares.

Note: The answer would essentially be the same under Delaware law, although requirements for timing and demands for special meetings are different. *See* DGCL § 211(c). "If there be a failure to hold the annual meeting . . . for a period of 13 months after the latest to occur of the organization of the corporation, its last annual meeting or the last action by written consent to elect directors in lieu of an annual meeting, the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director." *Id.* The DGCL does not mirror the MBCA provision that the corporation must call a special

meeting upon receipt of written demand of stockholders holding at least 10 percent of the outstanding shares of stock entitled to vote.

84. Keeping It in the Family.

Answer (B) is the best answer. We need a tool that accomplishes the limited goals of permitting Carolina to vote Indiana's shares and preventing Indiana from revoking the arrangement for three years. The best tool is probably an irrevocable proxy. A proxy is a specialized agency relationship that grants the authority to vote to another. The proxy does not transfer ownership or financial rights away from the owner of the stock. *See* MBCA § 7.22(b). A proxy appointment form or writing may provide the term of the appointment, but if it does not provide such a term, the default rule is that the appointment is effective for 11 months. *See* MBCA § 7.22(c). A proxy is revocable at any time unless the appointment form states that the proxy is irrevocable and it is coupled with an interest. *See* MBCA § 7.22(d). MBCA § 7.22(d) sets out some examples of proxies coupled with an interest without being brave enough to attempt an overarching definition. *See id.* Court decisions in a number of states hold that a proxy given by one shareholder to a fellow shareholder for their mutual benefit, as here, always is coupled with an interest and will be held irrevocable if the proxy (form of appointment) so provides. *See, e.g.*, *Haft v. Haft*, 671 A.2d 413 (Del. Ch. 1995) (irrevocable proxy to chief executive officer upheld because he was also a shareholder).

Answer (A) is incorrect. A simple proxy like the one presented here certainly satisfies Indiana's desire to retain ownership of the stock while also allowing Indiana and Carolina to maintain a majority vote, and the siblings could even draft the appointment to last for three years. But this does not satisfy Carolina's desire to prevent Indiana from unexpectedly showing up and reclaiming the voting power by revoking the proxy. The appointment form could specify that the proxy is irrevocable, and the required accompanying interest would be maintaining a majority vote in the siblings' mutual interest. This is best reflected by Answer (B).

Answer (C) is incorrect because, although shareholder voting agreements are permissible and are enforceable by specific performance, *see* MBCA § 7.31, these agreements still require each shareholder themself to vote. Thus, a voting agreement would not resolve the problem of Indiana's inaccessibility.

Answer (D) is incorrect because a voting trust requires that a shareholder "transfer their shares to the trustee." MBCA § 7.30(a). Thus, the shareholder would only retain equitable rights to the shares, and the legal rights would vest with the trustee. This would run afoul of Indiana's desire to retain ownership of the shares.

Note: The outcome would be virtually the same under Delaware law. *See* DGCL § 212(e); *Haft*, 671 A.2d at 416.

Corporate Governance

85. Ambush by Quorum.

Answer (A) is the best answer. The board of directors exercises its authority to manage "the business and affairs of the corporation," *see* MBCA § 8.01(b), either by voting at meetings or acting by written consent. *See* MBCA §§ 8.20 & 8.21. This includes removing officers from their appointed positions. *See* MBCA § 8.43(b). Board meetings may be regular or special. MBCA § 8.20(a). Usually, the time and place of regular meetings is established in the corporate bylaws, and these meetings may be held without any notice. *See* MBCA § 8.21(a). Special meetings, however, must be preceded by at least two days' notice. *See* MBCA § 8.21(b). Nevertheless, directors may waive notice for special meetings. MBCA § 8.23(a). A director entitled to notice waives any objection based on notice if they attend or participate in a meeting without objecting at the beginning that the meeting is improper and then refrain from voting on any matter taken at the meeting. *See* MBCA § 8.23(b). The default rule is that a quorum is established at a meeting if a majority of the number of directors are present, *see* MBCA § 8.24(b), and if a quorum is present when the vote takes place, "the affirmative vote of a majority of directors present is the act of the board of directors." MBCA § 8.24(c). Generally speaking, a director who is present at the meeting when corporate action is taken but does not object to the holding at the meeting is deemed to have assented to the meeting. *See* MBCA § 8.24(d). Here, the meeting-by-ambush probably worked to remove Nelson as CEO. Ordinarily, a special meeting would have required at least two days' notice, but the other directors had validly waived the right to notice of special meetings. Thus, everything turns on Nelson's conduct. Nelson had the right to notice of the meeting but likely waived any objection to the meeting on the basis of notice by addressing the substance of Donnell and Barnham's actions and voting against his removal. Had Nelson only said, "I object to this meeting because you haven't given proper notice," and then refrained from otherwise participating, the ambush would have been thwarted. Of course, this would not have stopped Donnell and Barnham from giving the notice for a special meeting to be held in two days, but then Nelson could have refused to attend — thus depriving the board of a quorum — or solicited the other directors to participate. In conclusion, Nelson is likely out as CEO.

Answer (B) is incorrect because, while it correctly states a part of the rule for notice of special meeting, it neglects to mention that objections on the basis of notice may be waived by participating in the meeting without objection.

Answer (C) is incorrect because Donnell and Barnham, speaking between themselves, did not have a quorum to take board action.

Answer (D) is incorrect because the other directors had validly waived notice of special meetings.

Note: Although Delaware law is a bit harsher (to Nelson!), the answer is the same. In fact, we can be more certain that Answer (A) is the best answer. Delaware law does not distinguish between regular and special meetings of the board. Instead, "[a] majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. . . . The vote of the majority of the directors presents at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number." DGCL § 141(b). Thus, unless the corporate bylaws impose additional requirements, all Delaware requires for a board meeting is a quorum of directors.

86. Flooding and Director Negligence.

Answer (C) is the best answer. Although the board of directors of a corporation is responsible for managing the business and affairs of the corporation, *see* MBCA § 8.01(b), the board of directors acts as a collective at meetings or through written consent, *see* MBCA §§ 8.20 & 8.21. No director is an agent of the corporation solely because they are a director. Thus, unless the corporation has otherwise authorized the director to act individually on behalf of the corporation (i.e., as an officer with actual authority), the director does not have individual authority to bind the corporation in contract or tort. Here, the facts are clear that Dorren was acting in her own capacity and without any notice to the other directors. Accordingly, the corporation is not vicariously liable for Dorren's conduct.

Answer (A) is incorrect because a director is not an agent of the corporation solely because they are a director, and there are no facts here to give rise to a principal–agent relationship between Small, Inc., and Dorren.

Answer (B) is incorrect because the facts make clear that the other directors did not have notice that Dorren was going to go out and do the work herself. Thus, the corporation did not ratify the conduct.

Answer (D) is incorrect because it understates the rule. True, the board did not have notice that Dorren was going to go out and do the work, but that would not be relevant if Dorren was an agent of the corporation. Answer (C) is a better answer than Answer (D) because it better states why the corporation is not vicariously liable here.

Note: The answer and analysis would be the same under Delaware law. *See* DGCL § 141(b).

87. An Imminent Proposal.

Answer (B) is the best answer. Although the rule for votes of the shareholders is "once a quorum, always a quorum," *see* MBCA § 7.25(b), this is not the rule for meetings of the board of directors. "If a quorum is present ***when a vote is taken***, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors or unless otherwise

expressly provided in this Act." MBCA § 8.24(c) (emphasis added). The official comments to the MBCA make clear that "[i]f directors leave during the course of a meeting, the board of directors may not act after the number of directors present is reduced to less than a quorum." Here, to have a quorum, there must be four directors present at the vote. That is exactly how many directors are present at this meeting. Thus, if Stewart is opposed to the expansion proposal and wishes to, at least temporarily, prevent it from passing, Stewart may simply leave the meeting and "bust" the quorum.

Answer (A) is incorrect because it wrongfully applies the shareholder quorum rule to meetings of the board of directors.

Answer (C) is incorrect because, if Stewart stays, the quorum remains at the time of the vote and the affirmative vote becomes an action of the board.

Answer (D) is incorrect because regular meetings may be held without notice of the purpose of the meeting, *see* MBCA § 8.22(a), and if Stewart remains, any motion to table or continue the discussion can be defeated by the other three directors.

Note: The result is likely the same under Delaware law, although the "quorum busting" rule is not as explicitly stated. "A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. . . . The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number." DGCL § 141(b). Thus, the critical piece is that the director must leave the meeting rather than simply remain and abstain from voting.

88. How Big a Board?

Answer (C) is the best answer. Notably, there is no statutorily required number of directors, *see* MBCA § 8.03(a) ("A board of directors shall consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws."), but the general trend in public corporations is that the board will consist of 8 to 12 directors. Since the enactment of the Sarbanes-Oxley Act of 2002, New York Stock Exchange and Nasdaq rules require that publicly-traded corporations have a majority of independent directors on their boards. The question of whether a director is "independent" is complicated, but it essentially boils down to the idea that the director has no material relationship with the corporation aside from being a director. That could mean that the director is not a major stockholder in the corporation or that the director does not receive additional compensation or is otherwise employed by the corporation. The idea is that having a majority of "independent" directors increases the quality of oversight and lessens the risks of conflicts of interest. Here, the lawyer needs to tell Prolong that four directors is likely too few and that the majority of directors needs to be independent. Neither Prolong nor Prolong's brother will satisfy that definition because of their close financial relationship. Accordingly, at minimum, the board should be expanded to five, and one more independent director should be elected. The better advice would be to expand the board to 8 to 12 directors.

Answer (A) is incorrect because the current composition of the board is problematic — there is not a majority of independent directors.

Answer (B) is incorrect because there is no mandatory number of directors.

Answer (D) is incorrect because it results in a board that is likely too large. Aside from being logistically unwieldy, The size of the board here would likely dilute the influence of the independent directors and enable the inside directors to exercise more control.

Note: The analysis would be exactly the same under Delaware law. *See* DGCL § 141(a) ("The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate.").

89. Governance by Committee.

Answer (C) is the best answer. Although "the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors[,]" MBCA § 8.01(b), "a board of directors may establish one or more board committees composed exclusively of one or more directors to perform functions of the board of directors[.]" MBCA § 8.25(a). Generally speaking, once appointed, a committee may exercise the powers of the board as specified by the board, the articles of incorporation, or the bylaws. *See* MBCA § 8.25(d). A committee may not, however, authorize or approve distributions; approve or propose to shareholders actions that are statutorily required to be approved by shareholder; fill vacancies on the board; or adopt, amend, or repeal bylaws (although nothing prohibits a committee from merely advising the board about any of these). *See id.* For public corporations, some committees are required under the Sarbanes-Oxley Act of 2002 and some stock exchange listing requirements: all corporations that file financial reports with the Securities and Exchange Commission must have an audit committee. Public corporations are also required to have a nominating committee and a compensation committee.

Answer (A) is incorrect because it overlooks the authority of the board of directors to appoint committees.

Answer (B) is incorrect because it fails to account for the committees required of public corporations.

Answer (D) is incorrect because, except as limited by statute, committees may exercise the authority of the board.

Note: The outcome would be the same under Delaware law, including the requirements that public corporations have an audit, nominating, and compensation committee. *See* DGCL § 141(c).

90. Removal as Retaliation.

Answer (A) is the best answer. A shareholder agreement to require the shareholders to elect each other to the board is enforceable — by specific performance if necessary. At the same

time, the corporation's business and affairs shall be managed by or under the direction of a board of directors. *See* MBCA § 8.01(b) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors."). The business and affairs of a corporation includes the appointment of its officers and other agents. Under the traditional governance model, by their contract, shareholders could not bind, "handcuff," or "sterilize" the board of directors, on decisions as to who the officers may be or on any other matter. Some courts struck down such contracts as efforts to conduct a corporation's business "as if it were a partnership." As a matter of policy, directors should have a full measure, or nearly full measure, of discretion, unfettered by prior restraints. Along similar lines, future shareholders should be able to elect directors with a full measure of discretion. Prior restraints on directors disenfranchises future shareholders. Once elected, directors generally have no power to remove fellow directors; that power resides either in the shareholders by majority vote, MBCA § 8.08, or by a court, MBCA § 8.09. Thus, Wettick is not entitled to be reappointed as an officer but may be entitled to damages if the contract provided for a salary. *See* MBCA § 8.44(b) ("An officer's removal does not affect the officer's contract rights, if any, with the corporation."). On the other hand, "[t]he appointment of an officer does not itself create contract rights." MBCA § 8.44(a). It is customary for minutes of directors' meetings to record the appointment of officers and the fixing of their compensation.

Answer (B) is incorrect because Wettick has no contractual right to remain an officer of the corporation.

Answer (C) is incorrect because the effort to remove Wettick from the board is ineffective.

Answer (D) is incorrect because Wettick has no right to remain an officer.

Note: Delaware law functions similarly as to the removal of officers. *See* DGCL § 142.

91. Firing an Officer.

Answer (A) is the best answer. "An officer may be removed at any time with or without cause by (i) the board of directors; (ii) the appointing officer, unless the bylaws or the board of directors provide otherwise; or (iii) any other officer if authorized by the bylaws or the board of directors." MBCA § 8.43(b). This is the rule no matter whether the position was created by the bylaws or established by the board. The official comments to the MBCA recognize that, to provide stability, the board may enter into an employment agreement with an officer, but "[s]uch an employment agreement does not override the removal power set forth in section 8.43(b) and may give the officer the right to damages, but not specific performance, if employment is terminated before the end of the contract term." Accordingly, here, the board retains the authority to remove Telfine as an officer at any time, although the corporation may be liable for monetary damages to Telfine for breach of the employment agreement.

Answer (B) is incorrect because the distinction between an officer position's being established by the board rather than the bylaws is irrelevant.

Answer (C) is incorrect because the employment agreement does not override the board's removal authority under MBCA § 8.43(b).

Answer (D) is incorrect because shareholders do not vote on the appointment or removal of officers.

Note: The outcome would be the same under Delaware law. *See* DGCL § 141(b).

92. Personal Backlash.

Answer (D) is the best answer. Although the business and affairs of a corporation are generally managed by the board of directors, and the appointment of officers is within the purview of the board, courts may exercise their equitable powers to enforce shareholder contracts pertaining to the appointment of officers when all of the shareholders are parties to the contract. Thus, a court in equity may hold that Rob and Bill lack the power to fire Sally.

Answer (A) is incorrect because, while it correctly reflects the general rule, it overlooks the court's equitable powers when all the shareholders enter into a contract.

Answer (B) is incorrect because an employment contract does not prevent an officer from being removed, but it may entitle the office to damages for a wrongful termination.

Answer (C) is incorrect because it is unclear that these circumstances involve a breach of fiduciary duty, but even if they did, the remedy may not be that Sally could get her job back.

93. A Lifelong Contract.

Answer (C) is the best answer. Boards of directors may abdicate their duty to manage through long-term (or overly broad) delegations of three kinds: (1) contracts with officers or employees; (2) contracts with outsiders; or (3) delegations to committees of their own number. With regard to the first, the traditional model is that the board appoints, and reappoints, the officers annually. Longer-term appointments tie the hands of future boards of directors and tend also to disenfranchise future shareholders. Lifetime, or excessively long-term, appointments were seldom, if ever, upheld. Today, courts apply a rule of reason analysis. How broad is the delegation? What is the term? What are the shareholders' other relationships to the corporation? What is the nature of the corporation: small, family-owned, closely-held, publicly-held? And so on. The easy fix is to draft a long-term contract, with the understanding that the contract will not stop the board from firing the officer. Instead, the contract may entitle the officer to damages if the officer is wrongfully terminated.

Answer (A) is not the best answer because, even if a lifetime contract would not be enforceable, this option does not address how the board could continue to engage with Vice President.

Answer (B) is not the best answer because, even though it correctly raises the concern of shareholder disenfranchisement, it does not address the possibility of a long-term employment contract.

Answer (D) is incorrect because it overstates the board's authority and fails to address how the board's proposed course of conduct may result in shareholder disenfranchisement.

94. Consulting Services.

Answer (D) is the best answer. There are two issues here. First, delegations to outsiders, such as consulting firms, today have also come to be judged by "rule of reason" analysis as well. How broad is the delegation? What is the term? What are the shareholders' other relationships to the corporation? What is the nature of the corporation: small, family-owned, closely-held, publicly-held? And so on. The legal objections to overly broad or lengthy delegations include that such delegations handcuff or tie the hands of future boards and disenfranchise future shareholders. Here, a 10-year contract is likely too great a commitment that could limit the ability of future directors to manage the business and affairs of the corporation. Likewise, under the Sarbanes Oxley Act, accounting firms that provide audit services are limited in what consulting services they may offer the same clients because of conflict-of-interest concerns.

Answer (A) is incorrect because it approves an improper delegation and conflict of interest.

Answer (B) is incorrect because BAF likely has the requisite expertise, but the contract is still problematic.

Answer (C) is not the best answer. It states a correct rule of law but overlooks the conflict of interest issue. Thus, it is not as good of an answer as Answer (D).

95. Executive Committees.

Answer (D) is the best answer. The general rule is that "a board of directors may establish one or more board committees composed exclusively of one or more directors to perform functions of the board of directors." MBCA § 8.25(a). But the board may not delegate all management of the business and affairs of the corporation to a committee. MBCA § 8.25(e). A committee may not "(1) authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors; . . . (2) approve or propose to shareholders action that this Act requires be approved by shareholders; . . . (3) fill vacancies on the board of directors or . . . on any of its committees; or . . . (4) adopt, amend, or repeal bylaws." MBCA § 8.25(d). Here, this delegation is certainly broad, and although some powers are reserved (dividends and the recommendation of mergers), it nevertheless exceeds the scope of delegation permitted. Specifically, this delegation is impermissible because it empowers the committee to "fill vacancies on the board of directors or . . . on any of its committees" and "adopt, amend, or repeal bylaws."

Answer (A) is incorrect because this delegation exceeds the permissible scope of delegation established by statute.

Answer (B) is incorrect because the matter of whether this delegation is efficient does not change the fact that the delegation is too broad.

Answer (C) is incorrect because some delegation of the authority of the board to a committee is expressly permitted.

Note: Delaware law similarly permits and limits the delegation of board authority to committees. *See* DGCL § 141(c)(2).

96. Shareholder Proposals, Part I.

Answer (D) is the best answer. This question addresses a classic problem — even though the shareholders own the company, they have very limited powers and even more limited powers of initiative. That is, by statute, shareholders' votes are necessary for mergers, sale of substantially all of the corporation's assets, amendment of the articles of incorporation, or dissolution of the corporation, but only based upon a recommendation made to them by the board of directors. Shareholders' powers of initiative are limited to rights to elect and to remove directors. Then, the business and affairs of the corporation are managed by the board of directors. *See* MBCA § 8.01(b). Thus, for example, if shareholders want a merger to take place, they cannot, strictly speaking, accomplish it directly. They must accomplish it indirectly. At their own expense, the shareholders must put up a slate of directors whom they believe will recommend the merger, solicit proxies, and then put their own nominees in office. Between annual meetings, they may first have to remove the incumbent board. With that said, it is entirely appropriate for shareholders to discuss the business and affairs at meetings and adopt resolutions, even if they are merely advisory. *See, e.g.*, *Auer v. Dressel*, 118 N.E.2d 590 (N.Y. 1954). Such resolutions are not futile because, if passed, they serve to put the directors on notice that the shareholders are less than pleased and may take more strident action, such as removal and election of a new slate of directors, should conditions not improve.

Answer (A) is incorrect because, while the phrase of the second resolution is problematic, it is appropriate for shareholders to discuss the state of the business and adopt advisory resolutions at shareholder meetings.

Answer (B) is similarly incorrect because shareholders have a right to discuss business matters; they simply cannot make business decisions.

Answer (C) is not the best answer. It is not as good as Answer (D) because the resolution is framed as a business decision rather than an advisory resolution.

97. Shareholder Proposals, Part II.

Answer (C) is the best answer. The Securities and Exchange Commission requires and regulates the solicitation of proxies to vote shares in publicly-held companies. Public companies must submit to the SEC, and send to their shareholders, an annual report, a notice of the shareholder's meeting, and a proxy statement. The latter is a disclosure document, but one limited in scope. It contains the text of resolutions to be voted upon and disclosure that will enable a shareholder to cast an informed vote. If the shareholders were insistent on including their own proposal, the shareholders would have to undertake the same process.

That is to say, the shareholders would have to prepare and file their own proxy statement and form of proxy, which they would then mail to the shareholders. SEC rules establish the process by which shareholders may submit proposals to be included on the solicitation. Assuming that the shareholder owns sufficient stock, timely submits the proposal, and submits the proposal in the proper form, the board of directors is required to include the proposal unless there is a basis to exclude it. Some common reasons for a board's properly excluding a proposal are if the proposal pertains to "a matter relating to the company's ordinary business operations" or "to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large." Here, the shareholder proposals could likely be categorized as related to personal claim or grievance and to ordinary business matters.

Answer (A) is incorrect because, even if a proposal is timely and properly submitted, there are various reasons a board may exclude the proposal.

Answer (B) is incorrect because there simply is no requirement that every proposal be included.

Answer (D) is incorrect because a board may be required to include proposals, even if the board does not support the proposal.

98. Clowning Around.

Answer (D) is the best answer. "A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws." MBCA § 8.40(a). The official comments to the MBCA clarify that no particular officers are required. The corporation must, however, "assign to an officer responsibility for maintaining and authenticating the records of the corporation." MBCA § 8.40(c). The MBCA refers to this officer as the "secretary of the corporation," *see* MBCA § 1.40, but there is no requirement that the corporation expressly title this officer as "secretary." For public corporations, the rules are different — the Sarbanes-Oxley Act of 2002 established requirements for chief executive officers and chief financial officers. These rules are not applicable to closely-held corporations. Thus, here, the slate of officers desired by Clowns, Inc., is entirely permissible under the MBCA, so long as the corporation designates at least one officer to maintain and authenticate corporate records.

Answer (A) is incorrect because there is no requirement to designate an officer by any given title.

Answer (B) is incorrect for the same reason as Answer (A).

Answer (C) is incorrect because the requisite officer responsibilities could be vested in one person.

Note: The outcome is the same under Delaware law. *See* DGCL § 142(a).

99. Removal of a Director.

Answer (C) is the best answer. "The shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause." MBCA § 8.08(a). Shareholders may vote at annual, *see* MBCA § 7.01, or special meetings, *see* MBCA § 7.01 (or via written consent if the vote to remove River is unanimous, *see* MBCA § 7.04(a)), but the notice of special meeting "must include a description of the purpose or purposes for which the meeting is called." MBCA § 7.05(c). Thus, assuming the articles of incorporation do not include a removal-for-cause provision, the only way that River could be removed as a director would be by plurality vote of the shareholders at a properly noticed meeting.

Answer (A) is incorrect because, unless the articles of incorporation include a removal-for-cause provision, a director on a non-staggered board may be removed by shareholder vote with or without cause.

Answer (B) is incorrect because it is incomplete. Unless the shareholder vote to remove River is unanimous, it can only be accomplished at a meeting of the shareholders.

Answer (D) is incorrect because directors do not have authority to remove other directors.

Note: Under Delaware law, a director can be removed by shareholder vote with or without cause. *See* DGCL § 141(k). Delaware law does not distinguish between annual and special meetings, and there is no statutory requirement that notice be given. Similarly, there is no statutory requirement that actions by written consent be by unanimous vote. If the board of directors is staggered, a director may only be removed for cause. *See id.*

100. Stuck with a Director.

Answer (A) is the best answer. A court "may remove a director from office or may order other relief, including barring the director from reelection for a period prescribed by the court, in a proceeding commenced by or in the right of the corporation if the court finds that (i) the director engaged in fraudulent conduct with respect to the corporation or its shareholders, grossly abused the position of director, or intentionally inflicted harm on the corporation; and (ii) considering the director's course of conduct and the inadequacy of other available remedies, removal or such other relief would be in the best interest of the corporation." MBCA § 8.09(a). Here, they may not have the shareholder votes to remove River, but Lake and Moon have the votes (as directors) to cause the corporation to sue for River's removal. This is their best, and likely only, option.

Answer (B) is incorrect for two reasons. First, the SEC, and not the company, has power to seek River's removal and obtain a "director and officer bar order." Second, this only applies to public corporations, not closely-held corporations.

Answer (C) is incorrect because it ignores that Lake and Moon could seek judicial removal of River; a temporary injunction, however, may be appropriate pending the outcome of the case.

Answer (D) is incorrect because it is insufficient. The priority is to stop more harm from occurring, not just to seek damages for past breaches.

Note: The outcome would be different under Delaware law. By statute, a court may only remove a director if they have been convicted of a felony or adjudicated to have breached their fiduciary duty. *See* DGCL § 225(c). Some Delaware courts have indicated a hesitancy to exercise equitable powers to remove a director. *See, e.g., Ross Sys. Corp. v. Ross*, 1993 WL 49778, at *17–18 (Del. Ch. Feb. 22, 1993). If Lake and Moon do not have enough of the shareholder vote, they are likely stuck with River as a director. Of course, from a practical perspective, they could likely fire River as an officer (if he had been appointed), cut off his access to funds, prevent him from entering the premises, or seek injunctive relief from a court. If this does not resolve the issue, then they may have to cause the corporation to sue River for breach of fiduciary duty.

101. Proof of Officer Authority.

Answer (D) is the best answer. "The business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors." MBCA § 8.01(b). "A corporation has the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws." MBCA § 8.40(a). A prudent attorney would want to confirm that the CEO's authority is rooted in an appointment by the board of directors, which would be reflected in a board resolution. Although there may be an argument that the CEO has apparent authority to enter the transaction by virtue of their "loaded title," it is questionable how reasonable it would be for a third party to rely simply on the title when executing such a significant contract. Here, it would be best to have a board resolution appointing the CEO and confirming that the CEO has the authority to enter into a transaction of this magnitude. In fact, it would be best that the board execute a resolution explicitly approving this transaction and authorizing the CEO to sign the contract.

Answer (A) is incorrect because the common law principle of apparent authority is unlikely to form a sufficient basis for the CEO to bind the corporation on a contract of this magnitude.

Answer (B) is incorrect because the articles of incorporation would not be the corporate record establishing the positions of officers or articulating their authority.

Answer (C) is incorrect because, although the bylaws may specify that the corporation will have a CEO and may articulate the CEO's authority, we do not know whether the current CEO was actually appointed by the board.

Note: The outcome would be the same under Delaware law. *See* DGCL § 142(a).

102. Cheers Indemnification.

Answer (D) is the best answer. Here, language of permissive indemnification expands the scope of protections for directors like Sam. This is the best argument for Sam to make.

Answer (A) is incorrect. Factually, Sam has not necessarily been wholly successful. He paid out $100,000 in settlement on a liability claim. MBCA § 8.52 provides that "[a] corporation

shall indemnify a director who was wholly successful, on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation against reasonable expenses incurred by him in connection with the proceeding." But Sam likely did not meet this standard.

Answer (B) is incorrect for two reasons. First, directors are not agents of the corporation, and they are not entitled to indemnification as agents might be. Second, Sam was not acting in his capacity as director of the corporation when this slip and fall accident occurred. Directors bind the company only through their actions as board members.

Answer (C) is incorrect. There is nothing in the fact pattern regarding insurance. Moreover, the existence of insurance *vel non* has nothing to do with the duty to indemnify.

Note: The outcome would be the same under Delaware law. *See* DGCL § 145.

103. Guarding Against Takeovers.

Answer (C) is the best answer. A shareholder rights plan (also called a "poison pill") is intended to make a corporation unattractive to hostile takeovers by making it more expensive or more difficult to acquire a controlling interest in the corporation. Any shareholder rights plan would be subject to judicial review, and potentially judicial invalidation. Thus, to posture the corporation to best defend against hostile takeovers, a board would be advised to adopt multiple defensive mechanisms. A staggered board can help guard against hostile takeovers because it would extend the amount of time that an activist would have to spend to elect enough directors to the board to take control of the corporation. Here, pairing a shareholder rights plan with a staggered board bolstered by a removal-for-cause requirement may be about the best defense the board could implement.

Answer (A) is incorrect because a court would not be likely to uphold the board's attempt to "handcuff" future boards from deactivating the shareholder rights plan.

Answer (B) is incorrect because such a plan would similarly "handcuff" future boards, at least for the first six months of their terms.

Answer (D) is not a good answer because, while at some point hostile takeovers become inevitable, there are other defensive mechanisms that could be implemented that this choice does not take into account.

104. A Selfish Board.

Answer (D) is the best answer. The challenge here is that the board's actions are technically lawful, but they are being undertaken for selfish reasons. This situation highlights the tension between freedom of contract and equity that frequently arises in the context of corporate governance. Likewise, it illustrates the court's broad equitable powers. In *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971), the Supreme Court of Delaware instructed the Court of Chancery to enjoin an annual meeting under factual circumstances nearly identical to this question. The Schnell court held that, even though both actions were technically permissible under the bylaws, it would not countenance wrongful subversion

of corporate democracy or impermissible manipulation of the election machinery. That is, "inequitable action does not become permissible simply because it is legally possible." *Id.* at 439. A later Delaware case, *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988), emphasized "the central importance of the franchise to the scheme of corporate governance" and clarified that, even if the board acted in good faith, any action of the board that impedes the stockholder franchise must be supported by a "compelling justification." More recently, the Delaware courts have recognized that *Schnell* and *Blasius* have been "folded" into the analysis of *Unocal Corp. v. Mesa Petroleum Corp.*, 493 A.2d 946 (Del. 1985), such that under the new test, when a stockholder challenges a board action that interferes with the stockholder franchise, the board bears the burden to prove that (1) "the board faced a threat 'to an important corporate interest or to the achievement of a significant corporate benefit'" and that (2) "the board's response to the threat was reasonable in relation to the threat posed and was not preclusive or coercive to the stockholder franchise." *Coster v. UIP Companies, Inc.*, 300 A.3d 656 at 672-73 (Del. 2023). Here, it goes without question that the Boatworth board took action that impacted the stockholder franchise by trying to "speed up" the process before Sureturst could acquire enough shares of stock to constitute a majority. But there is no indication of a "compelling justification," only of the directors' self-interested desire to entrench themselves to continue on the board. Thus, even if the action had been taken in good faith, it likely would not withstand scrutiny under the *Schnell* test as developed through its progeny.

Answer (A) is incorrect because it relies too much on the "technically lawful" action without further scrutinizing the board action through an equitable lens.

Answer (B) is incorrect for the same reason as Answer (A).

Answer (C) is incorrect for the same reason as Answer (A).

105. Remote Participation.

Answer (B) is the best answer. "Shareholders of any class or series of shares may participate in any meeting of shareholders by means of remote communication to the extent the board of directors authorizes such participation for such class or series." MBCA § 7.09(a). A shareholder participating remotely may fully participate and be counted present, but only if "the corporation has implemented reasonable measures . . . to verify that each person participating remotely is a shareholder, and . . . to provide such shareholders a reasonable opportunity to participate in the meeting and to vote on matters submitted to the shareholders, including an opportunity to communicate, and read or hear the proceedings of the meetings, substantially concurrent with such proceedings." MBCA § 7.09(b). Importantly, the board must permit a class of shareholders to participate; the board may not permit an individual shareholder to attend remotely without also authorizing all shareholders of the same class to do so.

Answer (A) is incorrect because it fails to account for remote participation.

Answer (C) is incorrect because a shareholder does not have an absolute right to participate remotely; they may only do so if authorized by the board.

Answer (D) is incorrect because the board does not have authority to grant special permission for a single shareholder without also granting permission for all other shareholders of the same class.

Note: Delaware law also permits remote participation in shareholder meetings subject to board discretion. *See* DGCL § 211.

Corporate Fiduciary Duty

106. Introduction to Corporate Fiduciary Duty.

Under the MBCA, each director, when discharging their duties as a director, is required to act in good faith and in a manner the director reasonably believes to be in the best interest of the corporation. *See* MBCA § 8.30(a). More specifically, the directors must be informed regarding the decisions they make and in exercising oversight of the corporation. *See* MBCA § 8.30(b)(1). Additionally, directors must disclose to the other directors any information that they have that would be material to the other directors' discharge of their decision-making and oversight functions. MBCA § 8.30(b)(2).

Under Delaware law, each director owes the corporation and the shareholders a duty of care and a duty of loyalty. The duty of care requires that directors adequately inform themselves prior to making any decision and then that they act prudently in carrying out their duties. *See United Food & Comm. Workers Union v. Zuckerberg*, 262 A.3d 1034, 1049 (Del. 2021). Gross negligence constitutes a breach of the duty of care. *Id.* The duty of loyalty requires undivided and unselfish loyalty to the corporation and that there be no conflict between duty and self-interest. *Id.* The duty of loyalty also requires that directors refrain from competing with the corporation, usurping corporate opportunity, or engaging in conflict-of-interest transactions. Finally, the duty of loyalty requires that directors exercise their duties in good faith. *See Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006).

107. A Bad New Idea.

Answer (C) is the best answer. Directors of a corporation owe the corporation and the stockholders a duty of care. "'[P]redicated upon concepts of gross negligence,' the duty of care requires that fiduciaries inform themselves of material information before making a business decision and act prudently in carrying out their duties." *United Food & Comm. Workers Union v. Zuckerberg*, 262 A.2d 1034, 1049-50 (Del. 2021) (alterations in original). In other words, "to allege that a corporation has suffered a loss as a result of a lawful transaction, within the corporation's powers, authorized by a corporate fiduciary acting in a good faith pursuit of corporate purposes, does not state a claim for relief against that fiduciary no matter how foolish the investment may appear in retrospect." *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996). Here, the facts indicate that the directors performed the standard due diligence and that they only learned about the new disease when it was publicly announced. Likewise, there is no indication that the directors were not acting in

good faith in pursuit of corporate purpose. Certainly, there is no indication that the directors were acting in a grossly negligent manner.

Answer (A) is incorrect because, even if the decision was foolish, the directors do not face liability merely because the decision turned out to be unprofitable.

Answer (B) is incorrect because the decision to enter into the contract appears to have been a decision made in good faith in pursuit of corporate purpose.

Answer (D) is incorrect because directors do owe a duty of care and face liability when they act in a grossly negligent manner.

108. The Business Judgment Rule.

Answer (C) is the best answer. Directors owe a fiduciary duty of care, that is, the amount of care that a reasonably prudent person would exercise in a like position in similar circumstances. The duty of care will be breached when the directors act in a grossly negligent manner or engage in intentional or knowing violations of law. Courts are hesitant to second-guess business decisions made by duly elected directors. Thus, "in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith." *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996). This "business judgment rule" serves first and foremost as directors' front-line defense to an allegation that they have breached their duty of care. The rule serves also as a means whereby courts may conserve the judicial resource, by determining the majority of cases at an early point in the litigation. Last of all, in cases where directors have been proactive in making decisions and judgments (rather than doing nothing), the rule does become the de facto standard for conduct of the board's activities. Here, the business judgment rule protects the board's decision from judicial scrutiny because there is no indication that the directors were acting in a self-interested manner or with improper motive. Rather, the board made a business decision that they believed in good faith was in the corporation's best interest, and it is of no legal consequence that a different decision would have been more profitable.

Answer (A) is not the best answer because it only offers the policy underlying the rule, not the rule itself.

Answer (B) is not the best answer because it assumes the outcome without addressing the rule.

Answer (D) is incorrect because it misunderstands the rule. The business judgment rule serves to protect board decisions; the rule does not require anything of the directors.

109. Failure to Monitor.

Answer (C) is the best answer. This question reflects the confusing relationship between the duty of care and the duty of loyalty. The duty of care requires directors to be reasonably informed in carrying out their oversight and decision-making responsibilities and to conduct themselves in a reasonably prudent manner, but it is well established that only gross negligence or an intentional or knowing violation of law will breach the duty of care. This

problem seems to present what is known as a "classic *Caremark* claim," so dubbed after the case *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). The crux of such claims is that the board of directors did not know about a problem within the corporation, but it should have known. It follows that, had the board known, its fiduciary duties would have required them to address it. In more recent cases, Delaware courts have clarified that a knowing disregard for duties or a sustained and systematic failure to exercise oversight, although perhaps ringing in the vernacular of the duty of care, is actually a failure to act in good faith. *See, e.g.*, *Marchand v. Barnhill*, 212 A.3d 805, 820–21 (Del. 2019); *Stone v. Ritter*, 911 A.2d 363, 370 (Del. 2006). Indeed, directors are required to have reporting information systems or controls to ensure that pertinent information is brought to their attention, and they are charged with monitoring those reporting systems. *See Marchand*, 212 A.3d at 821. As the *Marchand* court explained, "In short, to satisfy their duty of loyalty, directors must make a good faith effort to implement an oversight system and then monitor it." *Id.* The court further explained that "a corporate board must make a good faith effort to exercise its duty of care. A failure to make that effort constitutes a breach of the duty of loyalty." *Id.* at 824. The *Marchand* court also seemed persuaded that when a matter is mission critical to the organization, it deserves attention by the board. *See id.* at 824. Here, for an insurance company, cash reserves seem almost certainly "mission critical," and it would be incumbent on the board to ensure that a reporting system is in place for them to monitor the status of their reserves and their ability to pay out claims. After all, that is what insurance companies do. Accordingly, under *Stone* and its progeny, a modern Delaware court would likely conclude that the board here had failed to act in good faith, and thus, breached its duty of loyalty.

Answer (A) is incorrect because simple negligence does not breach the duty of care.

Answer (B) is incorrect because this does not appear to be an intentional or knowing violation of law.

Answer (D) is incorrect because there is no indication that the board has engaged in a conflict-of-interest transaction.

110. Who's to Blame? Part I.

Answer (D) is the best answer. Two principles should be brought to bear here. First, although no particular care and skill may be required to be a director, if an individual director does possess certain skills and knowledge (the actuary or the lawyer here), she must bring it to bear. Second, although no particular care and skill may be required as a prerequisite to being a director (the daughter or the son), upon joining a board, a director must, within a reasonable time, gain the skill, knowledge, and familiarity with the company's affairs that will enable her to function well as a director. If she is not able or willing to do so, she should resign. Many lawyers, accountants, bankers, and other persons in business-related professions (here, an actuary) no longer wish to serve on boards because they may be held to a "higher standard" — one that includes the baseline of knowledge and skill that a judge or jury believes a professional should possess. Additionally, the duty of care requires directors to become reasonably informed as they carry out their decision-making and oversight

responsibilities. A failure to become informed or monitor the corporation's affairs would likely be considered bad faith in breach of the duty of loyalty.

Answer (A) is incorrect because it wrongly lets the son and daughter off the hook, even though they are demonstrating a conscious disregard for their duties.

Answer (B) is incorrect because there is no reason to hold the two absent directors liable and let the two directors who made the decision off the hook.

Answer (C) is incorrect because there are substantial grounds for liability here.

111. Who's to Blame? Part II.

Answer (A) is the best answer. Although they may exist in reality, in law there is no such thing as a specialized, honorary, or figurehead director. A defense that a director was only a "figurehead" or a "specialized" director is simply without merit. If the corporation believes that it would benefit from having "big names" associated with it, it would be better to do something along the lines of forming an "advisory board" or, perhaps, appointing those "big names" as officers to limited roles.

Answer (B) is incorrect because directors are elected by the shareholders and owe the duties prescribed by law.

Answer (C) is incorrect because geography is irrelevant to board responsibilities.

Answer (D) is incorrect. Although there is no duty to attend meetings, all directors have the duty to keep informed. The best evidence that a director is informed may well be attendance at all, or most, of the board's meetings.

112. An Extravagant Deficiency.

Answer (D) is the best answer. Like directors, officers also owe fiduciary duties to the corporation and the shareholders. The president here, however, had to bring that standard of care to bear in more situations and day-to-day minutiae. The president likely breached these duties by failing to monitor the discrepancy between deposits and cash on hand as well as by failing to question the cashier's new lifestyle. Additionally, the directors owed a duty to monitor and to ensure that mission-critical information — such as cash on hand — was brought to their attention. Thus, here, the president is likely in breach for failing to detect that the cashier was stealing, and the directors are in breach for failing to have a reporting system in place to alert them to this discrepancy.

Answer (A) is incorrect because, while what the cashier did was certainly illegal, the cashier does not owe the corporation or the shareholders any fiduciary duty.

Answer (B) is not the best answer because it fails to account for the president's breach of fiduciary duty.

Answer (C) is not the best answer because it fails to account for the directors' breach of fiduciary duty.

113. A Sick Director.

Answer (D) is the best answer. Courts have been resistant to break the duty of care down into a list of sub-duties. However, if there were sub-duties, the two principal ones would be the duty to stay informed and the duty to make inquiry; it is not likely that the duty of care would impose an absolute duty to attend board meetings. Thus, as long as Veeck remains capable of staying informed on the corporation's affairs (and it certainly seems he is), he is likely upholding his duty of care. Whether he is reelected to the board is another question for the shareholders to consider at the next meeting.

Answer (A) is incorrect because it simply is not true. There is no formal duty to attend board meetings.

Answer (B) is incorrect because, factually, the opposite is true. Veeck has been upholding his duties to stay informed and exercise oversight.

Answer (C) is incorrect because it simply is not rooted in principle. Why should one more board meeting make the difference, so long as Veeck is staying informed?

114. A Rushed Proposal.

Answer (D) is the best answer. This question is based upon the Delaware Supreme Court's infamous decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). In that case, the directors of Trans Union Corp. did approve the transaction after only a two-hour meeting, with no deal documents, reports, or other information. While announcing a forgiving standard ("We think the concept of gross negligence is also the proper standard for determining whether a business decision reached by a board of directors was an informed one."), the court held that the directors had not even met the forgiving standard. Thus, they were not entitled to the protection of the business judgment rule. Reaching the merits as well, the court found that the directors had breached the fiduciary duty of care. On remand, the Delaware Chancery Court found that a sufficient price ("intrinsic value") would have been $65 per share. The directors, who were a prestigious group, were potentially liable for $133,577,580. *Van Gorkom* is a "reverse roadmap" case — that is, if an attorney or other advisor in a major merger or other transaction advises a board to do the opposite of everything that the Trans Union directors did or did not do, that board will be well on its way to complying with its fiduciary duties.

Answer (A) is incorrect because it involves almost no process which would tell the directors if $55 may be a good price.

Answer (B) is incorrect because it is incomplete. It properly frames the issue, but it does not offer the directors any sense of what to propose.

Answer (C) is incorrect. It is a better option than Answer (B) because it offers the good idea of referring this matter to a committee, but it is not as good as Answer (D), which is cumulative and therefore the best answer.

115. Officer Duties.

Answer (C) is the best answer. This question is loosely based on *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). "Corporate officers, when performing in this capacity, have the duty to act in good faith; . . . with the care that a person in a like position would reasonably exercise under similar circumstances; and . . . in a manner the officer reasonably believes to be in the best interests of the corporation." MBCA § 8.42(a). The official comments to the MBCA recognize that these standards of conduct generally match those owed by directors. Accordingly, here, President and CFO cannot escape liability for breach of fiduciary duty simply by arguing that they were acting in their capacities as officers rather than directors. Of course, whether President and CFO will actually be liable monetarily for their breaches of fiduciary duties is a different matter and is beyond the scope of this question.

Answer (A) is incorrect because it flatly misstates the rule.

Answer (B) is incorrect because officers owe fiduciary duties, even if they have not expressly agreed to undertake them.

Answer (D) is incorrect because the duties owed by officers are generally the same as those owed by directors.

Note: The answer is the same under Delaware law. In fact, *Gantler* itself expressly answers the question. *See Gantler*, 965 A.2d at 708–09 ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.").

116. Exculpation.

Answer (C) is the best answer. Following the decision in *Smith v. Van Gorkum*, the DGCL was amended to permit the inclusion of an exculpation clause in the certificate of incorporation that exculpated corporate directors from monetary liability for an adjudicated breach of their duty of care. In *Gantler v. Stephens*, 965 A.2d 695, 709 n. 37 (Del. 2009), the court noted that the exculpation provisions were permissible as to directors, but not officers. In 2022, the DGCL was amended once again and now permits exculpation of both directors and officers for "monetary damages for breach of fiduciary duty as a director or officer, provided that such provision shall not eliminate or limit the liability of: . . . [a] director or officer for any breach of the director's or officer's duty of loyalty to the corporation or its stockholders; . . . [a] director or officer for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . (iii) [a] director under § 174 of this title; . . . (iv) [a] director or officer for any transaction from which the director or officer derived an improper personal benefit; or . . . (v) [a]n officer in any action by or in the right of the corporation." DGCL § 102(b)(7).

Answer (A) is incorrect because the exculpation is too broad and does not extend to officers.

Answer (B) is incorrect because the exculpation is too broad.

Answer (D) is incorrect because it does not include officers.

117. Play Ball at Night, Part I.

Answer (A) is the best answer. The business judgment rule is not something with which directors are required to or must comply. If they do meet its requirements, they receive a more deferential review in court. But, if they do not, they may nonetheless defend themselves on the merits, that is, that they did in fact exercise the requisite amount of care. Some courts require boards to make an "independent" decision or judgment, rather than merely deferring or rubber stamping the will of another, as a prerequisite for claiming the protection of the business judgment rule. Here, the Baron board's mere deferral to Laker is probably insufficient to justify the protection of the business judgment rule.

Answer (B) is incorrect because it is an extreme statement of the rule.

Answer (C) is incorrect because the absence of conflicts of interest alone is insufficient. To invoke the rule successfully, directors must demonstrate that they exercised at least a modicum of care.

Answer (D) is incorrect because the business judgment rule is not the applicable standard — that would be the duty of care. Rather, the business judgment rule simply offers protections under certain circumstances.

118. Play Ball at Night, Part II.

Answer (B) is the best answer. A principal function of the business judgment rule is to filter or screen out cases against corporate directors, or some of them, prior to trial. Trials are useful to address questions such as "Did defendants exercise due care or reasonable care?" On the other hand, the business judgment rule prevents, at an early stage of the litigation, cases from proceeding when the allegations fail to establish that a director has not exercised reasonable care or has not made a procedurally sound decision. The business judgment rule would fail miserably in its role as a filter or screen that, among other things, fosters conservation of judicial resources. Instead, the business judgment rule only requires that directors demonstrate that they exercised some care, while at the same time requiring proofs on several other issues (a decision or judgment, independence and lack of conflicts, etc.). Gross negligence is the standard for breach of the duty of care, outside the protection of the business judgment rule. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Here, a shareholder might claim that the report was an insufficient basis upon which to make a decision because it was biased, but that is a decision that ultimately boils down to a matter of business judgment. Assuming there are no allegations that the directors are self-interested in the transaction or are acting for some purpose other than the best interest of the corporation, the business judgment rule will likely protect their decision and the court will quickly dispose of this case on a motion to dismiss.

Answer (A) is incorrect because it delves into the substance of the decision rather than the procedural soundness of it.

Answer (C) is incorrect because whether the board met its duty of care or acted with the utmost care is legally irrelevant, and even if it were relevant, it is questionable whether this decision truly would be of the utmost care.

Answer (D) is incorrect because the mere fact that directors are independent does not qualify their decisions for protection under the business judgment rule.

119. Political Forgiveness.

Answer (D) is the best answer. The "brooding omnipresence" in the business judgment rule is the requirement that the directors made their decision in good faith. Even though the technical elements of the rule are satisfied, in a given case the court may still hold the action over for trial on grounds that the board's actions were not taken in good faith. Two principal categories of cases exist in which courts have done so. One category involves board action taken in knowing violation of the law. Decisions which directors sincerely believe are in the corporation's best interests will not be protected if the directors know, or in the exercise of slight care should know, that those decisions are illegal. Here, the board's haste may place the decision outside the protection of the business judgment rule. The board knew that there was a question as to the legality of the forgiveness but proceeded with the action anyway, rather than further informing themselves of the potential legal implications.

Answer (A) is incorrect because the board made a decision that it was aware could potentially violate campaign finance law without further investigating the issue first.

Answer (B) is incorrect because the board's conduct appears to be reckless, not an exercise of due care.

Answer (C) is incorrect because the board did not know, at the time it made the decision, that the decision was legally permissible.

120. Takeover Threat, Part I.

Answer (D) is the best answer in the sense that it would be the worst thing the board could do. In the adoption of takeover defenses, board members may have a tinge or more of conflict of interest. A hostile takeover, in which a bidder seeks to acquire a majority of the voting shares, usually to be followed by replacement of the incumbent managers and board members, poses a personal threat to those in charge of the target corporation. They may lose salary, fringe benefits, and the prestige of office. Nonetheless, in most cases, courts have reviewed the adoption of takeover defenses under the duty of care and the business judgment rule rather than the duty of loyalty. One reason is that, in most cases, counsel for the target corporation has learned to script the process in a way that will lead to review under a business judgment rule type of standard. Those with the most at stake, the full-time managers, generally are excluded from the process at some point, or altogether. Even in the hands of the independent directors, the adoption of takeover defenses differs from other types of decisions that are reviewed under a business judgment standard. Takeover and takeover-defense decisions are surrounded by the "omnipresent specter that a board [even of independent directors] may be acting primarily in its own interests." For those and other reasons, led by the Delaware Supreme Court, corporate jurists have evolved a specialized form of the business judgment rule for reviewing adoption of takeover defenses. The "response phase" business judgment rule requires of directors the usual elements: a decision

or judgment, freedom from conflicts of interest, care in informing themselves on the subject matter of the decision, and a rational basis for the decision made. In addition, however, the directors must have "reasonable grounds for believing that a danger to corporate policy and effectiveness exist[s] because of another person's stock ownership." Once directors have in good faith developed that belief, any "defensive measure . . . must be reasonable in relation to the threat posed." *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Here, Answer (D) fails to meet the proportionality and other elements of the *Unocal* test. The bar is simply too low, too arbitrary, and is likely unreasonable in relation to the threat presented.

Answer (A) is incorrect because it would be a good thing to do. The board must ensure that any response to a takeover threat is reasonable in relation to the threat posed.

Answer (B) is incorrect because it is a good idea. Courts are more likely to look favorably upon responses to takeover threats approved by independent directors.

Answer (C) is incorrect because it is a good idea. A staggered board is a reasonable step to take to guard against takeovers and preserve institutional knowledge and experience.

121. Takeover Threats, Part II.

Answer (C) is the best answer. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the Delaware Supreme Court enunciated a second version of the business judgment rule applicable to takeover activities. In addition to the *Unocal* rule with its reasonableness and proportionality requirements, there comes a point where a hostile takeover is inevitable. At this point, the board's fiduciary duty requires it to cease being the defender of the corporate bastion and to shift to maximizing immediate shareholder value by securing the highest price available. Here, the hedge fund made the best offer, and so the board breached its fiduciary duty by recommending the Firstwave offer — especially when the justification for doing so was that Firstwave would retain the managers.

Answer (A) is incorrect because the directors' job was not merely to consider the offer but to maximize immediate shareholder value.

Answer (B) is incorrect because it applies the *Unocal* standard, even though it has now become inevitable that the takeover will go through.

Answer (D) is incorrect. This answer would be tempting, but the prompt indicated that the independent directors met; thus, by definition, these directors were free of disabling conflicts of interest. Mere sympathy, or empathy, for the incumbent managers does not, without more, disable them from making a choice.

122. Duty of Loyalty.

Traditionally, the duty of loyalty is implicated when the board or an officer has a conflict of interest, engages in competition with the corporation, or usurps a corporate opportunity. Recently, the Delaware courts have articulated a broader understanding of the duty of loyalty and explained that the duty of loyalty is breached when directors or officers fail to act in good faith. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006) ("[T]he fiduciary duty of loyalty is

not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.").

123. A Sneaky Director.

Answer (D) is the best answer. Overall, the duty of loyalty requires the fiduciary at all times to "serve the best interests of the corporation." While damage to the corporation is an element of duty of care violations, under the duty of loyalty, either damage to the principal (the corporation) or gains procured by disloyalty will suffice. Courts have also said that lack of disclosure by the director or officer is per se disloyal. Thus, fairness may not be a defense. Here, Birch and Golden Ale failed to disclose Birch's association with Golden Ale because of Birch's desire to purchase the line for a good price. At minimum, Birch had a duty to disclose his association with Golden Ale, and the best practice would have been for Birch to abstain from voting on the matter. This is a direct violation of his duty of loyalty.

Answer (A) is incorrect. This is a reference to the "entire fairness" test, which requires a showing of fair price and fair dealing. Here, because of Birch's deception, it is unlikely that a court would find that this was fair dealing, and so entire fairness would not save the transaction.

Answer (B) is incorrect. The courts make no differentiation between value that may be due to the fiduciary's status and value that has been added subsequently by his efforts.

Answer (C) is incorrect. Resignation after the fact would do Birch no good.

124. Interlocking Directors.

Answer (C) is the best answer. A director may be "interested" because she, or a family member or business associate, proposes to deal with the corporation (e.g., to sell a parcel of land or a piece of software to the corporation). Alternatively, a director may be interested when an entity in which the director has a substantial interest (at least 10 or 15 percent ownership) proposes to deal with the corporation. In those cases, the director should make full disclosure to the board of directors and seek the approval of a disinterested decision-maker (the disinterested directors, or the shareholders in general meeting); otherwise, she should be prepared to defend the fairness, or the "entire fairness," of the transaction. Here, however, Earheart has no substantial ownership interest in Overby, but she does sit on the Overby board of directors. Such cases, in which directors also sit on the board of another corporation but have no direct pecuniary interest in the transaction, are known as "interlocking directorates." Traditionally, corporate law has treated an interlocking directorate (common director) as a conflict of interest the same as any other. Thus, Earheart has a conflict of interest and must disclose all material facts to the board. The disinterested directors may then approve all future transactions nevertheless.

Answer (A) is incorrect. Earheart has a conflict of interest that triggers her fiduciary duty, regardless of the size of the transaction.

Answer (B) is incorrect. The "interlocking" position is itself a conflict of interest.

Answer (D) is incorrect because the directors can only approve future, not past, transactions. Any challenge to the past transactions must be considered under the "entire fairness" standard.

125. All About Fairness.

Answer (C) is the best answer. Modern Delaware law recognizes that conflict-of-interest transactions may actually be beneficial for a corporation, and thus, it provides "safe harbors" through which such transactions may be approved or ratified. The safe harbors are as follows: (1) the material facts are disclosed to the board and the transaction was approved in good faith by the majority of the independent directors, or a committee of independent directors, *see* DGCL § 144(1); (2) the material facts are disclosed to the stockholders and approved in good faith by majority vote of the stockholders, *see* DGCL § 144(2); or (3) "[t]he contract or transaction is fair to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders" — to wit, the "entire fairness" standard determined by a court in litigation. *See* DGCL § 144(3). Compliance bestows a certain amount of extra protection ("removes any interested director cloud") or, under the MBCA's subchapter F, makes the transaction well-nigh unassailable. However, the ultimate touchstone is fairness, not compliance with the statute, on which issue the interested director(s) will have the burden of proof.

Answer (A) is incorrect because conflict-of-interest transactions that are not approved by the disinterested directors or stockholders are voidable unless they can satisfy the entire fairness standard. This answer choices overlooks entire fairness.

Answer (B) is incorrect because DGCL § 144 does not require anything; rather, it provides a mechanism for approval of conflict-of-interest transactions.

Answer (D) is incorrect because there simply is no requirement that any loan by directors or shareholders be at a low rate; rather, the rate must be fair.

Note: The outcome would be virtually the same in an MBCA jurisdiction. *See* MBCA § 8.61(b) *et seq*.

126. Biased Directors.

Answer (D) is the best answer. This question demonstrates the difference between presence and quorum and actually voting on a matter. A director who is present at a vote and delivers notice of abstention may still be counted toward quorum. *See* MBCA § 8.24. Thus, there is certainly a quorum here as all the directors are present. There is not, however, any director who is disinterested and can vote to approve the transaction for purposes of ratifying the transaction under the safe harbor of MBCA § 8.62 (which requires that at least two disinterested directors vote to approve the transaction). In an abundance of caution, the directors may submit the matter to the shareholders for a shareholder vote to approve the transaction, *see* MBCA § 8.63, but depending on the circumstances, this may not be practical in terms of logistics or expenses. As a result, any challenge to this transaction will likely be reviewed under the entire fairness standard.

Answer (A) is incorrect because it makes two significant misstatements. First, the directors can acquire a quorum, even though they do not have the votes to approve the transaction. Second, the transaction can be approved through judicial review under the entire fairness standard.

Though an accurate statement of law, **Answer (B) is incorrect** because it does not address the more significant legal issue.

Answer (C) is incorrect. Even though the transaction is a conflict-of-interest transaction, the board can still go through with it. The transaction is merely voidable, and any challenge to the transaction would still have to overcome entire fairness.

Note: The answer would be the same under Delaware law. *See* DGCL § 144.

127. All the Facts.

Yes. Traditionally, a director's transactions with corporations on whose board he sat simply were void. Over time, this harsh common law began to be ameliorated. Such transactions became voidable at the instance of a complaining shareholder or the corporation, not void altogether. In 1931, California became the first jurisdiction to pass an interested director statute, which provided that if disclosure and a vote had been obtained, fairness to the corporation was a defense — or, more precisely, the complaining shareholder had the burden of proving that the transaction had been unfair. Conversely, if the interested director failed to comply with procedures, that director would have the burden of proving the transaction was entirely fair. In various forms, interested director statutes are common today. *See, e.g.*, MBCA § 8.62; DGCL § 144. But, whether at common law or under these "safe harbor" statutes, directors had a duty to make full and fair disclosure both of their interest and of the corporation's interests in the proposed transaction. Failure to do so would negate any safe harbor protection the director thought he had otherwise obtained by seeking director or shareholder approval. Lack of disclosure would relegate the transaction back to the voidable category. Here, despite his good intentions, Havarotti failed to make complete disclosure. He must therefore be prepared either to prove the fairness of the price he paid for the property or to make full disclosure and seek board approval for a second time.

128. Missed Opportunity.

Answer (A) is the best answer. A director's duty of loyalty requires them to act in the best interest of the corporation. When a director pursues or takes advantage of a business opportunity that should have first been given to the corporation, the director breaches their duty of loyalty. Section G of the MBCA describes a director's obligations when pursuing a business opportunity that should first be offered to the corporation, but it avoids giving an authoritative definition of "corporate opportunity." Instead, the MBCA recognizes this to be a fact-intensive inquiry. Courts employ a variety of tests, including the "interest or expectancy test," the "line of business test," and a general "fairness" test. At the heart of all these tests, however, lies the idea that the director took advantage of their position to take an opportunity for themself that should first go to the corporation. The MBCA offers mechanisms by

which a director may pursue these opportunities consistent with their fiduciary duty. *See* MBCA § 8.70. First, the director may disclose the material facts to the disinterested directors or to the shareholders and seek to have the corporation either disclaim their interest in the opportunity or permit the director to pursue it. Alternatively, the articles of incorporation may disclaim the corporation's interest in certain opportunities. Here, Weldon never disclosed anything to the directors or the shareholders, and he appears to have exploited an opportunity and position that he learned about in his capacity as a director. Thus, Weldon will not be able to claim the protections of the safe harbors, and a court will likely rule that Weldon breached his fiduciary duty of loyalty by usurping these opportunities.

Answer (B) is not the best answer because Weldon was likely privy to information in his capacity as director that led him to pursue these opportunities. At a minimum, Weldon should have disclosed his intent to pursue the opportunity for himself before doing so.

Answer (C) is incorrect. Although Weldon's conduct was certainly not fair, this answer does not describe the legal principles at work.

Answer (D) is incorrect because the resignation would not save Weldon. He still exploited his position as director in pursuing this opportunity.

129. Cellular Licenses.

Answer (B) is the best answer. This question is loosely based on *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). In *Broz*, the court held that a director does not have to expand her "corporate opportunity horizon" to include the scope of a prospective merger partner's business interests. In Delaware, multiple tests exist to determine what opportunities are corporate opportunities, and the tests are cumulative rather than alternative. These tests include considering whether the corporation has an interest or expectancy in the opportunity, whether it was in the corporation's line of business, and whether the corporation had the wherewithal to develop the opportunity. In the modern era, then, courts may well apply a multiple of tests. Think of the various tests as outwardly expanding concentric circles. Here, the significant facts are that these new FCC licenses were beyond the scope of Yalm's business, Yelm had no interest or expectancy in them and had turned them down, and Brody had not learned about the opportunities in her capacity as a director in Yelm. It also appears that the deal was essentially negotiated and functionally complete before the merger, so it certainly seems that Brody has upheld her fiduciary duty of loyalty to Yelm.

Answer (A) is incorrect because it is too harsh. A director may take an opportunity for herself under some circumstances.

Answer (C) is incorrect. Yelm is not conducting business in the cellular industry and so has no expectancy in this opportunity.

Answer (D) is incorrect because it states the rule too leniently. A director may compete with the corporation on whose board she acts, especially if the director was in the business before she went on the board. That principle, however, says nothing about deciding whether new opportunities that arise are corporate opportunities.

130. Brotherly Competition.

Probably not. Courts have held that, absent a past practice or policy of acquiring shares, purchase of shares in a corporation is not a corporate opportunity. *See, e.g., Zidell v. Zidell, Inc.*, 560 P.2d 1091 (Or. 1977). Because no policy or past practice existed here, Ajax was free to purchase Rosen's shares. Hector may claim breach of fiduciary duty, but the corollary is that control has its privileges. Hector may also claim that the corporation is closely-held, that he is being denied his reasonable expectations, and that he is therefore being oppressed. Oppression is a ground for invoking the statutory remedy of "involuntary dissolution." But all of this is premature. Denial of reasonable expectations generally envisions a pattern of conduct.

Shareholder Litigation

131. Introduction to Derivative Actions.

A derivative lawsuit is a lawsuit that a shareholder can file when the shareholder believes the board of directors has breached its fiduciary duties and caused harm to the corporation. Although generally the management of the corporation's business and affairs is vested in the directors, a derivative lawsuit reflects the idea that we cannot expect the directors to sue themselves. Thus, under some circumstances, a shareholder may claim this right and commence action on behalf of the corporation. A derivative lawsuit is truly two lawsuits in one. First, it is a lawsuit by the shareholder against the corporation to compel the corporation to act and sue the directors. In this sense, the shareholder is a nominal plaintiff (a plaintiff in name only) and the corporation is a nominal defendant (a defendant in name only). The allegations are truly against the directors and maintain that the corporation has been harmed. Thus, any remedy will flow to the corporation. Second, a derivative action is a lawsuit by the corporation against the directors to compel the directors to uphold their fiduciary duties and act as appropriate on behalf of the corporation.

132. Inspecting the Records.

Answer (A) is the best answer. A shareholder's inspection of a corporation's records is often a precursor to shareholder litigation. A corporation is required to maintain a record of its current shareholders. *See* MBCA § 16.01(c). Relatedly, a shareholder has an absolute right of access to inspect certain corporate documents. *See* MBCA § 16.02(a) (establishing shareholder right of access to articles of incorporation, bylaws, minutes of shareholders' meetings or other actions, all written communications to shareholders within the past three years, financial statements, a list of directors and officers and their addresses, and the most recent annual report filed with the secretary of state). Notably, the shareholder list is not one of them. Rather, a shareholder may only demand inspection of a shareholder list if "the shareholder's demand is made in good faith[,] the shareholder's demand describes with reasonable particularity the shareholder's purpose and the records the shareholder desires to inspect[,] and the records are directly connected with the shareholder's purpose. *See* MBCA § 16.02(c). Whether a shareholder's purpose is proper is a question of law and equity. *See, e.g., Compaq Computer Corp. v. Horton*, 631 A.2d 1, 3 (Del. 1993). This is distinguishable from a shareholder's right to inspect a list of shareholders entitled to notice of a meeting. *See* MBCA § 7.20(b); *see also* MBCA §§ 16.01(e) & (g)(1). If a shareholder demands to inspect the list of shareholders but the corporation denies the request, the shareholder may seek a court order

compelling inspection. *See* MBCA § 16.04(b). The shareholder will bear the burden to prove that their request to inspect the list of shareholders was made in good faith and for a proper purpose. Significantly, courts must resolve these matters on an "expedited basis" and, if the court orders inspection of the records, may award the shareholder their attorneys' fees. *Id.* Here, Faulkner's request will be governed by MBCA § 16.02(b) rather than § 7.20(b) because the annual meeting is eight months away. Accordingly, Faulkner's right to inspect the list of shareholders is not absolute, and the board may rightly deny the request if it is not made in good faith, is not for a proper purpose, or if the records are not directly connected with the purpose. Whether Faulkner's request is proper may be arguable, but if a court believed that Faulkner merely wanted to alert other shareholders to misleading statements by the board about the merger, the purpose is probably proper. Even if the board's suspicion were correct that Faulkner was fishing for other shareholders to join the lawsuit, this would probably still be a proper purpose.

Answer (B) is incorrect because, while Faulkner would have inspection rights of a list of shareholders entitled to notice of a meeting, this rule is inapplicable here and ignores her inspection rights under MBCA § 16.02(b).

Answer (C) is incorrect because pending litigation does not alter a shareholder's rights under MBCA § 16.02(b).

Answer (D) is incorrect because a shareholder does not have an absolute right to inspect a list of shareholders at any time for any reason.

Note: The analysis is a little different under Delaware law, but Answer (A) is still the best answer. "Any stockholder . . . upon written demand under oath stating the purpose thereof, [has] the right during the usual hours for business to inspect for any proper purpose . . . [t]he corporation's stock ledger, a list of its stockholders, and its other books and records[.]" DGCL § 220(b)(1). "A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder." DGCL § 220(b)(2). Thus, unlike a shareholder in an MBCA corporation that has an absolute right to inspect some corporate records for any reason, a stockholder in a Delaware corporation must show the heightened standard to inspect any records.

133. A Disgruntled Shareholder, Part I.

Answer (D) is the best answer. Generally speaking, "the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors." MBCA § 8.01(b). Nevertheless, shareholders retain the right to exert control over the corporation by (1) selling their shares of stock; (2) voting their shares of stock; or (3) through suing the corporation, the board of directors, or both. Under some circumstances, a shareholder may commence a derivative action — a civil lawsuit in the right of the corporation — against the corporation. *See* MBCA § 7.40. A derivative action is best thought of as two lawsuits in one: First, it is a lawsuit by the shareholder against the corporation to compel the corporation to sue the board of directors; the shareholder is the nominal plaintiff and the corporation is the nominal defendant. Second, it is a lawsuit by the corporation (via the shareholder) against the directors to compel the directors to take remedial action

on behalf of the corporation. The theory here is that the directors (who are responsible for managing the corporation) are harming the corporation, and we cannot expect them to sue themselves. So a derivative action permits a shareholder to step into the right of the corporation and sue the directors on the corporation's behalf. The allegations are that the directors have engaged in misconduct, and any relief or remedy will flow to the corporation — not the shareholder-plaintiff individually. Derivative actions require a shareholder to show standing and meeting heightened procedural requirements. "A shareholder may not commence or maintain a derivative proceeding unless the shareholder (i) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time and (ii) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation." MBCA § 7.41. Additionally, except under limited circumstances, no shareholder may commence a derivative action without first making a demand to the corporation to take corrective action. *See* MBCA § 7.42. Here, Falconer believes that the board has failed to take action to protect the corporation and that, as a result, the value of the corporation has decreased. Thus, a derivative action is the appropriate tool if Falconer can overcome the heightened procedural scrutiny.

Answer (A) is incorrect because, even though it is a correct statement of the law, it ignores the shareholders' ability to commence a derivative action.

Answer (B) is incorrect for the same reason as (A).

Answer (C) is incorrect because Falconer may have a right to commence a derivative action in the right of the corporation, but it is questionable whether Falconer could do so in his own right when the only harm alleged is harm to the corporation.

Note: Answer (D) is also the best answer under Delaware law, although the analysis is somewhat different. Derivative actions arose under Delaware law as a judicially crafted equitable remedy; the DGCL recognizes derivative actions but does not create them. *See* DGCL § 327. Procedural requirements are set forth in Del. R. Ch. Ct. 23.1.

134. A Disgruntled Shareholder, Part II.

Answer (B) is the best answer. The MBCA imposes a "universal demand" requirement on all shareholder derivative lawsuits. Under this requirement, "[n]o shareholder may commence a derivative proceeding until (i) a written demand has been made upon the corporation to take suitable action and (ii) 90 days have expired from the date delivery of the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation[.]" MBCA § 7.42. The only exception to this requirement is when irreparable injury to the corporation would occur as a result of waiting for the 90-day period to expire before filing suit. *Id.* Accordingly, Falconer must make demand on the board of directors to cure or sue for the alleged breach before filing the lawsuit himself.

Answer (A) is incorrect because, absent evidence of irreparable harm, Falconer must first make demand.

Answer (C) is incorrect because there is no requirement that a shareholder hold a specific percentage of stock before commencing a suit. Rather, the only standing requirements are that the shareholder was a shareholder at the time of the alleged breach and remains a shareholder throughout the proceeding and that the shareholder adequately represents the interests of the corporation in bringing the suit. *See* MBCA § 7.41.

Answer (D) is incorrect because there is no requirement that a shareholder first file a shareholder proposal before commencing suit.

Note: Under Delaware law, Answer (A) is likely the best answer. Delaware law similarly requires a stockholder make demand before commencing suit but excuses demand when demand would be futile. *See Aronson v. Lewis*, 473 A.2d 805, 814–15 (Del. 1984). Demand is excused when a stockholder establishes a reasonable doubt that the directors are disinterested and independent or that the challenged transactions were otherwise the product of valid business judgment. *See id.* at 814. Here, because the stockholder is challenging that the directors have breached their fiduciary duty of loyalty by engaging in a conflict-of-interest transaction, the stockholder is likely to be able to establish that demand is excused.

135. A Disgruntled Shareholder, Part III.

Answer (C) is the best answer. In shareholder litigation, it is important to distinguish between direct and derivative claims. Derivative claims are claims asserted by a shareholder on behalf of the corporation and are subject to heightened procedural obstacles. Direct claims, on the other hand, are solely on behalf of an individual shareholder and do not have to overcome the heightened procedural obstacles. Over time, courts and litigants alike have struggled to distinguish between these claims. At one time, courts applied the "special injury rule," which essentially inquired as to whether the shareholder's claims were unique to them or whether the shareholder was similarly situated to any other shareholder. In 2004, the Delaware Supreme Court rejected this standard as confusing and amorphous, and it instead adopted a two-part test: "A court should look to the nature of the wrong and to whom the relief should go. The stockholder's claimed direct injury must be independent of any alleged injury to the corporation. The stockholder must demonstrate that the duty breached was owed to the stockholder and that he or she can prevail without showing an injury to the corporation." *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1039 (Del. 2004). Applying the *Tooley* harm/remedy test here, Falconer's claim about retaliatory dividends is likely direct. First, the harm appears to be to Falconer and the other shareholders individually. They are not receiving dividend payments, and it appears that such payments are being withheld in an arbitrary — if not purposeful — way to deny them financial payment. Likewise, any remedy for the withheld payments would flow to the shareholders directly, not to the corporation. Thus, Falconer has a strong argument that the discriminatory dividend payments entitle him to assert a direct claim against the directors.

Answer (A) is incorrect because the harm to Falconer as a shareholder is distinct from any harm to the corporation, and any remedy would flow to Falconer directly.

Answer (B) is incorrect because it seems to be applying the "special injury" test that the court had rejected. The mere fact that other shareholders were harmed in the same way does not render this claim derivative.

Answer (D) is incorrect because the business judgment rule does not prevent a claim from being brought; it just may provide the court with a quick mechanism with which to dismiss the claim.

136. A Disgruntled Shareholder, Part IV.

Answer (A) is the best answer. Delaware law requires that a stockholder seeking to bring a derivative suit against a board of directors first make demand on the board to cure the breach or sue. *See Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984). The demand requirement, however, is excused when demand would be futile. *Id.* at 814. Demand is futile when the plaintiff can establish a reasonable doubt "that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Id.* Directors are entitled to a presumption that they are independent and disinterested and that they are acting in the best interest of the corporation. *See Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004). A director will be deemed to not be disinterested and independent when the plaintiff can show that the director has a personal interest in the outcome of the litigation. *Id.* at 1049. There may be a variety of motives to show that a director is not independent, including friendship. *Id.* at 1050. But mere friendship alone is insufficient to show such bias. Here, because there are six directors, Falconer need only demonstrate that three of them are interested in the action. Falconer can likely meet his burden by arguing that Manley, Manley's father, and Manley's brother are all personally interested in the underlying transaction. This alone should be enough to establish that demand would be futile because there is a reasonable doubt that a majority of the board is disinterested and independent. The next director most susceptible to being conflicted is the attorney, but it seems questionable whether there are enough facts here to show that close friendship and vacationing together would rise to such a level as to establish reasonable doubt about the attorney's independence. It will be even more difficult for Falconer to cause doubt about the accountant and the real estate agent's independence. Falconer need not do this, though, because he can easily establish that three of the six are conflicted, and thus a majority of the directors are not independent and disinterested.

Answer (B) is incorrect because it is very likely that Falconer will not be able to establish the attorney's conflict.

Answer (C) is incorrect because merely running in the same social circles will not conflict a director.

Answer (D) is incorrect because Falconer can likely establish that three of the six directors are conflicted.

137. A Disgruntled Shareholder, Part V.

Falconer's proposition is dangerous. Many courts interpret a shareholder demand as a stipulation that demand was required, and that the board is disinterested and independent and will respond to the demand in a way that it in good faith believes is in the best interest of the corporation. *See Rales v. Blasband*, 634 A.2d 927, 935 n.12 (Del. 1993); *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990). In other words, the board's response to the demand transforms the entire claim into a claim about the board's response to the demand — a claim that would trigger analysis under the duty of care and be subject to the highly deferential business judgment rule! If Falconer makes a demand and then seeks to challenge the board's refusal to cure or sue (a "demand refused" case), the court will likely apply the business judgment rule to the board's decision and dismiss the claim. It would be better to attempt to argue that demand should be excused as futile (a "demand excused" case) and hope that the court accepts the allegations in the complaint as a sufficient basis to determine that there is a reasonable doubt that the majority of directors are disinterested and independent or that the challenged transaction is otherwise the product of a valid exercise of business judgment.

138. A Disgruntled Shareholder, Part VI.

Under these circumstances, it would be best to appoint and refer the demand to a special litigation committee made up of the accountant and the real estate agent as disinterested and independent directors. The committee could then investigate the shareholder's demand and make a determination for how to best proceed — either by curing conduct, commencing litigation, or (most likely) refusing the shareholder's demand. A special litigation committee is likely to hire outside counsel to advise the committee and may consider factors beyond the shareholder's demand, including the potential waste of assets and public perception. As a practical matter, very rarely does a special litigation committee endorse a decision to sue the corporation. By referring this case to a special litigation committee, however, the board is likely to remove doubt that the decision to refuse the demand was conflicted or not the product of a valid exercise of business judgment.

139. A Disgruntled Shareholder, Part VII.

Answer (D) is the best answer. A special litigation committee represents the corporation's "last chance for a corporation to control a derivative claim in circumstances when a majority of its directors cannot impartially consider a demand." *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 939–40 (Del. Ch. 2004). A court must review a special litigation committee's recommendation through a two-part test. *See Zapata Corp. v. Maldonado*, 430 A.2d 779, 788 (Del. 1981). First, the court must determine whether the committee was independent and acted in good faith. *Id.* at 789. The corporation bears the burden to prove the committee's good faith and independence. *Id.* The court must conclude that the committee has shown a reasonable basis for its conclusion. *Id.* Next, the court must exercise its own "independent business judgment" that the lawsuit should be dismissed. *Id.* Thus, it is possible that a committee would recommend dismissal but the court would still deny the motion. Here, Answer (D) best reflects this two-step process.

Answer (A) is incorrect because the demand futility analysis is completely separate from any recommendation made by the committee.

Answer (B) is incorrect because a court does not have authority to make its own decision to dismiss a lawsuit without first considering the reasonableness of the committee's recommendation.

Answer (C) is incorrect because it fails to account for the court's own independent business judgment.

140. Shareholder Incentives.

Shareholders may have a range of personal incentives for bringing derivative actions in response to what they perceive as corporate mismanagement, but the key financial incentive is that a court can award the shareholder their attorneys' fees for bringing the action. *See, e.g.*, MBCA § 7.46.

Mergers & Acquisitions

141. Preemptive Rights.

Answer (A) is correct. Right of first refusal is a common preemptive right. Preemptive rights are shareholders' rights to preserve their proportionate ownership and control interest in the corporation. Right of first refusal means that the shareholder must match the terms which the third party is willing to pay.

Answer (B) is incorrect. There is not a legal concept of a stockholder's right of first sale. Rather, stockholders may have a right of first refusal or a right of first offer.

Answer (C) is incorrect. Stockholders may bargain for information rights, and they may have statutory rights to certain information like books and records, but this is not a preemptive right.

Answer (D) is incorrect. Liquidation rights, which are most commonly called liquidation preferences, specify how much a shareholder should get paid if the corporation liquidates. Preemptive rights, on the other hand, regard a shareholder's ability to maintain ownership and control of an ongoing corporation, and thus preemptive rights are not directly related to what happens when a company stops operating or otherwise liquidates.

142. Fabulous Defense.

In a hostile takeover bid, or tender offer (the two terms are used interchangeably), a bidder anticipates that the "target company" board of directors will not be receptive to a merger proposal. The bidder thus makes an offer directly to the target company shareholders. If the bidder obtains enough shares, the bidder elects its own people to the target board. Those new directors then propose a merger with the bidder or a subsidiary of the bidder.

Creating dual class capitalization by super voting stock, as contemplated here, is a general defense to all takeover threats whether identified or not yet identified. This defense measure could be adopted here and now, where there is no identifiable threat to defend against.

The key move behind this strategy is the issuance of super voting stock to an inner circle of "safe" shareholders. The corporate euphemism for such a defensive use of a company's capital structure is "dual class capitalization."

The mechanisms of issuing super voting stock vary. In the question, for example, Fabulous could seek to amend its articles to provide that shares held for over 10 years by the same

person or persons would have five times the normal voting power in the election of directors, thus vastly enlarging the inner circle's voting power.

Yet Fabulous might not need to amend its articles. Many companies have authority in their articles for "blank check" classes of stock. MBCA § 6.02(a) authorizes the practice: "If the articles of incorporation so provide, the board of directors may determine, in whole or in part, the preferences, limitations, and relative rights . . . of any class of shares before the issuance of any shares of that class." The board of directors is able to "fill in the blanks" on the blank check.

Some critics of this practice argue that blank check authority to issue "super voting stock" seems a corruption of the original purpose, but it has become an accepted practice in publicly-held corporations.

143. Preemptive IPO.

Answer (B) is correct. The preemptive right is the shareholder's right to preserve her proportionate ownership and control interest in the corporation by having a right of refusal on any new shares the corporation proposes to issue for cash (but not in merger or for property). Right of first refusal means that the shareholder must match the terms which the third party is willing to pay.

Answer (A) is no longer correct. Early case law found that preemptive rights were vested property rights, but the last of these cases were overruled by the end of the 1960s. Now, preemptive rights are not vested property rights.

Answer (C) is incorrect. Federal law has nothing to say about preemptive rights. They are governed by state corporation law and regard the "internal affairs" of a corporation.

Answer (D) is incorrect. The MBCA does recognize preemptive rights, provided that corporations opt in, as this one has here. Articles of incorporation must contain an "opt in." *See* MBCA § 6.30(a) ("The shareholders of a corporation do not have a preemptive right to acquire the corporation's unissued shares except to the extent the articles of incorporation so provide.").

144. Buy–Sell Agreement.

Answer (A) is the best answer, or at least that is what the Pennsylvania Supreme Court held in the case upon which these facts are based, *Seven Springs Farm, Inc. v. Croker*, 801 A.2d 1212 (Pa. 2002). There are two schools of judicial thought with regard to share transfer restrictions. The majority school is that they tend to be restraints on alienation and, therefore, should be strictly construed. Thus, each and every triggering event must be spelled out in the agreement (sale to a third party, sale to a fellow shareholder, merger, disability, cessation of employment, death, gift, and so on). Courts have held that "sale" means sale to a third party and does not include a sale to a fellow shareholder. Along the same lines, the Pennsylvania court held that a merger is a different thing than a sale. Thus, the best (majority) answer is that a merger is not a sale.

Answer (B) is the second-best answer. The minority school holds that share transfer restrictions are ubiquitous in business life. Every closely-held corporation will have a buy–sell agreement precisely to keep participation "close." Shareholders wish to have control over who their "partners" will be in these "incorporated partnerships." A court which follows this school might, for example, look to federal securities law, which has held for a number of years now that a merger is a sale.

Answer (C) is incorrect because there is no evidence that the buy–sell agreement contains any extreme and unconscionable terms. On the facts presented, this is an ordinary buy–sell agreement, which is a valid sort of contract and not a de facto invalid restraint on alienation of shares.

Answer (D) is incorrect because there is no evidence of failures to disclose, or of attempts to disclose in a misleading way, much less any evidence of intentional misrepresentation. There is simply no plausible allegation of fraud here.

145. Alaska–Hawaii.

Corporate combinations, at least friendly ones, begin with an agreement between senior managers, often memorialized in a "term sheet," "letter of intent," or "memorandum of understanding," which is an agreement to work toward creating a "merger agreement" or "plan of merger." Lawyers are heavily involved at this merger drafting stage, and these plans must be approved by the board and then presented to the shareholders for their vote.

The merger agreement or plan of merger will specify which is to be the surviving entity, who is to receive what (in terms of shares of stock of the surviving corporation, or cash), what warranties and representations the parties make to one another, and a myriad of details.

After adoption, the articles of merger, together with a certificate describing the meeting and the votes by which the shareholders approved the articles of merger, are filed in the secretary of state's offices. When the articles of merger are filed, the acquired corporation ceases to exist, by operation of the law. Its shareholders become shareholders of the surviving corporation, or creditors to a cash payment from it.

There are several types of statutory mergers. If the surviving corporation is to be an entirely new entity, into which both of the constituent corporations are to be merged, the transaction is often called a consolidation, rather than a merger. The Model Act drops the term "consolidation," but many lawyers still use the term to distinguish such transactions from those in which one of the constituent corporations is the survivor.

Many state statutes authorize use of short-form mergers. *See, e.g.*, MBCA § 11.04 (merger of 90 percent owned subsidiary). In a case in which a parent corporation owns 90 or 95 percent of the shares of a subsidiary, the parent may merge the subsidiary into another subsidiary and the 5 or 10 percent minority has no voting rights.

Another form of merger is the small-scale merger, which Delaware, Michigan, and a few other states have. *See* DGCL § 251(f). In that type of transaction, the statute excuses a

shareholder vote in the acquiring, or surviving, corporation. Generally, the vote is excused if the outstanding voting shares of the acquiring corporation will not be increased by more than a stated percentage (15 or 20) as a result of the merger (20 percent in Delaware).

Other deal forms are also viable. Purchasing shares in the market before a merger is not illegal if only the corporation (Alaska here), and not its executives, do it. It is, after all, self-developed inside information, upon which Alaska would be free to trade. Many corporations refrain from the practice because of the hard feelings it might cause among target company shareholders who sold and thereby forewent the (presumably) higher merger consideration.

Cash tender offers (takeover bids) conjure up visions of hostile acquisitions, but that is not always the case. The parties here could structure their friendly acquisition as either a cash or stock takeover bid, but it would eventually have to be followed by a merger to consolidate the two airlines' operations. The merger would be a forgone conclusion, though, because due to the tender offer, the acquiring company would already own a substantial share block.

Other options for deals include leveraged buy-outs, SPACs, and more.

146. Acquirer–Target, Part I.

Answer (C) is the best answer. A stock-for-assets deal means Acquirer can obtain Target's property without spending cash by issuing stock in exchange for these assets. The liabilities remain behind in the Target corporation, which does not automatically cease to exist as would happen in a statutory merger.

Answer (A) is not the best answer because Acquirer wishes to avoid successor liability, if it can. Merger of the two entities may automatically result in successor liability. This answer does not meet one of the client's three main objectives, so it is not the best answer.

Answer (B) is not the best answer. Paying cash for assets obviously does not meet Acquirer's goal of preserving cash by issuing stock instead. While the asset-purchase structure of the deal makes sense, this answer does not meet one of the client's three main objectives, so it is not the best answer.

Answer (D) is not the best answer. A stock tender has the same problems as a statutory merger, plus a tender offer could turn hostile and quickly get expensive. In merger, dissenters' rights spring into being. If any number of Target shareholders vote "no," dissent, and seek appraisal of their shares, payment to them may be a significant cash drain, even if the court does not appraise the shares at a number vastly higher than the value of their merger consideration. This is a wild card element in the equation that, along with the successor liability issue, tips the balance strongly against merger. Many statutes (Delaware's, for example) do not grant dissenters' rights in sale-of-assets transactions.

147. Acquirer–Target, Part II.

Answer (C) is the best answer. In a reverse triangular merger, Acquirer creates a temporary subsidiary called Merger Sub. Then Target performs a reverse statutory merger with Merger

Sub, whereby Target is the surviving corporation for legal purposes so that it can continue operating under its FCC license. Target ends up a wholly owned subsidiary of Acquirer.

Answer (A) is incorrect. The result of a statutory merger is that there is no separation between Acquirer and Target, which needlessly puts Acquirer assets at risk for liabilities associated with Target. Moreover, a standard or "forward" statutory merger would result in Target ceasing to exist, as it would be subsumed by Acquirer, and thus, this deal structure does not achieve the goal of this transaction.

Answer (B) is incorrect. Stock for assets would not work at all. The broadcast licenses are assets of the selling corporation. The attempt to transfer them, along with the other assets, may well result in their forfeiture back to the FCC.

Answer (D) is incorrect. The business objective can be achieved through various legal means.

148. Acquirer–Target, Part III.

Answer (B) is the best answer. Triangular mergers are utilized for a variety of reasons (to preserve a valuable brand, to maintain a veil of liability between acquired and acquiring companies, for other management or organizational reasons, and so on). Another reason is to avoid a shareholder vote in the acquiring company. More accurately, there still must be a shareholder vote, but the number of shareholders is one. The parent corporation votes the shares of the acquisition subsidiary, all of which the parent corporation owns. Those shares are voted by resolution of the board of directors of the parent corporation.

Answer (A) is not the best answer. Re-incorporating in a jurisdiction such as Delaware, which has a small-scale merger statute, would not solve the immediate problem. Re-incorporation would also require a special shareholders' meeting, solicitation of proxies, and expenses at least similar to what the deal structure aims to avoid.

Answer (C) is not the best answer. Cash for stock, or cash for assets, does not require a shareholder vote, but would require the parties to re-negotiate the deal, which they may not wish to do. They have agreed on stock for stock and merger.

Answer (D) is not the best answer. A tender is a tool to push through deals where shareholders and directors have divergent interests. Here, Target is a small startup, such that its shareholders, directors, and officers are likely to be the same small group of people. Moreover, conducting a tender offer does not itself avoid the need for Acquirer to hold a shareholder vote.

Note: To effect a triangular merger in a situation like this one, Acquirer forms a subsidiary, Acquirer Acquisition Corp. Acquirer drops into that subsidiary sufficient Acquirer shares (and/or cash) to make the acquisition. On the Acquirer side, the Acquirer board of directors votes (on behalf of the sole shareholder of the subsidiary) in favor of a reverse statutory merger of Target into a subsidiary. On the Target side of the transaction, there will still have to be a shareholders' meeting and solicitation of proxies.

149. Acquirer–Target, Part IV.

Answer (B) is the best answer. A takeover bid, also known as a tender offer or hostile tender offer, is an offer to purchase made directly to a company's shareholders, for cash or for stock, without the intervention of any intermediary, such as a stock exchange. The shareholders have rights to sell their stock without board approval. A publicly-traded acquirer will probably need to file SEC Schedule 14D and observe various rules and regulations about tender offers.

Answer (A) is incorrect. A proxy contest, or proxy fight, is a principal means of taking over a company by hostile means. It involves voting in a new slate of directors who will approve the deal. It does not, however, avoid board approval altogether. Also, proxy contests entail delays for regulatory filings that must be made with the SEC and for the actual solicitation process.

Answer (C) is not the best answer. Stock tender offers entail delays and expense because the corporation must file with the SEC before the actual solicitation process. It may also have to register additional stock for public issuance.

Answer (D) is incorrect. Shareholders have rights to sell shares and thus transfer control of a corporation even if the directors oppose it.

150. Dinosaur Classified Board.

Answer (B) is the best answer. Early on the courts decided that, if the process is scripted correctly (i.e., if independent directors approve the adoption), courts would review adoption of takeover defenses utilizing duty of care and deferential business judgment rule concepts rather than duty of loyalty analysis.

Answer (A) is incorrect. Board classification schemes are not permitted by all states. Moreover, the question is not whether the scheme is permitted in general, but whether this board's response to a perceived threat was somehow a breach of fiduciary duties.

Answer (C) is not the best answer because boards are not strictly prohibited from installing entrenchment devices.

Answer (D) is not the best answer because some states do not permit board classification. Moreover, the question is not whether there is blanket permission or prohibition for classified boards, but whether doing so was appropriate here.

151. Dinosaur Crown Jewel.

Answer (D) is the best answer. When directors unilaterally adopt defensive mechanisms in response to an alleged threat to corporate control or policy, courts apply the *Unocal* test, established in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). The *Unocal* test requires that defensive mechanisms pass a test of reasonableness and proportionality. Reasonableness means that the board must show that it had reasonable grounds to believe that a danger to corporate policy and effectiveness existed. Proportionality means that the board must show that the defensive mechanism was reasonable in relation to the threat posed,

meaning that at a minimum the action was not coercive or preclusive. When a corporate sale is imminent, boards go into "*Revlon* mode," named after the landmark decision *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), which held that directors have heightened fiduciary obligations, called *Revlon* duties, to maximize stockholder value by securing the highest sale price available. Here, Dinosaur's board has likely acted disproportionately with regard to a merger defense mechanism that could hurt corporate value, so Picken's challenge will likely prevail in court.

Answer (A) is incorrect. The directors are not necessarily entitled to business judgment protection when responding to a potential proxy contest by insulating the board from takeover bids. There is an inherent conflict of interest when directors seek to maintain their jobs that makes simple reliance on the business judgment rule inappropriate here.

Answer (B) is incorrect. Directors may be violating their duty of loyalty, even if they do not stand to personally profit from the transaction, by being the purchaser. Simply desiring to maintain board seats may be a loyalty concern. In any event, the appropriate test here is the *Unocal* test, not the business judgment rule, and the facts presented by this answer choice do not address this test's elements.

Answer (C) is not the best answer. Shareholder approval is not strictly required by the applicable tests for propriety of board defensive measures to prevent hostile takeovers. While shareholder approval can cleanse a director conflict-of-interest transaction, it may be difficult, expensive, untimely, and otherwise inappropriate to seek a shareholder vote on the defensive measures.

152. Dinosaur Duties.

Answer (C) is the best answer. This language is quoted from the landmark Delaware opinion regarding board duties during takeovers, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

Answer (A) is incorrect. Directors are forbidden from taking actions that are inconsistent with getting the best price for stockholders at a sale. Not only are they not obligated to mount a takeover defense, but they can breach fiduciary duties by instituting disproportionate takeover defenses.

Answer (B) is incorrect. The business judgment rule, a relatively lenient standard, is replaced by the heightened *Revlon* duties regarding a potential takeover.

Answer (D) is incorrect. The entire fairness standard is a higher standard that is not triggered unless a majority of the directors approving the transaction were interested in its outcome. Directors can be found to be interested if they "appear on both sides of a transaction [or] expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Once the entire fairness standard is triggered, the corporate board has the burden to demonstrate that the transaction was inherently fair to the shareholders, and it does this by demonstrating both fair dealing (i.e.,

process) and fair price (i.e., substance). This is a higher standard that does not apply here because no facts suggest that any directors (much less a majority of them) stand on both sides of this proposed transaction.

153. Dinosaur Equals.

Answer (B) is the best answer. The merger-of-equals situation was excluded from the *Revlon* holding by *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989). In this instance, Time was permitted to say "just say no" to a clearly superior bid by Paramount in favor of its merger of equals (MOEs) with Warner Communications. Time pointed to the carefully constructed makeup of the prospective Time-Warner Co., the CEO succession plan, and the necessity of permitting the Time board of directors to choose the "partnership" that would best preserve the unique "Time culture." The Delaware court pointed out that, in a true merger of equals, the target company is not "for sale." Because breakup or sale of the company is not in the works, or even remotely likely, and, after the transaction, a pool of disaggregated shareholders will still own the new company, *Revlon* does not apply.

Answer (A) is not the best answer because directors are not protected by the business judgment rule in the merger context, per *Unocal* and *Revlon*. It is more appropriate to say that the merger-of-equals situation exempts this particular merger situation from *Revlon* duties.

Answer (C) is incorrect because *Paramount Communications*, 571 A.2d 1140, modified the *Revlon* rule in the merger-of-equals context, such as this one. Directors are permitted to engage in a merger of equals even where doing so does not necessarily generate the highest value for stockholders.

Answer (D) is incorrect. The entire fairness standard does not apply to mergers unless a majority of directors are on both sides of the transactions (e.g., where directors of the target corporation are shareholders of the acquiring corporation). Moreover, deal protections are not presumptively problematic. In fact, deal protections can be necessary to secure the highest value for stockholders.

Insider Trading

154. Inside Information.

Answer (C) is the best answer. Insider trading may be defined, roughly, as trading or tipping others to trade, committed by someone in a fiduciary or similar relationship of trust and confidence, while in possession of material nonpublic information. The Securities Exchange Act of 1934, pursuant to which the SEC has adopted Rule 10b-5, provides for exclusive subject matter jurisdiction in the federal courts. Many states have their own securities acts, known as "blue sky laws." Blue sky laws typically contain a statutory provision that, by and large, tracks SEC Rule 10b-5. A disgruntled shareholder or investor could sue an insider under those statutory provisions as well. These shareholders have the added advantage that the statute directs the court to award reasonable attorneys' fees to the prevailing plaintiff. Additionally, some courts have held that when a director is in possession of knowledge constituting "special facts," the director owes a duty directly to shareholders either to disclose the "special facts" or to refrain from trading. "Special facts" are not precisely defined but are thought to include episodic evolutions in the corporation's life (a merger, sale of assets, liquidation, etc.). A favorable forthcoming earnings report or new contract probably does not constitute special facts. Other courts have expanded the "special facts doctrine," holding that special facts are any material facts likely to have an effect on the price of a security. Directors with knowledge of special facts, so defined, owe a duty not to buy or sell from their corporation's shareholders unless, of course, they disclosed their inside information. *See, e.g., Bailey v. Vaughan*, 359 S.E.2d 599 (W. Va. 1987) (holding liable bank director who bought up shares while knowing that bank would be sold to larger bank); *Van Schaack Holdings, Ltd. v. Van Schaack*, 867 P.2d 892 (Colo. 1994) (director of family farming corporation bought up shares knowing new Denver airport would be located on corporation's farmland). Here, it seems that Caron was likely aware of Floatman's interest in acquiring the bank and took advantage of the information in dealing with the sisters and other shareholders. This likely constitutes insider trading and a breach of fiduciary duty.

Answer (A) is incorrect because it ignores the viability of a lawsuit for breach of fiduciary duty.

Answer (B) is incorrect because it ignores the viability of a lawsuit for insider trading under Rule 10b-5.

Answer (D) is incorrect because common law fraud claims do not work well under these circumstances. Insider trading claims are claims of silence, while common-law fraud deals mostly with misrepresentation and half-truths. Fraud requires face-to-face dealings (privity)

which, while present here, would not be present in transactions taking place through a broker or over a stock exchange.

155. Good News Not Shared.

Answer (A) is the best answer. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). Insider trading has become one of the most prevalent white collar crimes of this century. Until recently, the insider trading prohibition under the federal securities laws has been a matter wholly of judge-made law. Rule 10b-5 is an opaque catch-all antifraud rule which also governs misrepresentations, half-truths, and omissions in the purchase or sale of any security (not just those issued by publicly-held companies). Insider trading cases are merely a subset of a subset (cases of silence or omission) of the broad array of cases Rule 10b-5 governs. The text of the rule itself offers little, if any, guidance. Insiders, though, are those "who by virtue of a fiduciary or similar relationship of trust and confidence" come into possession of inside information. *Chiarella v. United States*, 445 U.S. 222 (1980). Generally, an insider violates the law when they act on material information. A fact is a material fact if the "reasonable investor would consider it important in the making of his or her decision" — not necessarily that the investor would have acted in a different manner had they had the information. Materiality also is to be judged in light of the "total mix" of information available about the issuer and the developments at issue. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). Here, it seems almost a foregone conclusion that the presence of the largest gas field in North America is material information. Thus, the discovery of the gas field is inside information. Likewise, Twitty and Owen are insiders because they learned about the information by virtue of a position of trust and confidence. Similarly, Robbin had a position of trust and confidence. Thus, all of their purchases of shares before the information was widely disseminated likely constitutes illegal insider trading. Likewise, Husky likely traded too soon, doing so before the information had been disclosed and effectively disseminated.

Answer (B) is likely incorrect because Huskey traded too soon, that is, before the information had been disclosed and effectively disseminated.

Answer (C) is incorrect because Twitty and Owen are likely insiders and violated the law.

Answer (D) is incorrect. Although a respectable school of thought exists, mostly among economists, that insider trading should be permitted for reasons such as those enumerated in Answer (D), this is inconsistent with case law interpreting Rule 10b-5 to prohibit the practice.

156. Misappropriation.

Answer (C) is the best answer. This is the famous case of *Chiarella v. United States*, 445 U.S. 222 (1980), in which the court noted that insider trading requires more than mere access; it requires "a relationship giving access . . . to information intended to be available only for a corporate purpose." Those kinds of relationships, the Court noted, would be fiduciary or similar relationships of trust and confidence. But in *United States v. O'Hagan*, 521 U.S. 642 (1997), the Court recognized an expanded "misappropriation theory." The Court explained that Rule 10b-5 protects all buyers and sellers of shares, not any particular or identifiable

buyer or seller. "The misappropriation theory comports with § 10(b)'s language, which requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller." *Id.* at 658.

Answer (A) is incorrect because the misappropriation theory addresses Vincent's conduct within the context of insider trading.

Answer (B) is incorrect because one can engage in insider trading, even if one is not an insider.

Answer (D) is incorrect. Although this answer summarizes the outcome under *Chiarella*, it does not reflect the Court's ruling in *O'Hagan*.

157. Lucky Overhearing.

Answer (D) is the best answer. This question is based on *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984), in which the SEC charged then University of Oklahoma (and later Dallas Cowboys) head football coach Barry Switzer with insider trading. Coach Switzer won because his attorney read and applied the U.S. Supreme Court's opinion in *Dirks v. SEC*, 463 U.S. 646 (1983). In *Dirks*, the Court recognized tipping as an offense, but only when it is consistent with, and derivative of, an insider or temporary insider's breach of his fiduciary or similar duty of trust and confidence. In turn, the Court noted, the insider breaches his duty when "(1) he receives a benefit or expects to receive a benefit, loosely defined, from communication of the information; and . . . (2) the insider knows, or in the exercise of some care, should know, that the communication of the information will likely result in trading or the tipping of others to trade." The "benefit" may be increased influence or prestige with one with whom the insider wishes to curry favor, or reciprocity, or continued love and affection from a family member. Dirks, the defendant, a securities analyst, received material, nonpublic information about a massive fraud within Equity Funding, Inc. Because the tip came from a former executive who had been dismissed (not an insider source) and whose motive was revenge (not receipt of a benefit), the SEC failed to obtain an injunction. The Supreme Court circumscribed tippee–tipper liability carefully because one person's tip is another's diligent research. Securities analysts search far and wide for tidbits of information, which they piece together into a mosaic about a company or an industry. That process, which occurs thousands of times each day, promotes market efficiency. It is an activity we wish to encourage. An overly broad and ill-defined law of tippee–tipper trading would inhibit legitimate analyst activity and market research. The *Dirks* Court also eschewed broad equality of information as a policy goal for the law of insider trading. Some individuals (analysts, New York-based traders, etc.) often will have superior information about securities. The law of insider trading is not meant to level that playing field. In the instant case, Local CEO reaped no benefit and violated no fiduciary duty in conversing with his spouse. He also did not knowingly communicate the information to Coach Olsen. The coach is merely a fortuitous eavesdropper.

Answer (A) is incorrect because Coach Olsen is not an insider, and thus, is not a tipper. Likewise, the local auto dealer is not a tippee.

Answer (B) is incorrect because Coach Olsen has no liability.

Answer (C) is incorrect. The information is about the market for the company shares rather than classic inside information about the company itself, its assets, and its earnings. The courts have seldom explored the differences, but it is clear that they regard market information involving a change of control (at XYZ here) as visiting upon the possessor of that information a duty to "abstain or disclose."

Practice Final Exam: Answers

Practice Final Exam

158. Capital Structure.

Answer (C) is the best answer. The reason for holding some debt is that interest on debt is deductible (an expense) for the corporation. By contrast, payment with respect to shares is taxed once as profit for the corporation and again as dividend income for the shareholders, albeit now only at a modest 15 percent rate. Moreover, upon any forced liquidation, shareholders will be able to stand elbow to elbow with the unsecured creditors as to the contribution that has been structured as a loan, as long as the shareholders have not "thinly capitalized" the corporation.

Though it could suffice as well, **Answer (A) is not the best choice**. When all participants in the venture are making equal contributions, an alternative to the capital structure described in Answer (C) above is to have the corporation issue only common stock. This alternative has the virtue of simplicity.

Answer (B) is incorrect. There is neither now nor in the foreseeable future any need to authorize convertible participating or any other kind of preferred stock.

Answer (D) is incorrect for similar reasons. The business plan contemplates only modest expansion, if at all.

159. Activist Shareholders.

Answer (C) is the best answer. SEC Rule 14a-8 allows the activist shareholders to utilize management's annual proxy solicitation to present a proposed resolution and supporting statement to Northern Pines's remaining shareholders. While not without difficulties, the rule is a low-cost way to achieve some of their aims.

Answer (A) is incorrect. In all probability, the directors would assert, and the court would accept, a business judgment rule defense to the action. It is the directors, and not the shareholders, who manage the corporation's business and affairs, including the methods by which the corporation harvests its timber.

Answer (B) is incorrect. "Enlisting support" would constitute a solicitation under the SEC's rules, which define solicitation very broadly. Because no proxy statement had been filed with the SEC, it would also be an illegal solicitation which a court would quickly enjoin.

Answer (D) is incorrect. A full-fledged proxy contest would be exceedingly expensive. Better to try to use a Rule 14a-8 proposal to begin to get their views across and perhaps begin to persuade the directors.

160. Promoter Liability.

Answer (D) is the best answer. To avoid liability, an agent for a corporation to be formed must do all three things: indicate the non-existence of her principal; indicate her representative capacity; and provide for a novation in the future when the corporation does come into existence.

Answer (A) is incorrect. An agent warrants the existence of her principal. She can be held liable herself for breach of that warranty if the principal does not exist, but her correct action in this regard alone is not enough to escape liability.

Answer (B) is incorrect. Courts have held that if a promoter or corporate official signs "XYZ Co., Personal Name," both parties will be bound. The person must recite a title (e.g., President, Promoter) or use other words indicating representative capacity (e.g., "by"). However, indication of representative capacity alone, while necessary, is insufficient to get Frank "off the hook."

Answer (C) is incorrect. A novation where the company assumes liability from Frank is necessary but not sufficient to avoid his having personal liability.

161. LLC Informality.

Answer (A) is the best answer. Corporate law has a doctrine known as corporate disregard, or piercing the corporate veil. One ground for piercing is intermixture of the affairs of the owner and of the corporation. Failure to observe corporate formalities is evidence of intermixture of affairs.

Answer (B) is incorrect because the question involves a limited liability company, which contemplates more informal dealing and less strict observance of formalities than do corporations and corporate legal doctrines.

Answer (C) is incorrect. There is a requirement for maintaining books and records, but its violation does not necessarily lead to loss of limited liability on the owners' part.

Answer (D) is incorrect. Limited liability entities (corporations, LLCs) engage in ultrahazardous (blasting, crop dusting, etc.) activities all the time. The only requirement is that they have capital (owners' contributions and liability insurance) sufficient to cover the foreseeable risk of the venture.

162. M&A Defenses.

Answer (B) is the best answer. The crown jewel option is a rare defensive strategy, and here it would seem to be an extreme and disproportionate response to such vague concerns about a hostile takeover.

Answer (A) is incorrect. Staggering the board into three, with each class to be elected for a three-year term, is a common defensive strategy.

Answer (C) is incorrect. Requiring that directors may be removed only for cause is a common defense strategy.

Answer (D) is incorrect. Limiting the ability of shareholders to call special shareholders' meetings is a common defense strategy.

163. Partnership Professional Responsibility.

Answer (A) is the best answer. Many partnership agreements provide that the partners may by majority or super majority vote to expel a partner, with or without cause. Such clauses are known as "guillotine clauses." They are common in law firms as well as other partnership agreements. Several celebrated cases involve law firms' expulsion of partners because of political activities or failure to produce enough business.

Answer (B) is incorrect. There is no requirement for cause in many partnership agreements. A simple vote to expel is sufficient.

Answer (C) is incorrect. The tension that arises is that partners also are fiduciaries one to another. But, absent self-dealing or bad faith, courts have sided with the consensual nature of a partnership. Partners have no obligation to remain partners. Partners are bound together by shared values and expectations as to effort, collegiality, and professionalism. If a partner does not measure up to these mutual expectations, the partners should be able to exclude her from the partnership without liability for wrongful dissolution or breach of fiduciary duty.

Answer (D) is incorrect. In anything but an extreme case of wrongdoing, bad faith, or the like, courts uphold expulsion of a partner if the expulsion has been pursuant to the express terms of the partnership agreement. While courts have read rules of professional responsibility into attorney employment agreements, a law firm partner is not an employee. The partner-to-partner relationship has at its core trust and confidence in one's fellow partners.

164. Family Business.

Answer (B) is the best answer. Many MBCA courts have now held that, in a closely-held corporation, the participants and the corporation all owe duties one to another, akin to partners in a partnership, and not just to the corporation. This is known as the *Donahue* principle, after *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505 (Mass. 1975). The remedial implication is that a shareholder such as Olivia may obtain "me, too" relief. She may be able to obtain the same perks, or the monetary equivalent, as her brother Nate enjoys.

Answer (A) is incorrect. A traditional derivative suit results only in a payback to the corporate treasury. It would leave Olivia in the same position as before the lawsuit. In addition, it may just harden Nate's resolve and rend asunder any relationship they may have had as brother and sister.

Answer (C) is incorrect. There are no grounds for such a suit. There exists neither misleading disclosure or nondisclosure nor a purchase or sale of securities.

Answer (D) is incorrect. All Olivia wants is some return on her shares and some of the same benefits her brother enjoys. A suit for involuntary dissolution would be overkill.

165. Family Conflict.

Answer (A) is the best answer. MBCA, chapter 8, subchapter F, addresses directors' conflicting interest transactions. The subchapter attempts to achieve two ends. First is the adoption of a relatively narrow and all-encompassing definition of which transactions involve "conflicting interests." Second is an "unassailable safe harbor" for transactions that do involve a conflict but are approved by as few as one or two disinterested directors given full disclosure. A transaction merits special treatment if "the director knows at the time of commitment that he or a related person is a party to the transaction or has a beneficial interest in or is so closely linked to the transaction and of such financial significance to the director or related person that the interest would reasonably be expected to exert an influence on the director's judgment if he were called upon to vote on the transaction." MBCA § 8.60. Note that the director must "know" (not "should know") and that the transaction must be significant financially, and not merely socially or familially. For purposes of the definition, the subdefinition "related party" is narrowly drawn. It excludes first cousins: "Related person of a director" means "the spouse (or a parent or sibling thereof) of the director, or a child, grandchild, sibling, parent (or spouse of any thereof) of the director, or any individual having the same home as the director, or a trust or estate of which an individual specified in this clause is a substantial beneficiary." MBCA § 8.60. Here, although as a matter of common sense we might believe there is a conflict, Mott is not a "related person" of Sole, and therefore, this is no conflict of interest as defined under the MBCA.

Answer (B) is incorrect because it stretches the conflict-of-interest rule too far.

Answer (C) is incorrect because this situation is, by definition, not a conflict of interest. Thus, there is nothing for the board to resolve.

Answer (D) is incorrect because, as a matter of law, this is not a conflict of interest. But even if it were, that alone does not make the transaction impermissible.

Note: The outcome would be the same under Delaware law, but for a subtly different reason. In fact, the answer is more certain. DGCL § 144 addresses conflicts of interest but, by its definition, only focuses on the directors, not on related persons of directors, for purposes of defining conflicts of interest.

166. Stealing Information.

Answer (D) is the best answer. Horatio does not have a fiduciary or similar relationship of trust or confidence. He occupies no position at all. He was terminated months ago. Hence, he is a thief.

Answer (A) is incorrect because the definition of "insider" only includes directors, officers, 10-percent (or more) stockholders, or anyone who possesses inside information because of their relationship with the company or a director, officer, or major stockholder.

Answer (B) is incorrect because a "temporary insider" is someone who has entered into a special confidential relationship with the company and thus is given access to confidential information.

Answer (C) is incorrect because a "tippee" is someone who uses information that has been provided to them by an insider or a temporary insider. There was no tipping. Horatio simply stole information, in violation of a legally cognizable duty.

167. Dividend Issuance.

Answer (B) is the best answer. This question requires you to apply a statutory test for the legality of distributions (a cash dividend is one type of distribution). Here, payment of the dividend would cause a cash flow squeeze (if, indeed, the funds could be borrowed to make the distribution). The corporation would be left with little or no cash and $300,000 in accounts payable. This makes Pear insolvent "currently" in the equity sense, even though it is not insolvent in a balance sheet sense.

Answer (A) is incorrect. It uses terminology ("impairment of capital") which has become obsolete since the demise of the old "legal capital rules."

Answer (C) is incorrect. Giving effect to the dividend, Pear will still be solvent in the balance sheet sense ($500,000 in assets and $300,000 in liabilities). The difficulty lies with solvency in the equity sense.

Answer (D) is incorrect. While it is true that Pear does not pass the equity solvency test for this distribution, it does pass the balance sheet solvency test.

168. Partridge Proxies.

Answer (B) is the best answer. The hallmark of a voting trust is a complete separation of voting from the other attributes of share ownership. Voting trusts are sometimes used to impose stability upon a corporation emerging from bankruptcy or beset by arguments among shareholders.

Answer (A) is incorrect. If the siblings fight all of the time, they are likely to fight over this alternative. In addition, at age 23, even the older sibling seems very young to be entrusted with all of the family's power within the corporation.

Answer (C) is incorrect. A pooling arrangement would require that the parties thereto first attempt to reach an agreement of sorts (four siblings would have to agree), which they have shown themselves incapable of doing. Moreover, rule by majority rather than consensus is likely to exacerbate resentments and hard feelings that build up over time.

Answer (D) is incorrect. Achieving unanimity would be even more difficult than achieving the majority vote suggested in Answer (C).

169. Ultra Vires.

Answer (C) is the best answer. The MBCA provides that the defense of ultra vires (beyond the purpose or powers of the corporation) may be raised only in a proceeding brought by a shareholder, and only if the court finds that it is equitable to allow the defense.

Answer (A) is incorrect. LCI has not been enriched; it has only evaded a loss.

Answer (B) is incorrect. The MBCA does contain broad grants of implied powers (e.g., "to do all things necessary or convenient to carry out its business and affairs," MBCA § 3.02), but to say that furnishing plumbing supplies is implied by the purpose of "sales of lumber and plywood products" is too much of a stretch.

Answer (D) is incorrect. The contract has not been partially performed here. Before the ultra vires statutes were enacted, court decisions held that ultra vires could be raised only in cases of executory contracts (where neither side has performed in whole or in part). Here, however, the contract was executory.

170. Entity Choice — Golf Course.

Answer (C) is the best answer. The LLC would protect the owners from large tort or contract liabilities. It would also allow "flow through" of startup losses to the members, who could utilize the losses to shelter income from other sources. Last of all, unlike a limited partnership, LLC members could enjoy those benefits while also participating in decision-making (e.g., clubhouse and golf course design). They would not lose their limited liability by doing so.

Answer (A) is not the best answer. This LLP form of entity was designed with accounting and law firms in mind. While the entrepreneurs are golf professionals, they are not the sort of professionals whose ethics rules require them not to form an LLC. This is not the most suitable choice for this business.

Answer (B) is not the best answer. The corporate form facilitates outside investment, but that funding source does not seem necessary based on these facts.

Answer (D) is incorrect. A general partnership will leave all partners exposed to joint and several liability for partnership contracts and torts. This venture has sufficient liability to justify using a limited liability vehicle like the LLC.

171. Takeover Defenses.

Answer (C) is the best answer. This is the Delaware *Unocal* standard, after *Unocal Corp. v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985). In addition to satisfying other elements of the business judgment rule, in adopting takeover defenses, a target corporation's board of directors must conduct an investigation and satisfy itself that a credible threat exists to the corporation's policies or way of doing business. Then any defense adopted must be reasonable (proportionate) in relation to the threat posed.

Answer (A) is incorrect. As aforesaid, courts have evolved a more demanding version of the business judgment rule applicable to adoption of takeover defenses.

Answer (B) is incorrect because is incomplete. The directors must investigate and ensure that any defense adopted is reasonable in relation to the threat posed, as stated in Answer (C).

Answer (D) is incorrect. An irreversible (preclusive) defense is per se unreasonable.

172. Partnership Contract Liability.

Answer (C) is the best answer. If Betty is unhappy with how this partnership is run, she must dissolve it to end her general liability.

Answer (A) is incorrect. In a partnership, a majority vote would be necessary to impose a valid restriction on a partner's authority. A majority is 50 percent plus one. In a partnership of two persons, 50 percent plus one (a majority) is two. Betty cannot unilaterally restrict Abe's purchasing authority on behalf of their partnership.

Answer (B) is incorrect because there is no legal mechanism for a general partner to avoid partnership liability in this way. The parties could form a different sort of company, but that is not contemplated by this answer choice.

Answer (D) is incorrect. A suit for breach of fiduciary duty against Abe may or may not stop or deter him. If Abe has few assets, a suit may have little effect. The amounts in question are likely not enough to merit a lawsuit regardless. In small partnerships, in case of deadlock (e.g., one versus one, two versus two), the only recourse may be to dissolve the partnership.

173. Settling a Derivative Action.

Answer (B) is correct. Among the other procedural safeguards applicable to derivative actions, these lawsuits may only be settled with court approval. *See* MBCA § 7.45; Del. Ch. Ct. R. 23.1(c). Remember, when pursuing a derivative lawsuit, a shareholder does so in the name of the corporation and acts for the benefit of the corporation and all other shareholders. Thus, the court has a special responsibility to ensure that the settlement is fair to the corporation.

Answer (A) is incorrect because the parties may not settle without the court's approval.

Answer (C) is incorrect because derivative suits can be settled and resolved without going to trial.

Answer (D) is incorrect because the court must approve the settlement.

174. Pepsi-Cola.

Answer (C) is the best answer. This is the famous Delaware case of *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939). In the opinion, the court "layered" onto the interest and expectancy test a "line of business" test. An opportunity is a corporate opportunity if (1) it is in the corporation's line of business, broadly defined; (2) it is in a line of business in which the corporation might reasonably be expected to engage; or (3) it is in a line of business in which the director or officer knows the corporation has intentions of engaging. Note the extreme remedy when a corporate official is found to have breached his or her duty of loyalty. Besides a constructive

trust on the opportunity, courts also often require disgorgement of compensation received by the corporate official during the period in which she is found to have been in breach of her fiduciary duty.

Answer (A) is incorrect because the court looked beyond the "interest or expectancy" test to recognize a broader definition of corporate opportunity.

Answer (B) is incorrect because the remedy is too narrow; everything Guth received as a result of the diversion belongs to Loft.

Answer (D) is incorrect. Accepting this would exalt form over substance, and a court of equity will look beyond the mere labeling.

175. Share Transfer Restrictions.

Answer (D) is the best answer. To preserve shareholders' proportionate interests in the corporation several steps are necessary. A share transfer restriction would limit the ability of a shareholder to sell out to an "outsider" without giving the remaining shareholders an option (or right of first refusal) on the selling shareholder's shares. Such an agreement would not, however, govern issuances of new shares by the corporation.

Answer (A) is incorrect. A buy–sell agreement restricts the existing shareholders' right to sell their shares to third parties. But this does not itself address the issuance of new shares.

Answer (B) is incorrect. Preemptive rights govern issuance of new shares, requiring that the corporation give each shareholder the right to preserve her proportionate ownership and control (voting) interest. Yet, standing alone, preemptive rights are not sufficient because they do not prevent one shareholder from selling her shares to a third party.

Answer (C) is incorrect. Under the MBCA, in the articles of incorporation, the corporation must "opt in to" preemptive rights. Under MBCA § 6.30, however, even a corporation that "opts in" will find a number of exceptions to the statutory provisions (e.g., issuances to directors, officers, or employees of shares sold for other than money). A cautious practitioner might negate some or all of those exceptions in the corporation's articles. Even so, this does not forgo the need for a buy–sell agreement and preemptive rights.

176. Bad Director.

Answer (B) is the best answer. The MBCA provides for judicial removal of a director. Answer (B) tracks the language of the provision. A stated reason for the adoption was the difficulty of removing a badly acting director who had been elected by means of cumulative voting.

Answer (A) is incorrect. A director elected cumulatively will not be removed by majority vote if the number of votes cast against his removal would have been sufficient to elect him in the first place. This common provision would give Xavier power to block his removal by the normal process (majority vote).

Answer (C) is incorrect. Under the MBCA, you may now go to court to seek the removal of a badly acting director who had been elected by means of cumulative voting.

Answer (D) is incorrect. A director elected cumulatively will not be removed by majority vote if the number of votes cast against his removal would have been sufficient to elect him in the first place. Whether the shareholders are evaluating the director under cause or not does not change this analysis. This common provision would give Xavier power to block his removal by the normal process (majority vote).

177. Mistakes in Formation.

Answer (B) is the best answer. MBCA § 2.04 provides that "[a]ll persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable." Georgia and Hector thought that the corporation did exist; they had no knowledge to the contrary.

Answer (A) is incorrect. Courts have held that the above-quoted MBCA and predecessor provisions abolish the common law de facto incorporation doctrine.

Answer (C) is incorrect. The lack-of-knowledge defense would be stronger and more certain than the more nebulous defense that Georgia and Hector never "purported to act."

Answer (D) is incorrect. Although corporations are now either de jure or non-existent, with no middle ground such as de facto existence, Georgia and Hector lacked knowledge that the corporation had not been formed, and that provides a defense for them under the MBCA.

178. Poison Pill.

Answer (B) is the best answer. The answer states the correct triage when a colorable derivative suit has been filed against corporate directors: form an SLC, staff it with "expansion directors," and hire reputable independent counsel for the committee.

Answer (A) is incorrect because it is incomplete. The SLC will need independent counsel to aid it in the conduct of its investigation and to research and apply the applicable law.

Answer (C) is incorrect because it leaves too much to chance (i.e., in the normal discovery process). Also, the question of whether a derivative suit should proceed is not strictly just a matter of law. The corporation may choose not to stand on legal rights it has because doing so would not be in the corporation's best overall interests. That decision is to be made in the first instance by the directors or the SLC, and not by a court.

Answer (D) is incorrect. A "reasonable doubt" exists as to whether the directors, had they acted on any hypothetical demand, would have been entitled to business judgment rule protection. The directors' receipt of consulting fees could lead to a finding that they are not free of conflicts of interest or that they are not dominated by a controlling shareholder. They thus would not be entitled to business judgment rule protection for the decision they made with respect to the hypothetical demand.

179. Can't Take It On.

Answer (C) is the best answer. In some jurisdictions, including Delaware, lack of wherewithal means that the opportunity is not a corporate opportunity. *See, e.g., Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148, 155 (Del. 1996); *Schreiber v. Bryan*, 396 A.2d 512, 519 (Del. Ch. 1978).

Answer (A) is incorrect. There is no evidence Hemlock has ever been in or considered the recycling business.

Answer (B) is incorrect. Hemlock never had an "interest or expectancy" as courts use the term.

Answer (D) is incorrect. Celeste telephoned acquaintances within the industry and consulted a banker about financing. She used corporate resources in doing those things.

180. Shareholder Ratification.

Answer (C) is the best answer. The limits of shareholder ratification are said to be "fraud, illegality, or a gift or wasting of corporate assets." Within those limits, shareholders may, subject to full and fair disclosure, vote to ratify violations by directors or officers of the duty of care or the duty of loyalty.

Answer (D) is incorrect. Such a ratification need not be by unanimous vote.

Answer (B) is incorrect. Such blanket ratifications are worthless because they are not made pursuant to full and fair disclosure, which must include all the bad news.

Answer (A) is incorrect, although it may be a close question. "Waste" is defined as an exchange in which no reasonable person could say that the corporation received the rough equivalent of what it gave up in the transaction or endeavor. Undoubtedly, someone could be found to testify that what Sam and David did was a gamble, indeed a very unwise gamble, but that some prospect existed, however small, that the corporation might receive a return at least equivalent to its investment.

181. Film Projects.

Answer (A) is the best answer. Directors may compete with the corporation on whose board they sit, but often they will have to proceed carefully. The rule may be stated to be that a director may not engage in "bad faith competition" with the corporation on whose board she sits. Bad faith competition would include acts such as disparagement (commercial defamation), "passing off" (using the name of or association with the corporation to sell products or services), and use of customer lists, trade secrets, and other items of proprietary information. Also, if the incorporating jurisdiction has adopted the popular line-of-business definition of a corporate opportunity, the director will have to seek board permission to compete if the director was not already in the business. Here, however, Walter was in the filmmaking business before he joined Sterling, and Sterling never sought "Mutants" and it turned down "Polish."

Answer (B) is incorrect because the mere fact that Walter is producing other projects does not impermissibly place him in competition with Sterling, especially when Sterling declined one of the projects.

Answer (C) is incorrect because it would be a stretch for Sterling to insist on profits in a project it rejected.

Answer (D) is incorrect because it states the rule too broadly and ignores the notion of fiduciary duty.

182. Director Protections.

Answer (C) is the best answer. Directors' protection has four elements ("the four legged stool"): indemnification, insurance, opting out of duty of care liability, and a contract guaranteeing to an individual director that the first three elements will stay in place despite a change of control, a falling out with the other directors, and so on.

Answer (A) is incorrect. Stock ownership alone provides no direct, and only a modicum of indirect, protection.

Answer (B) is incorrect. Insurance may not be renewed in some future year. It may not be obtainable at all. Even if it is obtained and renewed, insurance alone does not afford complete protection because of deductibles, policy exclusions, and the like.

Answer (D) is incorrect. It, too, does not go far enough. Provisions implementing the authority granted by the statute, which by and large are enabling only and not mandatory, can always be amended or revoked by a subsequent board majority.

183. Martha's Troubles.

Answer (C) is the best answer. If anything, her actions are ordinary theft, which busy state court prosecutors may be unwilling to pursue.

Answer (A) is incorrect. Martha is neither a classic insider (director, officer) nor a temporary insider (attorney, accountant, consultant, banker) to whom material non-public information may be entrusted, but only for corporate purposes.

Answer (B) is incorrect. Martha would only be a tippee if Peter Finch were a tipper. He would be a tipper only if he breached his fiduciary duty in providing the information to Martha. He would have breached his fiduciary duty if he received some sort of benefit, broadly defined, for providing the information to Martha. He neither provided the information nor breached any duty.

Answer (D) is incorrect. The last category of persons against whom the "disclose or abstain" rule is invoked comprises persons who flat out steal (misappropriate) information, but they must do so in violation of a fiduciary or similar duty to someone (former employer, law firm). Martha violated no such duty when she purloined the ticker symbols from the Finch linen drawer.

184. CHC Oppression.

Answer (D) is correct. The most drastic, and effective, close corporation remedy is a suit for involuntary dissolution of the corporation on oppression grounds. The evolving test in U.S. courts has been merely that the plaintiff minority shareholder has been denied his "reasonable expectations" (of a job, of fringe benefits, of participation in governance).

Answer (A) is incorrect. It refers to an older test of oppression. It may be alleged in addition to "denial of reasonable expectations" but today would not be the primary allegation.

Answer (B) is incorrect. It refers to an older test of oppression. It may be alleged in addition to "denial of reasonable expectations" but today would not be the primary allegation.

Answer (C) is incorrect. A derivative suit would only result in a payment back to the corporation. It may well leave Jack in a worse position, with brother Zach still in control and angrier than ever.

185. SOX.

Answer (D) is the best answer. These are federal law remedies made available to/against publicly-held companies by the Sarbanes-Oxley Act of 2002. A U.S. attorney might well seek to invoke these remedies as part of a criminal prosecution.

Answer (A) is incorrect. This remedy would lie, but in a state court proceeding for breach of fiduciary duty (or as a pendent claim in a civil suit in federal court).

Answer (B) is incorrect. This classic remedy for breach of fiduciary duty would lie as well, but, again, in state court.

Answer (C) is incorrect because it is incomplete. Because management has done this before, a lifetime or similar ban from serving as a director or officer of a public company would be in order.

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