

**STUDENT
SUPPLEMENTARY MATERIALS**

Answers to Test Yourself Questions

BUSINESS ORGANIZATIONS

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Chapter 1: Introduction: Welcome to the Law of Business Organizations!

Test Yourself Answers with Explanations

1. The reasons for involving more than one person in ownership or operation of a business entity do not include:
 - a. The ability to shift risks to third persons.
 - b. The ability to diversify risks.
 - c. The ability to achieve economies of scale.
 - d. All of the above are reasons to involve more than one person.**

2. “Agency cost” means:
 - a. The commission that is paid an agent for obtaining a contract.
 - b. The pay due to one’s employees.
 - c. The costs to the principal associated with an agent’s motive to serve him or herself.**
 - d. Profit-sharing or other arrangements to align an agent’s motives with those of his or her principal.

3. “Limited liability” means:
 - a. That an investor cannot lose his or her investment.
 - b. That an investor cannot lose more than his or her investment.**
 - c. That an investor can lose his or her investment and may be responsible for a designated percentage or amount in excess of his or her investment.
 - d. That an investor must refrain from active management in order to limit his or her risk of loss to the amount of his or her investment.

4. Which of the following would not be resolved as a matter of the law of business organizations?
 - a. The obligations of corporate officers to the corporation.
 - b. The obligations of partners to one another.
 - c. The obligations of the corporation to avoid violating various laws of general applicability.**
 - d. The obligations agents owe principals.

5. A lawyer representing an entity such as a corporation:
 - a. Also represents its owners.

- b. Also represents its managers.
- c. Both answer a and answer b.
- d. Neither answer a nor answer b.**

Chapter 2: The Law of Business Organizations Generally, the Choice of Entity Problem, and the Basic Problems of the Business Counselor

Test Yourself Answers with Explanations

1. Alan, a hair stylist, has become at long last fed up with the despotic management of the salon where he works, and he has decided to strike out on his own. He plans to set up a salon in a back room in his home. He will be the only worker in the business, and he will fund its expenses entirely from his own savings. He has come to you for choice-of-entity advice, and he would like to know specifically whether he should incorporate, form an LLC, or take other formal action.

- a. First of all, if Alan takes no legal action, and just starts up his business, in what form of business will he be operating?

Alan will form a sole proprietorship by simply starting the business without any legal action.

- b. What are the pros and cons for Alan of incorporating? Is there an argument to be made that he should not take legal action as to choice of entity?

Incorporating will give Alan limited liability, but he will have to begin observing corporate formalities, become subject to double taxation, and owe some minor state regulatory compliance obligations.

It is possible that Alan may be better off by not taking legal action because the only clear benefit to him of incorporating (or forming any other entity) would be limited liability. That isn't likely to do him much good. Since he is the only person working in the business, any tort liabilities would likely be his personal liabilities—for example, if he hurts someone with scissors while cutting their hair—and he could not escape them merely by owning a limited liability entity. He also likely won't benefit much from limited liability for contract liabilities, because, as a small-assets start-up, most third parties would not extend credit to his business without insisting on his personal guarantee.

- c. Consider the possibility that Alan might be best advised to save the money he would pay you to incorporate his business or form some other entity, and spend it on something else, specifically. What might that other thing be?

Insurance for his tort liabilities.

2. Consider Robin, a woodworker, who, like Alan, decided to start her own small business making furniture from scratch. Initially she was the only worker and funded the business with her own savings. She chose to remain a sole proprietor. But after a few years of successful operation, Robin is ready to take the big step of hiring her first employee. Assuming you don't

disagree with her initial decision to remain in sole proprietorship, how does this new addition affect her choice-of-entity concerns?

The value of limited liability has increased substantially, since the business will now take on risk of vicarious liability for torts and contracts of the employee, that might not in and of themselves apply to Robin. For example, if the employee uses the company truck to make a delivery, and causes injury by driving it negligently, the liability will likely apply to the employer vicariously. If Robin's business remains a sole proprietorship, she herself would be liable as employer. But if the business is organized as a limited liability entity, the entity can be made the employer, and judgments for vicarious liabilities could only be executed against the entity's assets.

3. Which of the following characteristics do limited liability companies (LLCs) share with corporations?

- a. **Limited liability for all owners;**
- b. Strong, centralized management;
- c. Free choice with respect to whether federal taxation is two-tier or pass-through;
- d. All of the above are characteristics shared by LLCs and corporations.

(A) is correct because both LLCs and corporations offer limited liability for all owners. Corporations offer strong, centralized management, but LLCs offer more flexible management terms. LLCs enjoy pass-through taxation unless an LLC elects to be taxed as a corporation. However, a corporation is subject to two-tier taxation unless it satisfies the requirements that apply to S corporations and elects to be treated as one for tax purposes.

4. Which of the following characteristics do limited partnerships (LPs) share with general partnerships?

- a. **Unlimited liability for the general partners;**
- b. The risk of inadvertent formation;
- c. Participatory management;
- d. All of the above are characteristics shared by LPs and general partnerships.

(A) is correct. (B) and is incorrect because one cannot accidentally form a limited partnership. (C) is incorrect because the general rule is that limited partners may not participate in management.

5. True or False? With careful planning, a corporation may be able to avoid the burden of two-tier taxation.

True. As long as a corporation meets the requirement for S corporation status and elects to be recognized as an S corporation for tax purposes, it will be subject to pass-through taxation. In some instances, it also is possible to incur enough reasonable expenses payable to shareholders (for salary or rent) to avoid double taxation, because those expenses are deductible from the "income" that is taxable.

6. True or False? An interest in a general partnership usually is more liquid than an interest in a corporation.

A reasonable answer to this question would be “true,” though it really depends.

Under some circumstances, general partners have a liquidity advantage over corporate shareholders. On the one hand, if a corporation is publicly traded, its stock is highly liquid. However, stock in a *closely held* corporation is ordinarily highly *illiquid*. Closely held partnership shares—which is effectively to say all partnership shares—can be quite liquid so long as the partnership itself is profitable and the partners have not waived their statutory default right of unilateral dissolution.

As a practical matter, all general partnerships are closely held. For practical reasons, the general partnership is just not a form that lends itself to public trading. But under default partnership rules, every partner has a right of unilateral dissolution, and upon dissolution a right to insist on payout of the value of his or her interest, in cash. If other partners wish to continue, and assuming the firm is solvent, this power of unilateral dissolution effectively boils down to a right to force the continuing partners to buy out a partner who wants to leave. It will typically be better for them to make that payout than to allow a departing partner to force a dissolution and an actual liquidation of the business. And so, the power to dissolve effectively amounts to a tool for liquidity. Note, however, that the dissolution power is useful to the departing partner only if the firm is in the black. If the firm is in the red—meaning that its current liabilities exceed the value of the firm—then forcing a dissolution would actually cause the departing partner to *owe* money. But in any case, so long as the partners have not modified the default dissolution right, and so long as the firm is solvent, an interest in a general partnership is more liquid than a share in a closely held corporation.

7. True or False? Unlike the other primary forms of doing business, sole proprietorships cannot have employees.

False. Sole proprietorship means that only one person owns the business. As long as the relationships between the owner and the employees are truly employment relationships and the owner is the only owner of the business, the business is still a sole proprietorship.

Chapter 3: Introduction to Agency Law

Test Yourself Answers with Explanations

1. Bob runs an auto shop. State and federal law require him to dispose of used motor oil properly, which in Bob's case meant that he had to haul it himself to the dump and pay to have it recycled. Recently Bob was contacted by Phillip, who has begun a new business serving local auto shops by collecting and recycling used oil. Phillip convinces Bob that he can dispose of Bob's used oil more cheaply than he can do it himself, because Phillip can take advantage of volume discounts with recycling companies. Bob agrees to the service and agrees to pay Phillip on a monthly basis to pick up all the used oil he collects.

The relationship between Bob and Phillip is most likely:

- a. Principal and agent in which Bob is principal.
- b. Contract in which fiduciary duties apply.
- c. Principal and agent in which Phillip is employee.
- d. **None of the above.**

(D) is correct because Bob and Phillip have merely entered into an arm's-length contract. (A) and (C) are incorrect because no facts indicate agreement that Phillip would act on Bob's behalf or subject to his control, so the relationship is not an agency. (B) is incorrect because nothing in the contract itself imposed fiduciary duties on the parties (so far as we can tell from the facts), and in the absence of agency, mere contracting parties owe no fiduciary duties.

2. The distinction between "independent contractor agent" and "employee" is most relevant to:

- a. Vicarious contract liability.
- b. Agent's entitlement to compensation.
- c. Both vicarious tort and vicarious contract liability.
- d. **Respondeat superior.**

(D) is the best answer because principals are liable for torts of their employee-agents occurring within the scope of employment. They generally are not liable for the torts of independent contractors. By contrast, they are liable for the authorized contracts of agents of any type. (B) is incorrect because both contractors and employees are entitled to compensation.

3. John, an artist, asks his artist friend Tina to take some of his paintings to an art fair with her, and to sell them for him. The fact that John and Tina never discussed whether John would pay her for this service proves that:

- a. Their relationship is not an agency.
- b. Their relationship may be an agency, but if so it is "at will."

- c. Their relationship may be an agency, but it is an independent contractor relationship.
- d. **If anything, that artists are cheap.**

(D) is correct because compensation itself cannot determine whether two parties have formed an agency relationship. They can still form an agency relationship even if there is no payment involved.

- 4. Fill in the blanks: An employer is liable for the **contractual liabilities** of an employee, as well as for the employee's **tort liabilities within the scope of employment**. A principal is liable only for the **contractual liabilities** of an independent contractor, and not for the independent contractor's **torts**.
- 5. Fill in the blanks: The **agent** has the power to affect the legal relations of the **principal**.
- 6. Fill in the blanks: Formation of an agency relationship requires **mutual** manifestation of assent that the agent act on the principal's **behalf** and subject to the principal's **control**.
- 7. True or False? Co-agents represent co-principals.

False. They are two separate ideas. Co-agents are two or more agents who represent the same principal. Co-principals are two or more principals who each employ the same agent.

- 8. True or False? Sub-agency necessarily involves two agents and two principals.

True. A subagent has two principals – the agent who appoints the subagent and the appointing agent's principal. If A is B's principal and B appoints C as a sub-agent, A and B both are principals and B and C both are agents. Thus, the statement is true even though, in this scenario, there are only three people.

Chapter 4: The Consequences of Agency and Attempts to Avoid Them

Test Yourself Answers with Explanations

Questions 1-3 rely on the following facts:

DotBomb, Inc. runs an online retail business through its website, DotBomb.com. In addition to its own sales of a wide range of retail products, DotBomb sells advertising space on its site. It does so through a team of in-house salespeople, whom advertisers contact by calling a number on the “Contact Us” page of the website. (Often enough, though, DotBomb’s salespeople make cold calls to potential advertisers, which they can follow up with marketing materials including their business cards and correspondence on company letterhead.) Jenny, one of the firm’s brightest salespeople, recently scored a huge victory, selling a one-year advertising deal with AutoMax, the nationwide chain of auto dealerships. Or at least she thought it was a victory, until her supervisor pointed out that under the firm’s internal sales team handbook, contracts in excess of six months required approval by DotBomb’s CEO.

Meanwhile, a different sales person, Dave, has started behaving erratically lately, and hasn’t made any sales in a while, so DotBomb provides him written notice that his job will be terminated and that he is no longer entitled to act on DotBomb’s behalf. However, DotBomb management fears that after receipt of notice Dave will go “rogue” and will try to retaliate by committing DotBomb to a string of unfavorable advertising contracts.

1. AutoMax will be able to enforce its contract against DotBomb because:
 - a. Jenny had actual authority.
 - b. Jenny had apparent authority.**
 - c. Jenny had inherent authority.
 - d. It is not possible on these facts that the contract binds DotBomb.

(B) is correct because Jenny could have apparent authority based on her job title and materials indicating her status as salesperson, like business cards and company letterhead. While strictly speaking it is a fact question, it would probably be reasonable for AutoMax to believe that Jenny has the authority to enter into a sale contract. On the other hand, Jenny likely does not have actual authority because of the limitation in the internal sales team book.

2. When DotBomb salespeople make cold calls that result in contracts for the sale of advertising space, the contracts are enforceable because:
 - a. The salespeople have actual authority, assuming the contracts are for less than 6 months.
 - b. The salespeople have apparent authority by virtue of the business cards and other materials they can distribute.

- c. The salespeople have apparent authority if it is customary in the industry for contracts of this nature to be sold by salespeople without prior approval.
- d. Answers a and b are both correct.
- e. **Answers a, b, and c are all correct.**

(E) is correct because salespeople have the actual authority to sell the advertising space for a term no more than 6 months by the nature of the employment. Likewise, the business cards, the other materials, and industry custom can all demonstrate apparent authority.

3. It should be comparatively easy for DotBomb to avoid liability for unauthorized contracts entered into by Dave, because:

- a. It should be obvious to advertisers that Dave is not authorized to bind DotBomb.
- b. **Under these facts, it should be comparatively easy for DotBomb to make effective notice of withdrawal of Dave's authority.**
- c. In fact, contracts made by Dave after his termination will not bind DotBomb.
- d. Under these facts, notice of withdrawal of authority would be impractical.

(B) is the best answer. (A) and (B) are incorrect, because in the absence of some notice, Dave's loss of authority would not be obvious to third parties, and these contracts could in fact be binding with apparently authority. However, to avoid liability for contracts made with apparent authority, DotBomb could stop supplying Dave with marketing materials, business cards, and letterhead, and retrieve materials it had already given him. It could also exclude him from databases or other resources to find potential customers. And finally, DotBomb could contact current and potential customers and notify them of Dave's termination.

Questions 4-7 rely on the following facts:

Dena represents Wacky World, a family entertainment empire that operates several very popular amusement parks, with rides and attractions designed around characters from its signature animated films. Wacky World aims to build a new park in Florida, which would compete head to head competition with the well-known theme parks already established in Orlando. It instructs Dena to identify parcels near Orlando that might be stitched together into one block large enough for a new park. She is under orders not to disclose that she represents a principal, and not to make any purchases in excess of \$100,000 without prior approval. Dena nevertheless jumps at the opportunity to buy two parcels, one from Mary and the other from Robert. She bought Mary's first, even though Mary demanded \$125,000, because she was sure Wacky World would subsequently approve it. She then met with Robert, who had heard about Dena snooping around and the fairly miraculous price Mary got for her swampland. Robert asked Dena a number of probing questions, confident that she must represent a new park or some other major interest that would probably pay top dollar were its identity revealed. Dena flatly denied it, lying in fact, and insisting that the land was to be her own personal property. In the end, Dena purchased Robert's parcel too, this time paying \$130,000.

- 4. The contract with Mary is enforceable against Wacky World because:

- a. Dena had actual authority.
- b. Dena had apparent authority.
- c. Dena made the contract on Wacky World's behalf.
- d. **The contract is not enforceable against Wacky World.**

(D) is the correct answer because when the principal is undisclosed, the agent must have actual authority to bind the principal. Here, Dena believed that Wacky World would approve the contract, and if it did, it would ratify the contract and retroactively imbue it with actual authority. However, Wacky World also made it clear that Dena had no authority to purchase any land worth more than \$100,000 without prior approval. Unless and until Wacky World ratifies it, it would remain unauthorized. Therefore, Dena did not have actual authority and Wacky World would not be bound.

5. The contract with Robert is unenforceable against Wacky World because:

- a. **Dena lacked actual authority.**
- b. Dena lacked apparent authority.
- c. Dena lied in response to Robert's questions.
- d. The contract is enforceable.

(A) is the correct answer because Wacky World made it clear that Dena could not purchase land worth more than \$100,000 without prior approval. When working for an undisclosed principal, an agent would need actual authority to bind the principal. Here, Dena did not have actual authority to buy land worth more than \$100,000 without approval and therefore could not bind Wacky World. The fact that Dena lied about the principal would only have made the contract voidable at Robert's instance, if in fact it were otherwise enforceable.

6. In any case, both contracts are enforceable against Dena.

- a. **True, because she made them on behalf of an undisclosed principal**
- b. True, because she had apparent authority.
- c. False, because Dena made the contract on behalf of Wacky World.
- d. False, because she lacked actual authority.

(A) is correct because Dena did not disclose Wacky World as the principal at all and pretended to act for herself. An agent is always liable for a contract made on behalf of an undisclosed principal.

7. Now suppose that Dena was unable to keep the secret, and eventually disclosed to both Mary and Robert, before executing contracts with them, that she represented Wacky World, forgetting to mention her directions not to disclose and not to spend more than \$100,000. If the contracts are enforceable, it is because:

- a. Dena had actual authority.

- b. **Either custom in the market or some other evidence suggested that Dena could proceed this way.**
- c. Wacky World must have ratified them.
- d. The contracts cannot be enforceable.

(B) is the correct answer. Dena lacked actual authority to buy land for more than \$100,000. However, if custom or other evidence suggested that Dena could proceed this way, Robert and Mary could have reasonably believed that Dena had the authority to enter the contracts and therefore Dena had apparent authority.

Questions 8-10 rely on the following facts:

John is the owner and manager of an apartment building. Concerned about the safety of his tenants, John hires SafetyGuys, Inc., to provide security services in his building. SafetyGuys is a corporation formed for the purpose of providing security guards to private businesses. In making the arrangement, John deals directly with SafetyGuys' chief executive officer, a man named Richard, who explains to John that the security guards will be employees of SafetyGuys who will receive their instructions from their supervisor, another SafetyGuys employee. However, any agreement with SafetyGuys would be subject to John's specific requests concerning the conduct and duties of the guards, and John could make any further requests as he chose during the life of the agreement.

During the first week that a SafetyGuys guard was on duty in John's building, the guard mistook Peter, a tenant, for an intruder. A scuffle ensued and the guard beat Peter severely, causing significant physical injuries. Peter sues John for money damages for his injuries.

- 8. What is the relationship between Richard and the security guards?
 - a. Richard is their principal and they are his non-employee agents.
 - b. Richard is their principal and they are his employees.
 - c. **Richard and the guards are co-agents.**
 - d. Richard is their principal and they are his sub-agents.

(C) is the correct answer. Officers are agents of a corporation, and here Richard, as the CEO of SafetyGuys, is an officer and therefore an agent of SafetyGuys. Similarly, the security guards are employees of SafetyGuys and therefore agents of SafetyGuys.

- 9. What is the relationship between John and the security guards?
 - a. John is their principal and they are his agents.
 - b. John is their principal and they are his co-agents
 - c. John and the security guards are arm's-length contract parties.
 - d. **John and the security guards have no legal relationship.**

Of these answers, (D) is the best because it is the only one that could be right. Whether (D) actually states the correct legal relationship is a close question, because it really depends on

whether SafetyGuys, Inc. is John's agent. If so, then the guards are his sub-agents. If not, then John and the guards have no relationship. SafetyGuys, Inc. may well not be John's agent because, while he is contractually given some right to specify the guards' conduct, it is not clear that SafetyGuys, Inc. actually agrees to act subject to John's control or on his behalf. That really is a fact question for a trier of facts, but in any case (D) is the only answer here that could be right.

10. Which of the following facts, if true, would be most helpful to Peter in this action?
 - a. Richard, the SafetyGuys CEO, has encouraged all his guards "not to spare the rod" – that is, he has taught them that physical force is appropriate for self-defense and whenever the guards' orders are disobeyed.
 - b. Peter cannot win this action.
 - c. SafetyGuys is improperly incorporated and has committed federal securities fraud.
 - d. **John failed to inquire of Richard concerning the caliber of SafetyGuys employees.**

(D) is correct because it could be the basis for a theory of direct liability against John for negligent hiring or supervision. (C) might create serious issues to SafetyGuys, but seems irrelevant to Peter's case. (A) could be the basis for an action for direct liability against SafetyGuys, because if it were true then the beating may have been actually authorized. However, Peter has sued only John.

The following question stands alone:

11. Jim, an employee of Bill's Burger Hut ("BBH"), a corporation whose sole business is to own and operate a fast food restaurant, is entrusted with operation of the french fry cooker. One day Jim becomes incensed at a customer and savagely beats him with a spatula within the restaurant. If BBH escapes liability for the customer's injuries, it is most likely because of:

- a. Lack of an agency relationship between BBH and Jim.
- b. Lack of an employer-employee relationship between BBH and Jim.
- c. **The nature of Jim's work.**
- d. For reasons of public policy embodied in the concept of "respondeat superior," BBH likely cannot escape this liability.

(C) is correct. It is clear that Jim is BBH's employee-agent. However, given the nature of Jim's duties, it is possible that direct customer services is not within the scope of Jim's employment.

Chapter 5: Further Topics in Agency

Test Yourself Answers with Explanations

Questions 1-3 relate to the following facts:

After running a small business from her home for a few years, quite successfully, Priya took on a college student to help out, as a part-time employee. She taught the student, Alice, how to wrap up the firm's products and ship them to the firm's mail-order customers, plus several other more or less clerical tasks, which Alice did entirely from the make-shift office Priya had set up in her basement. Turns out Alice found sitting down there by herself pretty boring, and so she took it on herself to make some improvements in the business—and after her initial shock, Priya found both of them actually quite desirable. Alice's biggest step was signing a lease on Priya's behalf for warehouse space in which to move the business, with rent payable monthly. A fact that Priya had shared with no one was that she'd actually been planning to take just this step, and after her initial surprise and anger at Alice wore off, she realized that Alice had actually found an ideal location at a good price. Thing is, though, the first Priya heard of it was a month after Alice did the deal, when the bill for the first month's rent showed up. Anyway, after chewing out Alice, she calmed down and said, "Ugh. Okay, it's time to bite the bullet and take this risk."

Alice's other big step was to secure a used photocopy machine for the office, which she knew to be a steal at the offering price of \$2000. Turns out, before Alice could tell Priya what she'd done, the seller called Alice and said there'd been a mistake. He would not sell the machine for less than \$3,000.

1. Priya must pay the first month's rent. True or false?
 - a. True, because Alice had actual authority.
 - b. True, because of what she said to Alice.**
 - c. False, because Priya's business is a sole proprietorship.
 - d. False, because of the time period in which the debt was incurred.

(B) is correct. Although Alice did not have actual or apparent authority at the time of signing the lease, Priya approved Alice's act on signing the lease by saying "it's time to bite the bullet and take this risk." Therefore, she retroactively ratified Alice's action and made the lease binding.

2. A week after moving in to the new warehouse space, Priya discovers to her horror that the building is actually full of asbestos. She can get out of the contract. True or false?
 - a. True, because of the importance of this fact.**
 - b. True, but only if the lessor knew about the asbestos.

- c. False, because she has occupied the space.
- d. False, because she already has received the first bill without complaint.

(A) is correct because ratification requires that the ratifying person have actual knowledge of material facts. It is possible that Priya “assumed the risk” of her own lack of knowledge by ratifying without further investigating the state of the premises, as suggested in notes following Re(3) §4.06. But that seems unlikely here because there was no indication of any such serious problem at the time Priya ratified. For a person to be held to have assumed this risk, there usually must have been some indication that something is wrong or that otherwise material facts might be unknown.

- 3. Priya can buy the photocopier for \$2000. True or false?
 - a. True, because of the timing of the seller’s subsequent call to Alice.
 - b. True, unless Alice told the seller she was acting on her own behalf.
 - c. **False, because of the timing of the seller’s subsequent call to Alice.**
 - d. False, because this contract would never have been binding under any terms.

(C) is correct because Alice did not have actual or apparent authority to order the photocopier at the beginning, and the seller withdrew the offer before Priya could ratify it. Therefore, the contract is not binding on the business or Priya.

Questions 4-6 relate to the following facts:

PixCo, Inc., is a big chemicals firm based in Birmingham, Alabama. A pipe is currently leaking a dangerous substance just outside a PixCo plant building, near a stream. Under federal law, a plant owner who knows of such a condition and fails to report it is guilty of an environmental law violation. In each of the following cases, decide whether PixCo’s failure to report is illegal.

- 4. Arno, a regulatory compliance worker at PixCo, who is supposed to identify environmental risks and report them to his boss Sam, notices the leak on a routine plant inspection tour.
 - a. **Yes, because the information is material to Arno’s duties.**
 - b. Yes, because the information is material to Arno’s duties and within his scope of employment.
 - c. No, because Sam is not Arno’s principal.
 - d. No, for some other reason.

(A) is correct because one of Arno’s major duties is to identify environmental risks and report them to his supervisor. Neither the “scope of employment” test nor the fact that Arno is to report to a co-agent supervisor is relevant to imputation. Therefore, a notice about the leak is imputed.

- 5. It is Arno again who makes the discovery, but not on an official inspection tour. Instead, he notices the leak while he is on a hike for pleasure with several friends,

as PixCo has adopted a new policy permitting employees and their guests to use the company's expansive, wooded grounds for recreation.

- a. **Yes, because the information is material to Arno's duties.**
- b. Yes, because all information known to employees is imputed to their employer.
- c. No, because, while the information is material to Arno's duties, it is not within his scope of employment.
- d. No, for some other reason.

(A) is correct. A notice is imputed to the employer if the information is a material part of the employee's duties, the employee is not in adverse relationship against the employer, and the employee is not under a non-disclosure duty to another person.

- 6. This time, assume the discovery is made by Abigail, a clerk in PixCo's accounts-payable department.
 - a. Yes, because all agents are fiduciaries.
 - b. Yes, because all employees are fiduciaries.
 - c. **No, because the information is not relevant to Abigail's duties.**
 - d. No, for some other reason.

(C) is correct. Although (A) is a correct statement, it only imposes on Abigail certain obligations to PixCo, and does not in itself impute all her knowledge to PixCo. Notice is imputed only when the information is material to the agent's duties.

Questions 7-8 rely on the following facts:

Paul was aghast when he learned that his friend Arnie had made a deal for him to buy an old car from Tia. (Paul and Arnie were good, long-time friends, but had never had anything like a business relationship with one another. Paul had never met Tia.) "What?!?" said Paul, when Arnie told him. "Good lord, what were you thinking?," to which Arnie replied "Dude, I got it for a hundred and forty bucks." "Oh," said Paul, falling silent. Paul later told his brother Bob (who by coincidence knew Tia socially) that he actually thought Arnie had found a rare, great opportunity. Nevertheless, Paul decided against the deal and called Tia to tell her so. That upset Tia mightily, and all the more so the next day when Bob called to ask her if the deal had gone through, repeating what Paul had told him. Tia sued Paul on the contract.

Meanwhile, Paul and Arnie's friendship had been pretty much wrecked, and they wound up each filing third-party claims against each other in the same lawsuit, Paul alleging breach of fiduciary duty and Arnie claiming a right to a "finder's fee" commission of \$50 for his work in finding the car.

- 7. There could be no ratification in this case because:
 - a. Tia heard from Bob only after Paul called her.

- b. Paul said what he said only to Bob, and not to Tia.
- c. Paul said what he said only to Bob, and not to Arnie.
- d. **There could be an effective ratification in this case.**

(D) is correct. As indicated in Re(3) §4.06 cmt. d, a manifestation of assent to be bound by a transaction can ratify it even if the manifestation is not made to the other party to the transaction. Paul's statements to Bob could constitute ratification, and they occurred before Paul attempted to reject the purchase.

8. Which of the following claims will succeed?
- a. Paul's claim against Arnie.
 - b. Arnie's claim against Paul, if \$50 would be reasonable under the circumstances.
 - c. Tia's claim against Paul, if her understanding of events was reasonable.
 - d. Answers "a" and "b" are correct.
 - e. **Answers "b" and "c" are correct.**

(E) is correct. (B) could succeed because ratification can create an agency relationship, and agents are entitled to compensation, even if not otherwise agreed to, unless compensation is explicitly disclaimed or the circumstances indicate that the agency is gratuitous. Re(3) §8.13 cmt. d. (C) could succeed because Paul's statement to Bob could constitute a ratification. (A) will fail because even if the ratification created an agency relationship, ratification retroactively authorizes the ratified act. Therefore Arnie's act of entering into the transaction itself did not breach his fiduciary duties.

Chapter 6: Introduction to the General Partnership

Test Yourself Answers with Explanations

Questions 1-5 rely on the following facts:

Alex and Barb, platonic friends since childhood, have begun a newsletter or “zine” for fans of their local music scene. Though they’ve kept their day jobs, they spend most of their free time together producing the zine, which they create each week in the garage of the house they rent together. They distribute it for free but earn revenue through sales of advertising, and more often than not break even or even turn a small profit. Their dreams are much bigger, though, and they plan for it eventually to be their sole employment. The zine was initially Alex’s idea, and he put the first several issues together by himself in his dorm room while still in college. When he told Barb about it, she asked if she could help, and said “Just tell me what to do . . . I don’t know anything about this kind of stuff, so I’ll just do whatever you tell me to do.” They then bought some printing equipment to do a more professional job, deciding between themselves to “go half-sies” on the cost. They both worked on the actual production of each issue, made sales of advertising space, and made deliveries of the zine to newsstands, bars and coffee shops. Alex and Barb don’t keep formal books (except for the checkbook of their joint checking account, in which Alex deposits checks from advertising clients, and from which he pays expenses), and they have never written down any sort of agreement between themselves.

Barb’s uncle Charlie, a well-heeled retiree, wanted to help Barb and Alex realize their dream, and he made two offers to help the zine. First, Charlie offered to give Barb and Alex the use of \$5000 in cash to cover expenses. When Barb insisted that the offer was too generous, Charlie said, “Hey, don’t worry kid. Pay it back when you can. I’m proud of you.” Second, he introduced them to a friend named Paul, who runs a local nightclub. Charlie gave Barb Paul’s business card and, to make a long story short, Alex and Barb were able to use Charlie’s name as their introduction and land a lucrative advertising contract for the club. As a down-payment, Paul sent them a check for \$1500.

For reasons known only to themselves, however, and shortly after striking their deal with Paul, Barb and Alex closed down their business and absconded with Paul’s \$1500. Paul sues Charlie, the only viable defendant left to sue.

1. Which of the following suggests that Alex and Barb formed a partnership?
 - a. Evidence of sharing profits.
 - b. Capital contributions.
 - c. Evidence of sharing losses.
 - d. All of the above.**
 - e. Answers “b” and “c” are both correct.

(D) is correct. The indication that they share profits and losses is that the proceeds are deposited into and expenses paid from a joint checking account. And Alex and Barb appear to have made capital contributions by paying for equipment together.

2. Suppose that Paul manages to track down Alex and Barb, serves them with process, and joins them as defendants in his case against Charlie. Which of the following would be the most helpful fact for Barb in defending against liability?
 - a. The means by which the firm acquired its physical assets.
 - b. The means by which the firm acquired its headquarters.
 - c. **Decision making.**
 - d. The means by which the firm receives revenues.

(C) is correct. Barb will avoid liability if she can disprove the existence of the partnership. She can argue that when Alex asked for her help, she merely followed his directions, and so was an employee rather than a business partner. Because partners in a partnership usually enjoy managerial rights, here Barb can argue that her lack of managerial rights proves that she is not a partner.

3. Which of the following best characterizes Alex and Barb's relationship?
 - a. Agency.
 - b. **Partnership.**
 - c. Some limited liability entity.
 - d. It could be any of the above.
 - e. It could be "a" or "b."

(B) is probably correct. Although Barb might be merely an employee, the fact pattern probably favors partnership. They did business together as they both participated in production, distribution, and other important business matters, they split the costs of many expenses and have a joint account, and therefore have manifested an intent to do business and share profits.

4. Given the informal manner in which they formed their relationship, what would likely have been the biggest surprise to Alex and Barb about the legal entity that in fact they formed?
 - a. Alex's exposure to personal liability.
 - b. Barb's exposure to personal liability.
 - c. Barb's governance rights.
 - d. Answers "a" and "c" are correct.
 - e. **Answers "b" and "c" are correct.**

(E) is correct. Some facts indicate that Barb really anticipated no ownership or managerial responsibility, so both she and Alex may have expected that Barb would be only an employee.

They might be surprised, if Barb is held to be a partner, to learn that she both faces liability and has governance rights.

5. Paul's claim against Charlie will most likely:
- a. Succeed, because of Charlie's manifestations of intent.
 - b. Succeed, under either the doctrine of respondeat superior or some other rule of vicarious liability.
 - c. Fail, because while vicarious liability could be an appropriate theory, the relevant evidence is likely insufficient here.
 - d. **Fail, because of his relationship with Alex and Barb.**

(D) is the correct answer. Answers (B) and (C) could be correct only if Charlie was an employer of the zine or of Alex or Barb, but on the facts available that would be obviously untrue. As for answer (A), Charlie manifested no intent to create any other relationship that would make him responsible for the business's debts. There is no mention of intent that he would share profits, contribute or own any assets, or have a managerial role, so it is unlikely that he is a partner or proprietor of the firm. Likewise, no facts suggest that he meant to be a surety of any debts. In fact, by giving the firm "the use" of \$5000, without an expectation other than repayment of the principal amount, it appears that his only relationship may have been as gratuitous donor of a gift.

Questions 6-8 stand alone:

6. Because it's well worth your while to learn it before moving on, define a partnership.

A partnership is a business entity in which two or more people carry on as co-owners a business and share the profits. RUPA § 202(a).

7. What are the elements of a purported partnership?

- 1. Representation of a person as a partner, either by the person or by members of the purported partnership with the person's consent;**
- 2. That is made either directly to some third party or in a public manner of which the third party is aware; and**
- 4. Reliance by the third person on that representation in entering into a transaction with the partnership.**

RUPA § 308.

8. Fill in the blanks: Receipt of **profits** is presumptive evidence of the existence of a partnership. If, however, it was received as **salary, loan repayment, or rent** (there are more than three), no presumption arises.

Chapter 7: Finance and the Sharing of Profits and Losses

Test Yourself Answers with Explanations

Questions 1 and 2 stand alone:

1. A, B and C form the ABC Partnership. As part of their initial agreement, they each contribute \$10,000 in capital. At the time of formation, C owned a building with some unused office space. A, B and C agree that the partnership will have the use of this office space on a month-to-month basis, in exchange for \$500 per month paid from the partnership's funds. C is permitted to sell this office building at her election and to keep any profits earned thereupon. True or false?

- a. True, even though the building is partnership property.
- b. True. The building is not partnership property.**
- c. False. The building is partnership property.
- d. False. She is permitted to sell the building, because she has sufficient authority to do so, but she may not retain the profits from the sale for herself.

(B) is correct. Here, the partnership rents C's building and C did not contribute the building to the partnership. It therefore remains her personal property.

2. When Larry joined the ABC partnership, his only capital contribution was a pick-up truck with a fair market value of \$5000. Some years later ABC agreed to sell the truck for \$3000. ABC has four members, including Larry, and they have no written partnership agreement or any other explicit agreement between them, other than to act as co-owners of a business for profit. Assume that every year since the beginning of Larry's membership, ABC's revenues have precisely equaled its expenses. At the time of the sale of the truck, what amount should be reflected in Larry's capital account?

- a. \$5000.
- b. \$4500.**
- c. \$3000.
- d. None of the above.

(B) is correct. Larry's initial contribution is \$5000, and the firm during these years suffers no profit or loss except depreciation in the truck's value. Because he contributed the truck to the partnership, the truck is partnership property and the partners will share the losses pursuant to the default rule (because there are no other agreements, written or otherwise, among them). Therefore, each partner will bear a loss in the amount of $(\$5000 - \$3000)/4 = \$500$.

Questions 3 and 4 relate to the following facts:

JJ&J, an at-will, default partnership among Jen, Janey, and Joe fell on some pretty tough times last year, and also experienced personal conflicts among the partners. Jen and Janey appeared to have gotten pretty sick of the whole thing, and appeared likely to seek the firm's dissolution. In fact, they were pretty much absent during a period of about a month, and during that time Joe really had to step in and do it all himself. He estimates he spent an additional twenty hours per week working in the business. He also personally put an additional \$10,000 into the firm's coffers to keep it afloat (signing a written document to the effect, with the word "Loan" written at the top, and indicating that he would be repaid "with interest," but specifying no interest rate).

3. The written document memorializing Joe's "loan" is:
 - a. A breach of his fiduciary duty.
 - b. Fine, and enforceable as written.**
 - c. Not enforceable, because one partner acting alone cannot execute such an agreement on behalf of the firm.
 - d. Irrelevant, because his \$10,000 will actually constitute a capital contribution.

(B) is probably correct. While it is a fact question whether accepting the loan is within the ordinary course of business, so long as it is, then Joe had authority to incur the obligation on the firm's behalf. The fact that no rate of interest is specified does not matter.

4. To how much is Joe entitled from JJ&J, now, assuming the "loan" documents by its terms has become due and payable?
 - a. Nothing, because his extra efforts are not compensable and, despite the written "loan" document, his \$10,000 constitutes an additional capital contribution.
 - b. \$10,000 plus interest.**
 - c. \$10,000 plus the value of his additional efforts.
 - d. \$10,000 only.

(B) is probably correct. Again, assuming the loan was in the ordinary course of business, Joe is entitled to repayment of the loan with interest. He is not, however, entitled to compensation for work in the firm, absent contrary agreement.

Questions 5-7 stand alone:

5. Fill in the blanks: The balance in a partner's capital account equals his or her initial contribution, plus **share of any profits**, less **share of any losses**, and less **the amount that the partner has withdrawn**.
6. Does a partner's capital account represent an actual amount of money that the partnership has set aside? Why or why not?

No. A capital account is just a way to keep track of a partner's changing financial rights and obligations over time. Absent contrary agreement, the partnership has no obligations to distribute profits or return contributions until dissolution. Moreover, at any given time the amounts contributed to or earned by the partnership may well be invested in non-cash assets, not sitting around as cash.

7. What is the purpose of a drawing account? Does it represent an actual amount of money that the partnership has set aside? Why or why not?

A drawing account records the amount of withdrawals a partner makes. The value of a drawing account is always negative, but the absolute value of the drawing account reflects how much a partner has withdrawn rather than something he/she is entitled to receive.

Chapter 8: Management, Control, and Their Legal Consequences for the Firm and Its Partners

Test Yourself Answers with Explanations

Questions 1-5 rely on the following facts:

Hank and his friend Biff have developed a new condiment, “Near-Death Experience Hot Sauce,” for sale in local supermarkets. The idea and culinary talent mostly belong to Hank, but they agree they’ll make the product using Biff’s equipment, in Biff’s garage. As to the costs and managerial decisions, the only thing to which they explicitly agree is that it will be “all for one and one for all.”

Unfortunately, Hank knows first-hand the secret heartbreak of addiction to Unyun® brand snack treats, an artificial onion-ring-shaped snack Hank eats so compulsively that his unpaid tab at Big Billy’s Qwikie-Mart is now \$5000. Much to his surprise, Biff was recently confronted by Big Billy himself at the garage/workplace where Hank and Biff make their sauce. Big Billy insisted that since he had been unable to find Hank, Biff is obliged to pay off the entire \$5000 Unyun® debt. Now, Big Billy’s demand was not backed up with a threat of physical violence; Big Billy is only 4’ 9”. Rather, Big Billy says that unless Biff pays up, he will sue.

1. The relationship between Hank and Biff is best characterized as:
 - a. A mere contract, which in this case is consistent with the statute of frauds.
 - b. An agency relationship in which Hank is principal and Biff is agent.
 - c. **A partnership.**
 - d. Something other than a partnership because in these particular circumstances a partnership agreement would have to be in writing.

(C) is correct. Hank and Biff are carrying on a business together and sharing its profits. The agreement between them and their contributions of idea and capital (equipment and the use of the garage) are evidence of the existence of the partnership.

2. Assuming Big Billy has not secured any sort of court order to enforce Hank’s Unyun® debt, he should be able to collect:
 - a. \$5000 from any of Hank, Biff or their business.
 - b. \$5000 from Hank or the business.
 - c. \$5000 from the business.
 - d. **\$5000 from Hank.**

(D) is correct, because the debt is clearly personal.

3. Assume that Big Billy secures a court order to collect on Hank's \$5000 Unyun® debt as against Hank's interest in the hot sauce business. Such an order would:
- Entitle Big Billy to insist on immediate payment by the partnership of \$5000.
 - Entitle Big Billy to one half of the excess of all assets over liabilities, upon dissolution and winding up, to a maximum of \$5000.**
 - Entitle Big Billy to one half of the excess of all assets over liabilities, upon dissolution and winding up.
 - In fact, no such order would be available. Hank's debt is purely personal and could not be executed against the business.

(B) is correct. As the holder of a charging order, Big Billy has some limited procedural rights, like the right to seek a foreclosure of his interest or to seek judicial dissolution and winding up in the event that he is treated unfairly by the remaining partners. Except where those remedies are available, however, his only option is to wait until Hank's share of profits are distributed, and in the case of a default partnership like this one there is no legal obligation to distribute profits until dissolution. Once the full value of Billy's claim is paid by the partnership, the charging order is satisfied and Billy would have no further claim to Hank's share of the profits.

4. Assume that Big Billy secures the court order described in Question 3, but Biff refuses to release any funds to Big Billy. Big Billy can, upon an appropriate showing in court:
- Secure a dissolution of the business.
 - Secure a foreclosure of Hank's interest.
 - Secure a winding up of the business.
 - Answers "a" and "b" are both correct.
 - Answers "a," "b" and "c" are correct.**

(E) is correct. A creditor with a charging order may seek a court-ordered foreclosure, and any transferee of a partner's interest may seek judicial dissolution and judicial winding up.

5. Hank could have tried to settle his debt with Big Billy by:
- Assigning to Big Billy his interest in the business's inventory.
 - Assigning to Big Billy his interest in the joint checking account into which Hank and Biff have deposited all of their business's revenues.
 - Allowing Big Billy to take his place in the business completely.
 - None of the above.**

The only thing of value in a partnership assignable by an individual partner is their "interest" in the partnership, meaning their right to share in the profits and losses. (A) and

(B) are both incorrect, because Hank’s interest in items of partnership property is not transferrable. (C) is incorrect because a person can be admitted as a partner only with unanimous consent of the partners.

Questions 6-8 stand alone:

6. X, Y and Z are the members of the XYZ Partnership (“XYZ”). They are each skilled craftspeople who make handmade furniture for the partnership to sell, using tools and raw materials purchased by the partnership. Z has made a chair, in the same manner in which he’s made all his other products for the partnership, but he is particularly fond of this chair and does not want to part with it. Z can unilaterally refuse to sell this item, despite X and Y’s desire to sell it. True or false?

- a. True. He made it and it is therefore his.
- b. True. The chair is an item of “partnership property,” and the partnership cannot assign any of the partners’ interests in “specific partnership property” unless it assigns all of their interests.
- c. True. See Revised Uniform Partnership Act§401(j).
- d. False.**

(D) is correct. Z made the chair using tools and raw materials that were themselves partnership property, and therefore the chair is also partnership property. A partner has no right to use partnership property for non-partnership purposes.

7. Traditionally, the “exhaustion rule” required:
- a. For all claims, execution against partnership assets only.
 - b. For contract claims, execution against partnership assets only.
 - c. For contract claims, execution against partnership assets prior to execution against partners individually.
 - d. For all claims, execution against partnership assets prior to execution against partners individually.**

(D) is the correct statement of the “exhaustion rule.”

8. Shady Bros. Properties is a general partnership that invests in real estate properties for the purpose of re-selling them for profit. Late last year the only property in Shady Bros.’ ownership was a downtown retail building. Scott, one of the three general partners at Shady Bros., meets a willing buyer for the downtown building, and unilaterally executes an agreement for immediate sale of the property. The sale agreement most likely is:

- a. Unenforceable. Scott lacked authority for this kind of transaction.
- b. Unenforceable because of the nature of Shady Bros.’ business.
- c. Enforceable because of the nature of Shady Bros.’ business.**
- d. None of the above.

(C) is correct. While ordinarily sale of the firm's only asset would require unanimous approval as outside the ordinary course of its business, sale of real estate parcels in fact was in this particular firm's ordinary course of business.

Chapter 9: Dissolution and Winding Up

Test Yourself Answers with Explanations

1. When they formed the A & B Company, a general partnership, A contributed \$250 cash in capital and B contributed \$50 cash in capital. Their partnership was formed solely with a handshake and a mutual oral promise that it would be “all for one and one for all, share and share alike.” When they dissolved and wound up their business, following payment of creditors there remained only \$100. To how much are A and B entitled of this amount?

- a. A: \$250; B: \$50 – they are each entitled to a return of their initial capital.
- b. **A: \$150; B: (\$50) – A will take the \$100 in remaining proceeds and B will have to contribute \$50 to cover the shortfall.**
- c. A: \$75; B: \$25 – they should share 3 to 1, since that was the ratio of their capital contributions.
- d. A: \$50; B: \$50 – since they did not agree otherwise, they share profits and losses equally.

(B) is the best answer. Under the law as it exists in most states, the partnership is obliged to return each partner’s capital (for a total of \$300). It is \$200 short, and each partner must bear one-half the loss (\$100 each), because of their “share and share alike” agreement. (The same would be true if they had no agreement on sharing profit or loss.) This means that A is entitled to \$150, leaving A with a loss of \$100, and B must contribute \$50 in order to suffer the same loss. The \$50 from B will, of course, go to A.

Note, however, that under the latest version of RUPA (which has been adopted in only a few states) partners do not have to contribute to make one another whole. This means that A would get the \$100 and that would be the end of it.

2. X and Y form a partnership in a RUPA (1997) jurisdiction for the purpose of speculating on certain real estate investments. To establish their partnership X and Y execute a written partnership agreement. A provision of this agreement entitled “Duration and Termination” provides that “the XY partnership shall exist no longer than two years.” Y, however, is fed up at the end of the first year of business and informs X of his decision to leave the firm. X wishes to continue the firm for the full two years. The agreement contains no terms relating to retirement, buy-out or post-dissolution continuation.

Y will be entitled to a buy-out of his partnership interest, but it will be reduced by the value of:

- a. Damages caused.
- b. The goodwill of the XY Partnership.
- c. Damages and goodwill.

d. Neither damages nor goodwill.

(D) is correct. Language establishing a *maximum* term, like “the firm will exist no longer than X years,” does not create a fixed term.

3. A, B and C form a partnership, which they call the ABC Partnership. The partnership is formed with the purpose of building an office building. The major source of operating capital for ABC is a \$5,000,000 bank loan, which is taken out immediately after ABC’s formation. The anticipation of the partners is that the building will be sold on completion, though ABC may rent it out as office space for some period until a suitable buyer is found. The partners anticipate that ABC will not engage in any other sort of business.

After five years, shortly before completion of the building (and, incidentally, shortly before the last of the \$5,000,000 bank loan will be spent on construction expenses), A retires. According to the partnership agreement, A is entitled to a buy-out equaling the value of his capital account at the time of retirement. Much to his surprise, however, he learns only at that point that the value stated in his capital account is “\$0,” even though the market value of the building upon completion will be quite significant. A’s outside accountant reviews the partnership’s books and assures him that the statement in his capital account is correct.

This result:

- a. Probably gives rise to a cause of action on A’s part against his partners.
- b. Suggests self-interested misconduct on the part of B and C.
- c. **Should have been expected.**
- d. Might have been expected, though if A is surprised, then it probably suggests mismanagement by B and C.

(C) is correct. It appears that A left the firm before it had ever earned any revenues, at least any revenues it could have earned in renting the building, and since the initial \$5 million loan was the only source of operating capital, it sounds as if the firm didn’t have any other meaningful assets or operating businesses. Moreover, it has paid out almost \$5 million for the expenses of building the building. And since assets are conventionally accounted for at their historic acquisition cost, the fact that the nearly complete building likely has substantial value would not be reflected in the firm’s financial accounting or in A’s capital account.

Questions 4-6 rely on the following facts:

Flarnstein, Jehozephat & Cadiddlehopper Dental Associates (FJ&C) is a general partnership engaged in the provision of dental services. FJ&C’s founding partners formed their partnership using a printed form partnership agreement which they purchased at a bookstore, and which they did not read carefully. Among many other things, their agreement contained the following two clauses:

“This partnership shall exist no longer than 5 years from the effective date stated herein.”

“Every partner, at his or her election, shall be entitled to an annual distribution, from partnership funds, of \$5,000.”

The founding partners created FJ&C when they signed their partnership agreement on January 1, 2012. Camille Cadiddlehopper, one of the founding partners, sent a letter to her partners dated December of 2018, requesting her distribution of \$5000, even though none of the partners had previously requested such a thing. In response, another founding partner named Filbert Flarnstein immediately insists upon dissolution and winding up of FJ&C.

4. Is FJ&C a partnership at will? Did it even still exist at the time of the events now in dispute?

Yes. FJ&C is at will because the partnership agreement did not specify a fixed term. (It stated only a *maximum* term.) It still existed at the time of the disputed events because, even though the expiration of the stated maximum term caused an event of dissolution on January 1, 2000, the partners effectively agreed to waive dissolution and winding up by their continued performance of the partnership’s ordinary business.

5. Is Camille entitled to receive her \$5000?

Yes, per agreement.

6. What is the effect of Filbert’s effort to dissolve? Will he owe damages? Can he seek a winding up?

Filbert can dissolve and insist on winding up, and because his dissolution is not wrongful (since the partnership is at will), he is not liable for damages.

Chapter 10: The Limited Partnership

Test Yourself Answers with Explanations

1. ABC, Ltd., a limited partnership formed under a relatively bare-bones partnership agreement that left most terms of the state limited partnership statute unmodified, manufactures gaskets for the automobile industry. Jane is ABC's sole general partner and Paula is its sole limited partner.

- a. On March 1, a car maker that is one of ABC's chief customers informs ABC of a defect affecting a large batch of gaskets. The customer demands repayment of their value, whereas ABC happens to be sufficiently low on cash at the moment that satisfying the obligation could make the firm insolvent. Alarmed at these events, on March 3 Paula engages a law firm to represent ABC in what seems to be shaping up to be litigation, and she also makes overtures to the car maker's executives to try to work out a compromise. If the car maker reduces its claim to judgment, and the value of it exceeds the net value of ABC, Ltd., for how much of the excess are Jane and Paula each liable?

They could both be personally liable for the entire amount. Jane has unlimited liability as the sole general partner. Paula, as a limited partner, would ordinarily enjoy limited liability, but here, by hiring an attorney and dealing with the customer on the firm's behalf, may have impermissibly engaged in management and may take on personal liability.

- b. Assume that the gasket conflict is resolved amicably, but that it caused lasting strife between Jane and Paula. At wit's end, Paula decides her only option is to quit ABC altogether. Never one to stand on formalities, she visits Jane in person to give her the sad news. Paula demands reduction of the value of her partnership share to cash, with payment within the month. What effect?

By statutory default, Paula may withdraw unilaterally, but she must give 6-month written notice to Jane. The withdrawal of a limited partner does not cause dissolution, but it does trigger an obligation to pay the partner the value of her interest.

2. XYZ, Ltd., is a limited partnership with a corporate general partner and 275 limited partners, all of whom are individuals and none of whom have any other relation to the general partner, and all the limited partnership shares are currently traded on the New York Stock Exchange. Mark is one of those limited partners.

- a. Two years ago, XYZ had a very tough year, and it failed to distribute any profits at all to its limited partners. Incensed, Mark brings suit, asserting that he was entitled to a distribution of \$5,000. What must be true in order for Mark's lawsuit to recover the unpaid distribution to succeed?

There is no right to interim distributions absent a provision in the limited partnership agreement. So, in order for Mark to succeed, there must either be such a provision or some other basis on which the refusal breached some enforceable duty. A case might be made for a distribution in the event of bad faith withholding. Such a case might be established if the general partner were refusing to make distributions in order to conserve funds for non-partnership purposes or in order to force the limited partners to sell their interests. In the case of a publicly traded limited partnership, the latter is very unlikely.

- b. At the end of its last taxable year, XYZ distributed \$10,000 of its profits to Mark. Will those profits be subject to two-tier taxation? Do you have enough information to know?

LPs enjoy pass-through taxation *unless* they are publicly traded – which XYZ is. There is an exception, however, for companies in the exploration, development, or distribution of minerals or natural resources. We do not know what XYZ’s business is, so not enough information has been provided to determine whether there is two-tier taxation.

3. PQR, L.P., is a limited partnership. The agreement of limited partnership provides that the limited partners are entitled to receive annual distributions equal to no less than 20 percent of the amount of their capital contributions. At the end of year one, the distributions are made, leaving PQR, L.P., unable to pay its creditors. If the creditors sue the limited partners, must they return their distributions?

Yes. No distributions can be made if such distributions will make the LP insolvent, and creditors can sue the limited partners for their returns of capital contribution when the LP has insufficient assets. Here, the distributions clearly left PQR unable to pay its debts as they came due, so the creditors could sue the limited partners.

4. Larry is a limited partner in Limited, L.P., a limited partnership. He also is the 100 percent shareholder of Limited, Inc., the corporate general partner, as well as its only director and president. At a Rotary Club luncheon, he meets Sue, a supplier of a product that Limited, L.P. uses. He hands her a business card that says “Larry, Limited Partner, Limited, L.P.” Larry subsequently phones Sue, identifies himself as “Larry from Limited.” He reminds her where they met and places a large order. The order is delivered and the product is used, but not paid for. If Limited, L.P., is unable to pay, will Sue be able to recover from Larry? If so, under what theory or theories? Does it matter whether RULPA or ULPA (2001) applies?

Because Larry acts within one of the safe harbors of RULPA 303(b), he should not be liable simply because he was an officer, director and shareholder of the corporate general partner. On the other hand, he did not indicate he was acting as an agent for the general partner and in fact never mentioned the general partner when he met Sue and/or made the call, and therefore might be liable as an agent for an unidentified principal. Moreover, since he did not indicate he was acting on behalf of the general partner he quite arguably personally participated in control, in which case under RULPA 303(a) his liability would depend on whether Sue thought he was a general partner. The fact that he gave her a card stating that he was a limited partner could be helpful to him, but would not be dispositive. Under ULPA,

general partners have limited liability, so the possibility that Larry might be treated as though he were a general partner would not expose him to liability.

Chapter 11: The Limited Liability Company, Its Special Attributes, and Other Modern Alternatives

Test Yourself Answers with Explanations

1. Jim and Joe created a two-member default LLC in an ULLCA state, called Happy Time Amusements, LLC (Happy Time). Happy Time manufactures large, arcade-style video game consoles that it distributes to arcades and other public venues. Happy Time has elected to be taxed as a partnership. After a successful first year of operations, Jim believes he and Joe both ought to receive payments from the substantial profits the firm earned. Joe is opposed, and Jim is prepared to sue.

- a. Given the facts stated, is Happy Time a manager-managed or member-managed firm?

Member-managed. The statutory default of the ULLCA is member-management. In addition, the fact that Jim and Joe are involved in deciding how to distribute profits indicates they believe they have the right to participate in management.

- b. Could Happy Time become publicly traded while remaining an LLC? Would it have to make any changes to its governance or organizational structure? And assuming it could, could it retain pass-through tax status?

In principle it is possible, but in Happy Time's case it would require extraordinary organizational changes and the firm likely could not retain pass-through tax status. A publicly traded LLC effectively must be manager-managed and its shares must transferable, and so at a minimum the firm's agreement would have to be modified to change those two statutory defaults. A number of other changes would also be needed or desirable. Furthermore, the firm would have to comply with federal securities requirements for publicly traded firms.

Finally, publicly traded unincorporated firms can retain pass-through tax status, but only if they have always made most of their profit from the energy or natural resource sectors. Happy Time is simply not in the right line of business.

- c. Given the facts stated, how much will Jim win in his suit for a distribution of profits?

Probably \$0. ULLCA default rules on distribution largely follow the default rules for general partnerships. Thus, the default is that members of an LLC receive shares of profits but are not entitled to distributions at their will.

2. Why do you suppose only a manager-managed LLC can be publicly traded?

For the same reason that public shareholders by and large can't be involved in managing their corporations. It would be prohibitively difficult to organize any meaningful member participation in management.

3. Bob is an attorney hired by several individual investors. They desire to establish a firm, to be known as XYZ, LLC, as a manager-managed limited liability company. Bob drafts the articles of association and instructs his paralegal to file them with his state's secretary of state, on May 1. The paralegal does so, and the next morning Bob phones the investors to tell them. On May 4, two of the investors execute a lease for office space to serve as XYZ's headquarters. They signed only in their representative capacities, as officers of XYZ, making clear that they did not personally intend to take liability. The following week, on May 9, Bob receives a notice from the secretary of state indicating that the articles of association were drafted incorrectly and will be rejected, requiring resubmission. The next day, May 10, XYZ's financing falls through, and the investors decide to abandon the project.

Who, if anyone, is liable on the lease for office space?

The investors who personally signed, since the LLC was not in existence. A person purporting to act on behalf of a principal they have reason to know does not exist is personally liable. Re(3) §6.04. Whether the other investors are jointly and severally liable for this obligation depends on whether they "purported to act" on the firm's behalf, or were merely passive investors. (It would be more clear that each of them is liable if they had elected member-management.)

4. Alice, Bo and Conchita file the necessary paperwork to create the ABC LLC under state law. They subsequently enter into an operating agreement containing a clause agreeing that all disputes relating to the LLC will be subject to arbitration in a state other than the one in which the LLC was formed. Alice, Bo and Conchita sign the agreement but there is no signature line for the LLC. Which of the following is most true?

- a. ABC LLC will be subject to the arbitration clause described;
- b. Alice, Bo and Conchita will be subject to the arbitration clause described;
- c. Neither answer (a) nor answer (b) is true;
- d. **Both answers (a) and (b) are true.**

(D) is the correct answer. Courts often give the maximum of freedom in written agreements regarding LLCs, and case law has demonstrated that exclusive forum selection and arbitration clauses are generally acceptable and can change corresponding default rules. The LLC need not separately sign – although, for planning purposes, an attorney certainly should suggest a separate signature.

5. Which of the following represents advice that you would give a client? (Assume that all of the business forms alluded to would be available and mark all choices that would apply.)

- a. **There are circumstances in which a general partnership would be a better choice than an LLP.**

- b. **There are circumstances in which a limited partnership would be a better choice than an LLLP.**
- c. **There are circumstances in which either an LLP or an LLC could accomplish the same goals.**
- d. **There is never a reason to prefer a Subchapter S corporation to an LLC.**

In principle, all of statements (A)-(C) could be true in at least some circumstances, because the particular needs and details of individual businesses vary so widely. Admittedly, answers (A) and (B) are probably true only in limited circumstances. (A) might occasionally be true in those states that still require some professions to be performed without limited liability. There also are occasionally instances in which for regulatory reasons there might be an advantage to choosing the GP, as when a particular state tax is imposed on LLPs but not on GPs. It is a little harder to see what advantages the LP has over the LLLP, but the fact remains that there are large numbers of LPs still in the world while LLLPs remain rare. (C) is probably the only answer that is very generally true. The LLP and the member-managed LLC are in fact quite similar.

As for (D), while it is true that the LLC can usually accomplish anything that a Subchapter S corporation can (including even the Edwards-Gingrich payroll tax loophole, see Chapter 1, since an LLC can take the Subchapter S election), it seems very unwise to say “never.”

- 6. True, false, or indeterminable? An LLP is to a general partnership what an LLLP is to a limited partnership.

True. An LLP essentially is a general partnership whose general partners have limited liability. An LLLP essentially is a limited partnership whose general partners have limited liability. Answering “Indeterminable” would also be acceptable, if the reason given is that an LLLP formed under ULPA (2001) could have limited partners with the right to participate in management. Nothing about the LLP election enlarges anyone’s possible management rights.

- 7. True, false, or indeterminable? An LLC is more like a limited partnership than it is like a corporation.

Indeterminable, because both an LLC and a corporation are sufficiently flexible that each could be organized to have widely varying characteristics. For example, both a manger-managed LLC and a corporation with many passive shareholders resemble the LP, in that both have one or more strong managers and some class of passive investors. But a member-managed LLC and a closely held corporation whose shares are owned by the officers and directors are both more like a GP with respect to their management than like an LP.

- 8. True, false, or indeterminable? Adoption of LLP status means that no partner may be called upon to contribute amounts that will permit the partnership to satisfy its obligations.

False. Unless the very latest version of RUPA is adopted, partners still must contribute the amounts necessary to permit the partnership to satisfy its obligations to return capital. It also is important to remember that partners are responsible for their own torts and injuries caused by unauthorized contracts. In addition, it is possible for partners to sign capital call agreements.

Chapter 12: Fiduciary Duties in Agency and Unincorporated Entities

Test Yourself Answers with Explanations

1. X, Y and Z form the XYZ partnership. They establish their firm through a written partnership agreement, but it contains very little except their agreement to form the business for profit with themselves as members. The business is engaged in oil and gas exploration, and its main activity is identifying new oil and gas deposits and selling them to oil companies. The partners, however, have made money in other ways, such as investment in securities and loans to other promising start-ups. Though they didn't provide for it explicitly in their agreement, they each understand that they will share all management responsibilities equally. Z recently invested a significant amount of the firm's liquid cash in publicly traded securities, which ultimately lost a lot of money, and the loss of which turned out to be of no tax benefit to the firm.

X and Y sue Z for the entire amount of the loss. This lawsuit most likely will:

- a. Succeed, because Z will be unable to prove the fairness of the transaction.
- b. Succeed, because of the substantive standard of care that applies to partners' managerial decisions.
- c. Succeed, because this particular sort of transaction would require specific authorization of the other partners.
- d. **Fail.**

(D) is the correct answer, as a consequence of the business judgment rule.

2. On the facts of the previous question, assume instead that Z invested the money in a chain of ice cream stores, indulging a childhood dream of entering that business. His action:

- a. **Breached his fiduciary duty of care.**
- b. Breached his fiduciary duty of loyalty.
- c. Did not breach a duty, though he will be personally responsible for any losses.
- d. Did not breach a duty, and he will bear no personal liability for it.

(A) is correct, if it can be shown that Z made the investment in disregard of the firm's best interests. That is, if he truly acted to indulge his personal interest either knowing it would not profit the business or not caring one way or the other, then he has breached his duty of care.

3. Miguel was hired as chief executive of Greenwood, LLC, a prominent Chicago real-estate development firm. Greenwood is a manager-managed Illinois limited liability company. Miguel was lured to the position with a lucrative contract, renewable annually, still with six months before its expiration in the current year. While his tenure at Greenwood has generally been a success, Miguel recently made some regrettable headlines. While addressing an industry social gathering covered by the Chicago press, and having apparently gotten quite intoxicated, Miguel

made both a series of inflammatory sexual and racial comments and a number of statements boasting of his managerial role at Greenwood.

What remedies might Greenwood have against Miguel?

- a. Termination, despite his contract.
- b. Damages.
- c. **Both.**
- d. Neither.

(C) is correct. Miguel’s conduct breached his duty of care. Greenwood may pursue monetary damages. Moreover, because fiduciary breach is a material breach of contract, Greenwood may terminate his employment despite the sixth months remaining on his contract.

4. On the facts of the previous question, assume that it was not Miguel who spoke off-color at the industry gathering, but Melinda, a Greenwood member and a retiree who resides most of the year in North Carolina.

What remedies might Greenwood have against Melinda?

- a. Termination of her membership.
- b. Damages.
- c. Both.
- d. **Neither.**

(D) is correct. Because Greenwood is a manager-managed LLC, any member who is not a manager has no fiduciary duties to the firm.

5. ABC, LLP is a dental practice organized as a limited liability partnership, owned by three practicing dentists named Anil, Barb and Chuck. Unfortunately, during its brief lifetime, ABC has been an unhappy little family. In particular, conflict between Anil and Barb has led Barb to decide to leave the firm and begin her own solo practice. When she first came to this resolve, some months ago, she sent a letter to each of the patients whom she’d served while working at ABC, advising them that she’d soon be in her own practice and accepting new patients. (She never told Anil or Chuck that she’d sent this letter.) In the intervening months, she’s taken several other steps to start her new venture, including securing office space, leasing office equipment, and entering into a substantial, long-term contract with a business printer to print business cards and advertising materials.

Which of the following statements is true?

- a. Barb’s letter violated her duty of care.
- b. **Barb’s letter violated her duty of loyalty.**
- c. Barb’s letter and printing contract, both conducted in secret, violated her duty of disclosure.
- d. Barb’s letter and printing contract violated her duty of loyalty.

- e. None of Barb's actions violated a fiduciary duty.

(B) is the correct answer. Barb owes a fiduciary duty of loyalty not to compete with the firm, and advising her patients she is leaving and will be available to serve them at a new location seems explicable only on the basis of a motive to compete. On the other hand, the various steps she took to *prepare* to compete—preparing a new office space and engaging a marketing printer—are mere preparations and are entirely permissible.

6. On the facts of the previous question, assume that one of the events that so soured Anil and Barb's relationship was Anil's unilateral decision to make himself a loan from ABC's bank account, pursuant to a written contract that he wrote and executed himself. The contract obliged him to repay the principal within six months, at 4.25% interest. Had he gotten the loan from a bank, he likely would have paid something in the range of 4% to 4.5% interest. Only after executing the writing, withdrawing the funds, and spending them did Anil disclose the facts to Barb and Chuck.

Which of the following is most likely to be true?

- a. **The loan is illegal for reasons of secrecy and its purpose.**
- b. The loan is automatically illegal, regardless of any other facts.
- c. The loan is illegal because it is not "inherently fair."
- d. The loan is not illegal.

(A) is probably the best answer. As Anil would have paid an interest rate between 4% to 4.5% on a bank loan, and he repaid the firm at 4.25%, the loan is probably not substantively unfair. However, the intrinsic fairness test also requires procedural fairness, and Anil's failure to disclose this loan to his partners was probably procedurally unfair.

Questions 7-10 rely on the following facts:

For some time Julie has successfully run a chain of laundromats in Wisconsin and Minnesota, and she wants to expand her business into jukeboxes placed in bars and restaurants. But since that market is already rather saturated in her area she thinks her best bet is to buy in to an existing operation. To help her find one, she engages a business broker named Guadalupe. Guadalupe's standard contract provides that she works according to her client's directions in return for a stated compensation, that she works only in a fully disclosed capacity—making clear to sellers that she represents a client—and that she is not responsible for damages arising from conflict of interest. Guadalupe identifies not one but two promising opportunities for Julie, the American Amusements Company and Coin-Op Entertainment, Inc. The owners of American Amusements offer Guadalupe a bonus commission of \$1,000 if she can convince Julie to buy their business; the owners of Coin-Op offer her no commission. Guadalupe tells Julie of the American Amusements opportunity, and since the \$100,000 purchase price is pretty clearly below market value, Julie jumps at it and buys it outright. Thereafter, Guadalupe purchases the Coin-Op business herself. She never told Julie about Coin-Op, because she believed American Amusements was the better deal. Coin-Op's purchase price was higher and, in Guadalupe's opinion, it was of no greater value than American Amusements.

7. Julie discovers that Guadalupe accepted the \$1,000 payment and sues for breach of fiduciary duty. She may recover:

- a. **\$1,000.**
- b. \$1,000 plus damages.
- c. Nothing, because Julie purchased the American Amusements at less than market value.
- d. Nothing, because Guadalupe's contract waived the relevant fiduciary duty.

(A) is correct. Julie can recover the \$1,000 because secret profits are forfeited to the principal. (C) is therefore incorrect. (B) is also incorrect because there likely are no damages to recover—the other opportunity was for more money. And (D) is incorrect because a waiver of loyalty claims as broad as the one in Guadalupe's contract is unenforceable.

8. The waiver in Guadalupe's contract is effective:

- a. True.
- b. False because the relevant duty is usually non-waivable.
- c. **False, because of its scope.**
- d. It's actually irrelevant, because Guadalupe is not Julie's agent.

(C) is correct. A fiduciary duty waiver must be reasonable, and cannot destroy the fundamental fiduciary character. Furthermore, loyalty waivers must be specific. Here, the language waiving all liabilities "arising from conflict of interest" is too broad and is very likely invalid.

9. By purchasing Coin-Op, Guadalupe improperly took a business opportunity that belonged to Julie.

- a. **Probably true, because she learned of it in the course of her duties for Julie.**
- b. Probably true, because she learned of it using Julie's property or confidences.
- c. Probably false, because it was not as good a deal as American Amusements.
- d. Probably false, for some other reason.

(A) is correct. (B) would also be a reason that Guadalupe could not take the opportunity, but it appears to be factually untrue in this case.

10. Guadalupe's purchase and operation of Coin-Op is separately a violation of her duty not to compete with Julie.

- a. Probably true, because of how she learned of the opportunity.
- b. Probably true, because of the subject matter of her duties.
- c. **Probably false, because of the times at which relevant events occurred.**
- d. Probably false, for some other reason.

(C) is correct. It appears that Guadalupe began operation of Coin-Op after the agency had terminated, at which point she no longer owed fiduciary duties and was free to compete. That said, someone might argue that her failure to disclose the opportunity was a form of competition – but characterizing it simply as a usurped opportunity is cleaner.

Chapter 13: Incorporation, Organization, and Promoter Issues

Test Yourself: Answers And Explanations

Assume applicability of the most current version of the Model Business Corporations Act.

Questions 1-3 rely on the following facts:

Frieda believes she has a great idea for a new business: Frieda's Frozen Fish Pops! Frieda doesn't have any money, however; just an idea and a lot of ambition. Fortunately for Frieda, her mother is a person of some means and has already told Frieda she'd be glad to invest in the business. Her mother does not care what form of business Frieda chooses, so Frieda tells her mom she's going to incorporate, and some days later, in exchange for a check for a substantial sum, Frieda gives her mom a stack of stock certificates indicating that she's a shareholder.

Newly infused with her mother's cash, Frieda goes about her efforts to get Frieda's Frozen Fish Pops up and running, and, among many other steps she takes, she signs a lease for retail space. At length, however, her business goes awry and Frieda never makes enough money to pay any rent on the lease.

Incidentally, Frieda lied to her mother and never filed any articles of incorporation.

1. Is Frieda liable on the lease she signed?
 - a. **Yes.**
 - b. Yes, unless Frieda told the lessor the corporation had not yet been formed.
 - c. Yes, unless Frieda told the lessor she was acting on behalf of a corporation.
 - d. No, unless Frieda told the lessor the corporation had not yet been formed.

(A) is correct. Under both the MBCA and the common law of agency, a person is liable on a contract made purportedly on behalf of a principal they had reason to know did not exist.

2. Is Frieda's mother personally liable on the lease signed by Frieda?
 - a. Yes, because promoters are always liable under pre-incorporation contracts.
 - b. Yes, because promoters are partners by operation of law, and are jointly and severally liable for liabilities to third parties, even where they have been dishonest with one another.
 - c. No, because only Frieda signed the lease.
 - d. **No, because her role in the business is passive.**

(D) is correct. Under the theory stated in the *Timberline* case it is most likely Frieda’s mother would be held not to be a “promoter” at all, because she did not purport to act on the corporation’s behalf. If she had known what Frieda was doing *and* that the corporation had not been formed, she probably would be liable as a partner.

3. Suppose (changing the facts stated above) that Frieda did file articles of incorporation subsequent to the date she entered the lease agreement, and that the articles are accepted by the Secretary of State before Frieda’s business went awry. Is Frieda liable on the lease she signed?
 - a. Yes, because at the time the lease was signed she knew the corporation had not been formed.
 - b. No, because the lessor was not harmed by the delay in filing.
 - c. **Yes, unless the lessor knew the corporation had not yet been formed and agreed not to hold Frieda liable.**
 - d. Yes, and so is Frieda’s mother.

Because Frieda knew she was acting on behalf of a non-existent principal, she would be liable under the common law of agency, as well as under the MBCA. If, however, the third party knew of the non-existence and nonetheless agreed not to hold Frieda liable, then there is a lack of consideration and the contract would not be binding on anyone.

Question 4 stands alone:

4. In Model Business Corporation Act jurisdictions, a corporation comes into existence:
 - a. When the incorporators indicate their desire to incorporate by spoken words, written words, or conduct.
 - b. When articles of incorporation are delivered or mailed to the Secretary of State.
 - c. When two or more persons agree to act as co-owners of a corporation for profit.
 - d. **When articles of incorporation are filed by the Secretary of State.**

The MBCA provides a clear line with respect to when corporate existence commences: It is when the articles are filed. Although one colloquially refers to the incorporator as being the one who files the articles, a quick look at the statute makes it clear that the incorporator causes the delivery of the articles to the Secretary of State for filing. The filing is, however, retroactive to the date of delivery.

Questions 5- 9 rely on the following facts:

Some time ago, Joe Johnson and his friend Bill Baxter started a business selling leather apparel, called “Johnson’s Leather.” Joe put up the money for the business and has pretty much called the shots. Bill didn’t put in any money, but agreed he would contribute his physical labor. In return, each week since they started Joe has given Bill \$100 in cash from the company’s receipts. They never wrote down any agreement between them. The business is located in a Model Business Corporation Act (“MBCA”) jurisdiction.

Last week was a crazy one for Johnson's Leather. The following things happened:

- Monday: Joe drafted and filed articles of incorporation on behalf of the business, naming it "Johnson's Leather, Inc.," and filed them with the Secretary of State. The articles specified that Joe would be the corporation's initial director.
- Tuesday: Joe signed two written agreements, signing both "By Joe Johnson, CEO, Johnson's Leather, Inc." First he signed a contract with Bill promising a paycheck of \$100 per week in exchange for his continued labor, for the next year. Second, he signed a written agreement with his longtime supplier of leather handbags, Gucci, providing for a large purchase of new bags.
- Wednesday: A clerk from the Secretary of State's office called to tell Joe the articles of incorporation had been rejected for technical reasons.
- Thursday: Joe filed corrected articles of incorporation and they were immediately accepted for filing by the office of the Secretary of State.
- Friday: Joe cut a check in the amount of \$100, payable to Bill, drawn on the company's bank account.

5. Prior to the events of last week, Bill was:
- A partner in a partnership.
 - An employee of a sole proprietorship.**
 - An employee of a partnership.
 - A shareholder.

Note that neither (A) nor answer (C) are theoretically impossible, but they are much less likely than (B). It does not appear that Bill has sufficient control to qualify as an "owner" for purposes of the test for the existence of a partnership. (D) is wrong because at that time no corporation was in existence, and even had there been one, the facts do not indicate that any issuance of shares to Bill was ever authorized.

6. If Bill now has an enforceable right to payment as against Joe, for the next year, it is because of:
- MBCA § 2.01.
 - MBCA § 2.04.
 - The common law of agency.**
 - Answers b and c are both correct.

This is a bit of a trick question. Section 2.04 says that where a person acts on behalf of a corporation not yet formed he takes on personal liability, but only if he knows that no

corporation is yet in existence. Here it seems likely that Joe did not know that the corporation didn't exist. However, as we know, promoters can be liable for pre-incorporation contracts by operation of agency law even though § 2.04 itself otherwise would not impose liability. Thus *if* Bill has an enforceable right against Joe, it would be on that basis. (A) is incorrect because § 2.01 provides for incorporators but does not impose liability on them.

7. If Bill now has an enforceable right to payment as against Johnson's Leathers, Inc., it is because of:
- a. Informal ratification.
 - b. Informal adoption.**
 - c. Explicit novation.
 - d. None of the above.

(A) is wrong because a corporation cannot ratify – that is, cannot bind itself retroactively – to a pre-incorporation contract. Since there is no trace of an explicit novation in the fact pattern, (C) is wrong. (D) is wrong because (B) is correct.

8. If the handbag supply agreement is unenforceable as against Joe, it is because of:
- a. Ratification.
 - b. Adoption.
 - c. Facts believed to be true by Gucci.**
 - d. None of the above.

If Gucci believed that Johnson's Leathers had been incorporated at the time of contracting and intended that it bind only the company, Joe may have a defense of "corporation by estoppel." His case would be bolstered by the manner in which he signed the contract, apparently with Gucci's acquiescence. Thus, (C) is correct. (A) and (B) are incorrect because the corporation has taken no acts with respect to the Gucci contract subsequent to incorporation and because, while those are theories under which a *corporation* might be liable, they do not establish defenses for individual actors.

9. If the handbag supply agreement is unenforceable as against Johnson's Leathers, Inc., it is because of:
- a. MBCA §2.01.
 - b. MBCA §2.04.
 - c. The common law of agency.**
 - d. None of the above.

This is a bit of a toughie. Pre-incorporation contracts do not bind an as-yet unformed corporation even if the parties so intend. This rule is not imposed by the MBCA itself, but rather arises as a result of the common law of agency.

Chapter 14: Corporate Power and Purpose

Test Yourself Answers with Explanations

1. If someone were to say “the purpose of the corporation is to make money for its shareholders,” he or she would, as a legal matter –
- generally be correct.**
 - be correct unless the relevant jurisdiction had adopted a corporate constituency statute.
 - be correct only if the relevant jurisdiction had adopted a corporate constituency statute.
 - generally be incorrect.

(A) is correct. The purpose of a corporation is to make money for its shareholders. Even if a state adopts a corporate constituency statute, the statute does not change the purpose of making money for its shareholders. The statute merely allows factors other than money in decision making while reserving making money for its shareholders as a main goal.

2. Which of the following most accurately describes the doctrine of *ultra vires*?
- The doctrine of *ultra vires* is totally defunct.
 - The doctrine of *ultra vires* is useful in preventing the making of over-large corporate gifts.
 - The doctrine of *ultra vires* generally presses the founders of corporations to form them for the broadest purpose possible.**
 - The doctrine of *ultra vires* can only be invoked by shareholders and not by the corporation itself.

(C) is correct. The *ultra vires* doctrine is old and fading in significance, but it is still the law. Because most corporate planners prefer managerial flexibility, its main modern significance is to cause corporations to favor very broad purpose clauses. (A) is incorrect because there are still a few applications of the doctrine. (B) is incorrect because corporations have all the powers of individuals. It is true those powers are to be exercised for carrying on the corporate business, so if the directors decided to give away *all* the corporate assets, an *ultra vires* issue might arise. (D) is incorrect because the corporation can invoke the doctrine against decision makers causing it to take *ultra vires* acts, and the doctrine can also be invoked by the state.

3. PC, Inc. is limited in its articles of incorporation to the business of manufacturing and selling pollution control equipment. Which of the following is most true?

- a. PC, Inc.'s purpose is not valid because it arguably is in the public interest, rather than the best interests of shareholders.
- b. PC, Inc. lawfully may engage in any business its managers choose because of the permissive nature of modern statutes.
- c. **PC, Inc. lawfully may engage only in the business of manufacturing and selling pollution control equipment.**
- d. PC, Inc.'s issuance of debt would be *ultra vires* because it is something other than the manufacture or sale of pollution control equipment.

(C) is correct. (A) and (B) are incorrect because the *ultra vires* doctrine is perfectly alive and effective where a corporation has in fact adopted a limiting purpose clause. (D) is incorrect because issuance of debt is a question of power, not purpose. Nothing indicates that PC, Inc. has limited powers.

Questions 4 -5 relate to the following facts:

Harry owns 75 percent of the stock of Harry Corp.; his ex-wife, Esther owns the rest. Harry is the president and controls the board of directors. Harry decides he wants to donate to a worthy cause the maximum amount of the corporation's substantial income that will be deductible for federal income tax purposes. When he can't find a cause quite worthy enough, he decides to create his own foundation, to be known as the Harry Charitable Foundation ("HCF"). The purpose of the HCF is to operate a ranch so that children from homeless shelters in urban locations can spend time in another type of environment.

4. Harry explains to Esther that the board will be unable to declare dividends in the near future because it has determined that it needs to reinvest all of the company's earnings in excess of the intended donation in expanding Harry Corp.'s facilities. Esther consults you about whether a suit demanding that the board be ordered to pay dividends would be successful. Your advice to her is that:

- a. The board's determination with respect to reinvestment is unlikely to be second-guessed by a court.
- b. The board's determination with respect to the charitable donation is unlikely to be second-guessed by a court.
- c. **Answers a and b are both correct.**
- d. Neither answer a nor answer b is correct.

(C) is correct, because both decisions are within the bounds of *intra vires* and will be subject to the business judgment rule.

5. If the donation is made and Esther brings litigation, which of the following is most likely to be true?

- a. The gift will be found to be a breach of fiduciary duty.
- b. The gift will be found to be *ultra vires*.
- c. **Answers a and b are both correct.**

d. Neither answer a nor b is correct.

(D) is correct, for the reasons just stated. It is true that some gifts to pet charities have been struck down, but so long as the amount is within what is allowed as a tax deduction (which keys off of the concept of reasonable business expenses) it almost certainly will not be problematic.

Chapter 15: Introduction to Shares, Shareholders, and Corporate Debt

Test Yourself Answers with Explanations

1. Preferred stock is more like debt than like equity because:
 - a. It earns fixed periodic returns, casts no vote, and is not subject to federal securities law.
 - b. It earns fixed periodic returns and must be retired according to its terms.
 - c. **It earns fixed periodic returns and enjoys a liquidation preference.**
 - d. Preferred stock does not resemble debt.

(C) is the best answer. Preferred stock generally enjoys a dividend preference, which means that so long as the company pays a dividend in a given year, the preferred enjoy some return. But it is a fixed return, because each preferred share will only get the fixed amount to which it is entitled. The common shares may then be paid their own dividend, which in a profitable year might be much larger than the dividend paid to the preferred. Likewise, preferred stock is generally entitled to a liquidation preference, which means that when the company is liquidated, and assuming that funds are available after the creditors are paid, each preferred share must receive some payout. But again that preference is fixed. Even if there are proceeds left, each preferred share gets only the fixed amount to which it is entitled. Whatever is left after that is then shared by the common stock, and in principle it can be more than the preferred shares got. But on the other hand, the common stockholders are not actually entitled to receive anything, so the preferred shareholders have an entitlement to some payment of dividends and liquidation proceeds before the common stock can have anything. Situations are common in which the preferred can receive something and the common are left with nothing. In other words, the common stock—the paradigmatic “equity” ownership interest in a corporation—takes more risk, in that it may not receive anything in dividends or liquidation when times are tight, but also enjoys an unlimited upside, and can receive an unlimited share in whatever profits or liquidation proceeds there might be, when times are good. The preferred are therefore more like debt, in that these risks are more limited, but the benefits of the upside are as well.

(A) is wrong because preferred stock is subject to federal security law just as are other securities. (B) is incorrect because, while preferred stock can be redeemable if its terms so provide, they do not routinely do so. (D) is incorrect because, as answer (C) demonstrates, there are indeed similarities between debt and preferred stock.

2. NewCo’s articles of incorporation authorize the issuance of up to 100,000 shares of \$1 par value stock. NewCo issues 10,000 shares to Ali for \$5,000 and 10,000 shares to Bonita in exchange for her promise to work for one year. After the year has passed and Bonita has

performed the work, NewCo incurs a debt to Big Bank of \$15,000, which it ultimately is unable to pay. If Big Bank sues both Ali and Bonita, which of the following is most likely to be true?

- a. Big Bank will recover \$5,000 from Ali and \$10,000 from Bonita.
- b. Big Bank will recover nothing from Ali but will recover \$10,000 from Bonita.
- c. Big Bank will recover \$5,000 from Ali but will recover nothing from Bonita.
- d. **Big Bank will not recover from either Ali or Bonita.**

(D) is correct. Ali acquired her stock for less than the par value, the difference being \$5,000. Under earlier versions of the MBCA, this would result in what is known as “watered stock liability” and the \$5,000 would be subject to recovery for purposes of paying corporate debt. Now, however, par value has no legal meaning – shareholders simply must pay the agreed upon consideration for shares, which Ali evidently did. This means (A) and (C) are incorrect. (B) is incorrect (as is (A)) because, although predecessors to the current version of the MBCA prohibiting issuing stock in return for future services, that is no longer the case. Neither are the facts sufficient to justify a piercing of the corporate veil. Therefore, Big Bank can recover nothing from Ali or Bonita.

3. Start-up, Inc.’s articles of incorporation authorize the issuance of up to 100,000 shares of \$5 par value stock. There is nothing else in the articles that would affect the answer to this question. Start-up issued ten shares, at a price of \$1000 per share, to each of Angus and Bo and subsequently became quite profitable. It has attracted the attention of Carl, who is willing to pay \$200,000 for ten shares. Angus, the only director, decides to cause Start-up to issue the shares to Carl on those terms. Which of the following is most likely to be true?
- a. Bo has the right to insist that an equal number of shares be offered to him on the same terms.
 - b. Bo has the right to prevent the sale to Carl.
 - c. Bo has no rights with respect to the sale to Carl.
 - d. **Bo has the right to require that the sale to Carl be made at a fair price.**

(D) is correct. First, we know that Bo, as a common shareholder, does not have preemptive rights, because we are told that the articles do not have anything in them that would affect the answer and, under the current MBCA, preemptive rights are “opt in.” That is, they must be specified in the articles. However, all shareholders have rights against unfair dilution. While we don’t know what Start-up’s current stock value is, Bo can require Angus to issue Carl the stock at a fair value.

4. Which of the following statements is most true with regard to the similarities and differences between debt and equity?
- a. Payments to shareholders are deductible while payments to creditors are not.
 - b. **Debt usually must be paid off according to a specific schedule while equity need not.**

- c. The amounts that may be paid to creditors are subject to legal limits while the amounts that may be distributed to shareholders are not.
- d. It is always preferable to hold debt rather than equity.

(B) is correct. (A) is backwards—interest is deductible by the corporation but dividends are not. (C) is wrong because dividends are subject to legal limits, most importantly that they cannot be paid if they would make the corporation insolvent. (D) is wrong because debt and equity each have pros and cons, from the investor’s perspective, and indeed many investors prefer to have a diversified portfolio including both.

5. Carlos is a creditor of Sketchy Co., while Sara is a shareholder. There is substantial doubt as to whether Sketchy Co. will be able to pay off its debt to Carlos as it comes due. Which of the following statements is most likely to be true?
- a. The directors of Sketchy Co. owe a duty to Carlos to see that the company’s debt to him is paid.
 - b. If Sketchy Co. cannot pay Carlos, Sara will be obligated to do so.
 - c. **In the event Sketchy Co. actually becomes insolvent, Carlos’s claims as a creditor will be satisfied before Sara’s claims as a shareholder.**
 - d. In the event Sketchy Co. actually becomes insolvent, Carlo’s claims as a creditor will be satisfied before Sara’s claims as a shareholder only if he is a bondholder.

(C) is clearly correct. (A) is tempting because some courts have held that corporate fiduciaries owe duties to creditors when the corporation is in the “zone of insolvency,” but it is not as clearly correct as (C). (B) is wrong because a shareholder would be liable to a creditor only where the stock has not been paid for or if facts suggest the creditor could pierce the corporate veil. (D) is wrong because all creditor claims are superior to those of shareholders. Technically, bondholders may have a preference over other *creditors*, because they are entitled to satisfaction out of the collateral that secures the bonds before unsecured creditors can be paid, but all creditors must be satisfied before shareholders can get anything.

6. Hugham holds 51 percent of the shares of Votex, Inc. He also is one of the two members of the board of directors, but is not an officer. If he learns of a piece of property that he believes Votex should purchase,
- a. He can enter into a binding purchase contract in the name of Votex, Inc., signing as its majority shareholder.
 - b. Whether he can enter into a binding purchase contract in the name of Votex, Inc., depends on whether the shares he holds are common or preferred.
 - c. He can enter into a binding purchase contract in the name of Votex, Inc., signing as a member of the board of directors.
 - d. **He cannot, without the approval of the other director, enter into a binding purchase contract in the name of Votex, Inc.**

(D) is correct. (A) and (B) are incorrect because shareholders have very limited involvement in management; usually they can only approve fundamental transactions, such as M&A and liquidations. Here, purchasing property is not a fundamental transaction and even if it were, the board of directors would have to recommend it before the shareholders would have the right to approve it. Members of the board are not agents of the corporation, so (C) is incorrect. Hugham can only enter the contract if he is actually or apparently authorized to do so, but there is no indication that the corporation has manifested to Hugham or to the seller of the property that he is authorized.

Incidentally, as to answer (D), note that Hugham would require not only a vote of the board to authorize the transaction, but a unanimous vote. It is irrelevant that he holds 51% of the stock, because as a director he only casts one of two votes. And if the other director opposes the purchase, then there is not a majority in favor of it.

7. Delilah is one of Derivicorp's shareholders. She is disgruntled (the opposite of grunted!) to learn that the board of directors has announced that it has authorized a contract to purchase property in downtown Detroit. Delilah thinks this is a terrible investment and plans to sue. Which of the following is most true?

- a. Delilah's claim is direct.
- b. Delilah's claim is derivative.**
- c. Delilah will win if she is a preferred shareholder.
- d. Delilah will win if she is a common shareholder.

(B) is correct. The gravamen of Delilah's claim is breach of the fiduciary duty of care, which is a claim that belongs to the corporation and therefore can be brought by a shareholder only derivatively. She is unlikely to win, given the breadth of the business judgment rule, but that is a different question.

Chapter 16: Piercing the Veil of Limited Liability

Test Yourself Answers with Explanations

1. BigCo, Inc., a publicly traded holding company, owns 100% of the shares of LilCo, a corporation engaged in oil exploration. LilCo's board is appointed and elected entirely by BigCo. BigCo has often instructed LilCo's board to distribute funds to BigCo, without interest, when BigCo is in need of cash. Recently LilCo announced that because of poor earnings it will be unable adequately to fund employee pension obligations, which are a contractual obligation of LilCo. LilCo's employees bring a "piercing the corporate veil" cause of action against BigCo and its shareholders for this breach of contract. This action most likely will:

- a. Succeed with respect to both BigCo and its shareholders.
- b. Succeed with respect to BigCo but not its shareholders.**
- c. Succeed with respect to BigCo's shareholders but not with respect to BigCo.
- d. Fail.

(B) is probably the correct answer, because BigCo failed to treat LilCo as a genuinely separate entity. There are no apparent grounds for holding BigCo's shareholders liable (such as undercapitalization or syphoning of funds) so (A) and (C) are incorrect. In fact, there are virtually no cases in which the shareholders of a publicly held corporation have been held liable for its debts.

Questions 2 – 4 rely on the following facts:

AgBeast, Inc., a publicly traded corporation, is a holding company operating in a variety of agricultural lines of business. An AgBeast subsidiary called LilMoo Corp. owns and operates several mid-sized dairy farms. AgBeast's CEO, Bob, happened to be visiting LilMoo's headquarters last year and was surprised to learn that LilMoo's delivery drivers had been instructed never to exceed a posted speed limit. Knowing that one of LilMoo's most significant problems was customer anger over poor delivery times, Bob drafted a memo to all LilMoo drivers instructing them to drive at up to ten miles over any posted limit, whenever feasible. Bob insisted that the memo be distributed immediately on LilMoo letterhead.

Shortly thereafter, a LilMoo employee named Biff, a delivery driver for the company, drove a LilMoo delivery truck at ten miles over a posted speed limit. During this delivery, which was in the normal course of his duties, Biff struck and seriously injured a pedestrian.

2. Which of the following facts, if true, would most help the injured pedestrian to get recovery directly from AgBeast?

- a. AgBeast has occasionally caused LilMoo to make distributions to AgBeast when AgBeast itself has had cashflow needs.
- b. Bob is an employee of LilMoo.
- c. **Bob is not an employee of LilMoo.**
- d. The CEO and chairman of LilMoo is also an AgBeast director.

(C) is correct because the most likely theory of liability against AgBeast is that it is directly liable for having caused the tortious injury through its own agents, the theory identified in *Bestfoods*. That case will be easier to make if Bob is not also employed by LilMoo, because in that case plaintiff would have to prove that at the time he wrote the memo Bob was not acting on LilMoo's behalf. (A) is tempting but is not correct because no one factor alone would be sufficient to pierce the corporate veil. (B) and (D) are not correct because, under *Bestfoods*, corporate actors working for parents and subsidiaries essentially are presumed to be wearing the correct "hat" when they make decisions.

3. Assume that under the new LilMoo delivery driving policy, injuries involving LilMoo drivers increased 400%. On those facts, Bob's wrongdoing would strongly support piercing AgBeast's corporate veil. True or false?
- a. True. The doctrine of piercing the veil is applied very flexibly to "prevent fraud or injustice."
 - b. True. The facts suggest that Bob considered LilMoo to be AgBeast's "alter ego."
 - c. **False. On these facts there could be no showing that LilMoo was AgBeast's "alter ego."**
 - d. False for some other reason.

(C) is probably correct. Certainly the facts as stated give no hint that LilMoo has been treated with the disregard of formality and legal distinctness needed to pierce the veil. In fact, unless LilMoo is wholly owned (the facts do not state), it is very unlikely that the kind of disregard necessary could occur, without inviting shareholder litigation or objection by LilMoo's management. (A) is incorrect because, although the doctrine is applied to "prevent fraud or injustice," application is not particularly flexible. Limited liability is statutory, and courts attempt to honor it. (B) is incorrect because the state of mind of one corporate agent should have nothing to do with the liability of the shareholders. (D) is false because (C) is correct.

4. Assume that AgBeast has caused LilMoo to sell its products exclusively to other AgBeast subsidiaries, and to do so at cost. As a result, LilMoo has never operated at a profit. Which of the following is most true?
- a. **Even if LilMoo's veil is not pierced so as to impose liability on AgBeast, it is possible that liability might be imposed on the AgBeast subsidiaries receiving LilMoo's product at cost.**
 - b. The additional facts assumed for purposes of this question do not affect the likelihood that liability for Biff's accident might be imposed on AgBeast,

- c. Provided that LilMoo’s directors held regular meetings, kept minutes, assured that all business was transacted in the corporate name, and made no illegal distributions to AgBeast or its other subsidiaries, LilMoo’s veil cannot be pierced.
- d. LilMoo’s veil cannot be pierced to impose liability for a tort obligation such as the one incurred as the result of Biff’s accident.

(A) is correct, because of the enterprise liability theory – which is essentially “horizontal” veil piercing. (Moreover, if LilMoo has outside shareholders, they may well have an action for breach of the duty of loyalty against AgBeast.) (B) and (C) can be discarded as logically mutually exclusive. (D) is incorrect because corporate veils can be pierced for both tort and contract claims.

Questions 5 and 6 stand alone:

5. Chas and Jana decide to incorporate for the purpose of operating a limousine service. Each pays \$1,000 to the corporation and receives 1,000 shares of stock. In addition, Chas lends \$15,000 to the corporation. The \$15,000 is used for the down payment on a limousine the corporation purchases.

One week after the service begins, the limousine is involved in an accident, resulting in two wrongful death judgments against the corporation. Jana was driving the limo at the time of the accident. These judgments exceed the corporation’s liability insurance (which is \$1,000,000) by \$500,000. The corporation then files a voluntary bankruptcy petition.

Based on the foregoing, which of the following statements is most likely to be correct?

- a. Chas and Jana are personally liable for the corporation’s debts.
- b. Assuming strict adherence to the necessary formalities for incorporation and the conduct of corporate business, Chas and Jana have no personal liability.
- c. **The existence of a statute mandating a certain level of insurance for a limousine service could have some relevance to a court’s willingness to pierce the corporation’s veil.**
- d. There are no grounds for imposing personal liability on Chas and Jana.

(C) is the correct answer. The company’s assets were small at the time of formation—\$2000 in cash and the value of the limousine—and undercapitalization is a fact relevant to piercing the veil. However, as in *Walkovsky v. Carlton*, if Chas and Jana insured the vehicle consistently with state law, that fact may undercut a claim for undercapitalization. (A) is incorrect because it is too definite and in conflict with (C). (B) is incorrect because compliance with corporate formalities is not dispositive with respect to veil piercing inquiries. (D) is not a bad answer, but it disregards the deference courts give to legislatures in determining the amount of mandatory insurance.

Note, incidentally, that Jana presumably would be personally liable for the injury she caused, since her personal conduct was the cause of injuries that were tortious (as indicated by the fact that wrongful death judgments were entered). But none of the answers concerns

judgments entered against Jana (they deal only with judgments entered against the corporation), and in any case, none of the answers states that only Jana would have personal liability.

6. Fill in the blanks: Three of the factors taken into account by courts in deciding whether to pierce a corporate veil are **alter ego, fraud or injustice, and undercapitalization.**

These are only a few of the long list of factors many courts identify as relevant, so answers may vary. Importantly, many courts—as in *Complex Computing*—write that two factors are most important, and probably subsume the others. First, a plaintiff may prove that defendant used the corporation as an “alter ego,” a showing that can be made by the many other frequently discussed factual considerations, like undercapitalization, commingling of funds, and failure to observe formalities. Second, the plaintiff may show that that disregard of the corporate form caused some fraud or injustice, which must be something more than merely that the corporation itself is unable to satisfy the plaintiff’s claims. It could be shown, for example, by evidence that defendant deliberately caused the company to be undercapitalized at the time of plaintiff’s claim to avoid liability, or commingled funds among various companies that defendant controls, in order to avoid their creditors.

Chapter 17: The Basics of Corporate Governance

Test Yourself Answers with Explanations

1. At the request of a shareholder, a corporation's secretary has called a special meeting pursuant to MBCA §7.02, for the properly noticed purpose of voting on the removal of a particular director for cause. At the meeting, the removal is defeated. One of the shareholders present then moves that the shareholders vote to endorse the current board. The motion is

- a. **Out of order because it was not covered by the notice of the meeting.**
- b. Out of order because it does not relate to legitimate shareholder action.
- c. Permissible only if the moving shareholder owns at least 5% of the stock of the corporation.
- d. Permissible because it is so innocuous.

(A) is the correct answer. A special meeting can only be about topics specified in the notice or fairly within the meaning of the notice. (B) is incorrect because endorsing the board is no more than advisory, and therefore something shareholders validly may do. (C) is incorrect because the amount of stock owned is relevant to federal securities matters, but not to state law with respect to the validity of motions. (D) is incorrect because (A) correctly reflects the state of the law. There is no exclusion for "innocuous" motions.

2. Joe, John and Jim are three shareholders of XYZ, Inc., and together they own 45% of its shares. They know that voting together they can control a large portion of the company's board of directors. They also know that Joe is brightest among them and most involved in the company's affairs, so they provide in a written agreement among them that they will each vote all of the shares at each annual shareholders' meeting exactly as Joe directs them to do. This arrangement is legally unenforceable because:

- a. It is void as against public policy.
- b. There are shareholders who are not parties to it.
- c. It is unsupported by consideration.
- d. **On these facts there is no obvious reason that this arrangement would be legally unenforceable.**

(D) is the correct answer. Shareholder voting agreements are generally binding, except where they are void as against public policy for undermining the authority of the board. Merely coordinating votes for board elections, even where the effect will be to control the election, does not violate that rule.

3. Nellie owns 50% of the shares of the N&N corporation. Nancy owns the other 50%. Both have served on the two-person board of directors for some years. Nancy refuses to attend shareholders meetings.

- a. Nellie can elect both directors at the next annual meeting.
- b. Nellie can elect both directors at the next annual meeting unless the corporation's articles provide for cumulative voting.
- c. Nellie can elect one director at the next annual meeting if the corporation's articles provide for cumulative voting.
- d. No annual meeting can be held.**

(D) is correct. If Nancy refuses to attend the meeting, only 50% of N&N's shares will be present at the shareholder meeting, less than the minimum requirement for a quorum (more than 50%). Therefore, any votes at the meeting will not be valid.

4. Which of the following best characterizes the enforceability of a shareholders' agreement providing that they will elect themselves as directors, and that as directors they will vote for the maximum dividends legally allowable?

- a. Enforceable, because shareholders are permitted to bind themselves as to any matter on which they are entitled to vote.
- b. Enforceable, because directors are permitted to bind themselves as to any matter on which they are entitled to vote.
- c. Enforceable because both election of directors and declaration of dividends are legitimate shareholder actions.
- d. Unenforceable if the corporation is publicly traded.**

(D) is the best answer, because this contract is void as against public policy. While shareholders can agree as to how they will vote, including as to how they will vote in board elections and even if the effect is to secure control of the board, they cannot bind the board to decisions that must remain in the board's discretion. Strictly speaking, although (D) clearly is true, the same result would follow in closely held firms so long as at least some shareholders are not parties to the agreement. There is some authority that where all shareholders are parties to a voting agreement in a closely held firm, the parties have more leeway to bind director votes, even as to sensitive discretionary matters like dividends.

5. BigCo's board of directors has thirteen authorized seats, nine of which are currently filled. A quorum of BigCo's board is:

- a. 13.
- b. 7.**
- c. 6.
- d. 5.

(B) is the correct answer. By default a quorum is a majority of authorized seats, regardless how many are currently filled.

6. ABC, Inc., has 100 shares of stock outstanding. Assuming that the votes of all shares represented at a meeting are cast either for or against a proposal, the absolute minimum number of shares that must be voted in favor of a proposal for it to carry is:

- a. 1.
- b. 26.**
- c. 51.
- d. 100.

(B) is the correct answer. The absolute minimum “in favor” votes should be the majority of voted shares. To take valid shareholder action, the shares present must satisfy the quorum requirement (which is to say that a majority of the shares with voting power must be present at the beginning of the meeting). Therefore, with 100 outstanding shares, the quorum is 51. If 51 shares are present, the proposal needs at least 26 votes to pass.

7. XYZ, Inc.’s board of directors has nine seats, two of which are unfilled. The absolute minimum number of votes at any meeting of this board needed to take effective action is:

- a. One.
- b. Three.**
- c. Four.
- d. Five.

(B) is the correct answer. The Board needs a majority of votes cast to take effective action. That is on top of satisfaction of the quorum requirement, which is a majority of authorized seats. A quorum of a nine-member board (regardless of vacancies) is five, and so the minimum votes that could be cast and approve an action is three.

8. Due to recent retirements, five of the nine authorized seats on ABA Corp.’s board are currently unfilled, and the annual shareholders’ meeting will not be held for another seven months. ABC’s board:

- a. Cannot take legally effective action on behalf of the corporation until the annual shareholders’ meeting.
- b. Can take legally effective action on behalf of the corporation only by calling a special shareholders’ meeting.
- c. Can take legally effective action on behalf of the corporation by appointing one new director to the board.**
- d. None of the above.

(C) is correct. Board vacancies can be filled in three ways: 1) at the next shareholder meeting, 2) at a special shareholder election (meeting), or 3) by the board itself. If there are fewer board members in office than the quorum requirement demands, they still can act to fill vacancies (although if there are more than a quorum in office the quorum requirement must be satisfied). Therefore, (C) is the correct answer.

Chapter 18: Fiduciary Duties in the Corporate Context: Duty of Care

Test Yourself Answers with Explanations

The Los Angeles Machine Company ("LAMC") is a major producer of industrial machinery. In order to save costs, its Board of Directors decides to relocate the factory to a fairly remote area in the Mojave Desert. Because LAMC relies on its skilled labor force, it is reluctant to lay off all of its employees or lose them in the move. At the same time, the prospect of moving from LAMC's urban location to a remote desert area will be unattractive to many of the company's employees.

After a lengthy and detailed process of study, the Board decides to build a "company town" surrounding its new factory. Houses are built for employees and sold to them at cost, stores are built to provide a variety of consumer goods at reasonable prices, and a new entertainment complex is constructed, with sports and theater facilities that the Board expects to be used by employees as well as for sports and entertainment events sponsored by the corporation.

1. A stockholder of LAMC brings a derivative suit challenging the development of the new company town. If the suit proceeds to the merits, the shareholder most likely will:
 - a. Win, because the board is favoring the employees over the stockholders.
 - b. Win, because there is a strong argument that the board has breached its duty of care.
 - c. **Lose, because such expenditures are within the legitimate range of the board's business judgment.**
 - d. Lose, because the expenditures obviously are fair.

(C) is the correct answer. This action will likely be based on breach of the duty of care, which means the directors will have the benefit of the business judgment rule. Here, the directors spent time studying the new plan, analyzed pros and cons, and the final proposal is a comprehensive response to their discussions and study. Therefore, it will likely fall under the business judgment rule and the stockholder will lose.

2. Despite the allure of this company town, not all of the company's employees wish to move. In order to help these employees find new jobs, or obtain training for new careers if similar jobs are unavailable, the Board retains a professional career counseling and vocational training firm, for a period of a year, at a cost of approximately ten percent of LAMC's net income. A shareholder again sues derivatively. If the suit proceeds to the merits, the shareholder most likely will:

- a. Win, because a business corporation is not a charitable endeavor; therefore the expenditures are *ultra vires*.
- b. Win, because the corporation owes no legally enforceable duty to its employees.
- c. **Lose, because the Board rationally could have decided that such expenditures were in the corporation's long-term interest.**

- d. Lose, because the corporation has the right to do anything that an individual could do.

(C) is correct, for the same reasons as above.

3. Suppose that the board's planning process before deciding to move the plant, build the company town, and retain the career counseling and vocational training firm was not "a lengthy and detailed process of study." Instead, these decisions were made in a two-hour meeting following a presentation by the Chief Executive Officer, who has a vacation home in the Mojave Desert. If a shareholder were to bring a derivative suit seeking to impose monetary liability on the members of the board, the shareholder probably would:

- a. **Lose if LAMC's Articles of Incorporation contain a "raincoat" provision.**
- b. Lose, whether or not LAMC's Articles of Incorporation contain a "raincoat" provision.
- c. Win, because the directors breached their duty of care.
- d. Lose, because the business judgment rule would protect the Board's decision.

(A) is probably correct. If, however, there were no "raincoat" provision protecting against the monetary liability the shareholder is seeking, (C) would probably be correct. To receive the benefit of business judgment rule, directors must go through an adequate procedure in decision making. Here, moving the factory, building a new "town," and retaining a professional training company for a year are all big decisions. They do not require immediate action, there are many important factors and details to consider, and therefore a 2-hour meeting with a presentation by someone who may have personal interest on the subject seems insufficient. The procedural defects are obvious and the stockholder will probably win.

4. Fill in the blanks: The duty of care obliges corporate directors to act with the **diligence**, **skill**, and **prudence** of an ordinary person in similar circumstances.

5. Fill in the blanks: A "raincoat" provision can protect a director from monetary liability for breaches of the duty of **care** but not for breaches of the duty of **loyalty**.

6. Fill in the blanks: The theoretical limits on the application of the business judgment rule include **illegality** and **intentional wrongdoing**. [Other answers may also be correct.]

Chapter 19: The Duty of Loyalty and Conflicts of Interest: Self-Dealing Transactions and Corporate Opportunities

Test Yourself Answers with Explanations

Questions 1-3 rely on the following facts:

ABC, Inc., a Delaware corporation, owns 65 percent of the voting stock of another Delaware company, XYZ, Inc. Another 25 percent of XYZ's shares are owned by the California Public Employees Retirement System ("CalPERS"), a major pension fund, which is not otherwise affiliated with either company. An XYZ bylaw provides that board candidates will be nominated by any shareholder with more than 50% of XYZ's voting stock. XYZ's articles of incorporation contain what commonly is known as a "raincoat" provision.

CalPERS has brought suit against ABC and against XYZ's entire board. CalPERS seeks money damages against ABC and an injunction against the XYZ directors, to remedy what CalPERS believes was an improperly motivated distribution of dividends to XYZ's shareholders. CalPERS puts on uncontroverted evidence that (1) at the time of the dividends, ABC was in great need of ready cash, and (2) the dividends in question exceeded XYZ's entire revenues for the year.

1. ABC:
 - a. Owes no fiduciary obligations to XYZ.
 - b. Owes fiduciary duties in light of its ability to elect the board of directors.**
 - c. Is probably not a controlling shareholder of XYZ, in light of the consolidated, institutional ownership of the minority shares.
 - d. None of the above.

(B) is correct. Shareholders usually do not have fiduciary duties to the corporation, but here ABC itself has the majority of XYZ's voting shares, and based on the bylaw, ABC is the only shareholder with the power to nominate director candidates. Therefore, the facts demonstrate that ABC is a controlling shareholder.

2. Assuming that ABC does owe fiduciary duties to XYZ, in the CalPERS suit, ABC:
 - a. Must show that the dividends were "intrinsically fair."
 - b. Will win unless CalPERS can show that the dividends were "intrinsically unfair."
 - c. Will be liable because dividends in excess of revenues are waste.
 - d. Must defend its actions under the business judgment rule.**

(D) is correct, and the Delaware Supreme Court so held on essentially identical facts in *Sinclair v. Levien*. Though ABC had a pecuniary interest in dividend payments, it did not have a conflict of interest because the decision affected all shareholders equally. Thus, the

question is one of a possible breach of the duty of care, affording ABC the protection of the business judgment rule.

3. In the CalPERS suit, the XYZ directors:
 - a. Must show that the dividends were “intrinsically fair.”
 - b. Will win unless CalPERS can show that the dividends were “intrinsically unfair.”
 - c. May be liable for monetary damages because the “raincoat” provision will not protect them.
 - d. Must defend their actions under the business judgment rule.**

(D) is correct. The claim against the directors, like the claim against ABC, will be about breach of duty of care, because there is no indication that any of the directors has a financial interest in this transaction.

Questions 4-6 rely on the following facts:

Tough Guys, Inc., a closely held company incorporated in Delaware, produces a magazine called Tough Guys Weekly. Tough Guys’s CEO, Rufus McPiercedlip, recently got a call from a friend asking whether Tough Guys might be interested in investing in a new start-up magazine, to be called You Wouldn’t Want To Meet Me In a Dark Alley, Illustrated. The friend tells Rufus that the company, Dark Alley, Inc., has a 10% block of its own stock set aside for purchase by the right investor, and would like it to go to someone with knowledge of the business, who could provide advice and insight from time to time. In fact, it occurs to Rufus that the new magazine would likely be a direct competitor of Tough Guys Weekly, and that it would hardly be wise for Tough Guys, Inc., to encourage its own competition. Rufus, however, is a man who knows how to hedge his bets, and he thinks this new magazine is likely to be a profitable enterprise, so without telling anyone at Tough Guys, Inc., he arranges to buy the 10% stake in Dark Alley with his own personal funds.

Billy Bob Tattooson is among the founders and is still a shareholder in Tough Guys, Inc., though he has been largely uninvolved in the company’s affairs for some time. Billy Bob learns of Rufus’s investment and he brings suit, alleging that in fact Tough Guys, Inc., should have been given the opportunity to invest in the 10% block of stock.

4. If the matter goes to trial, which of the following would be most damaging to Rufus?
 - a. Dark Alley, Inc., was looking for an investor experienced in the magazine business.
 - b. Rufus’s friend contacted him in his official capacity as CEO of Tough Guys, Inc.**
 - c. Dark Alley’s business probably will compete with Tough Guys’ business.
 - d. Rufus’s failure to offer the Dark Alley investment opportunity to Tough Guys, Inc.

(B) is correct. Courts take it as a key indicator to ask in what capacity an opportunity is offered to the defendant fiduciary. Certainly, (D) would also be important in a jurisdiction

that follows the ALI approach to corporate opportunity, but the logically prior question is whether what was taken was a corporate opportunity in the first place.

5. Rufus's purchase of the 10% block of stock creates a conflict of interest. True or false?
- a. True, because his fiduciary obligations to Tough Guys, Inc. may now be in conflict with his fiduciary obligations to Dark Alley, Inc.
 - b. True, because his fiduciary obligations to Tough Guys, Inc. may be at odds with his own pecuniary interest.**
 - c. Answers "a" and "b" are both correct.
 - d. False.

(B) is correct. (A) is incorrect because it is extremely unlikely that Rufus owes fiduciary duties to Dark Alley. Therefore, (C) and (D) are both incorrect.

6. If Tough Guys, Inc. were incorporated in a state following the ALI approach to corporate opportunity, which of the following would be most damaging to Rufus at trial?
- a. Dark Alley, Inc., was looking for an investor experienced in the magazine business.
 - b. Rufus's friend contacted him in his official capacity as CEO of Tough Guys, Inc.**
 - c. Dark Alley's business probably will compete with Tough Guys' business.
 - d. Rufus's failure to offer the Dark Alley investment opportunity to Tough Guys, Inc.

(B) is correct. In an ALI jurisdiction this fact makes the opportunity a corporate one as a matter of law, and it cannot be taken by the fiduciary without a prior presentation and a proper rejection by a corporate representative with authority to do so. Once again, (D) is attractive, but the question resolved by (B) (that the investment was a corporate opportunity) is logically prior.

Questions 7-10 rely on the following facts:

John is the chief executive officer and chairman of the board of BigCo, a publicly traded Delaware corporation. John believes the company should adopt a new compensation package in order to attract top quality young executives. In particular, he would like the company to adopt a plan he has devised that would entitle all executives of the company to receive shares of BigCo's stock as annual bonus compensation, based on performance. Concerned about structuring the plan properly, John seeks the opinion of an outside law firm and an outside corporate financial advisor. After some weeks of study, both reply favorably on the proposal and suggest it would be both legal and in the company's best interests. In particular, the financial advisor suggested that similar plans are in place at many similarly sized firms in BigCo's industry.

BigCo's board of directors has thirteen authorized seats, nine of which are currently filled. Of those nine, five are outside directors. At the meeting at which the stock compensation plan was first considered by the board, seven directors attended, including the four inside directors. After receiving a lengthy report from the same attorney and financial advisor who had given John their

opinions, the seven board members present voted unanimously in favor of the stock compensation plan. The board members were concerned about potential conflicts of interest, however, so the three outside directors present then convened separately to consider the proposal again, and they unanimously approved it.

7. At the initial board meeting at which the stock compensation plan was first adopted, four of the seven board members who voted had conflicts of interest, and therefore the board's vote was ineffective and the plan in fact was not adopted. True or false?
- a. True, because the board lacked a quorum as to the stock compensation plan.
 - b. True, because the conflicted votes cannot be counted and therefore the plan did not receive a majority of the votes.
 - c. True, unless the plan was later presented to the full board and approved again.
 - d. **False.**

(D) is correct. A self-interested transaction is no longer invalid just for this reason, and the modern statutory approach is to permit conflicted votes to be counted for quorum and purposes of authorization.

8. The subsequent vote by outside directors was ineffective as a ratification. True or false?
- a. True, because the board did not formally delegate authority to the committee.
 - b. True, because the committee lacked a quorum.
 - c. True, because the board that appointed the committee lacked a quorum.
 - d. **False.**

(D) is correct. Three out of five disinterested directors approved this deal. That means that most courts would (like Delaware courts) hold that the transaction would stand unless proven by the plaintiff to be unfair.

9. The opinions presented by the outside attorney and financial advisor are relevant to which of the following?
- a. The substantive fairness of the plan.
 - b. The procedural fairness of the plan.
 - c. Compliance with the duty of care of the outside directors.
 - d. **All of the above.**
 - e. Answers "a" and "b" are correct.

(D) is correct. The opinions themselves go to show that the plan is comparable to plans at similar firms and are substantively desirable to BigCo, and therefore they tend to show substantive fairness. The fact that they were secured at all, and prepared with due time for the board and management of BigCo to consider them, goes to procedural fairness. Both issues would be relevant if the plan is challenged in a duty of loyalty claim, and procedural propriety would be relevant to a duty of care claim.

10. If John is personally sued for his role in establishing the stock compensation plan, what standard will govern his liability?
- a. Intrinsic fairness, as to which John bears the burden of proof.
 - b. Intrinsic fairness, as to which the plaintiff bears the burden of proof.**
 - c. Business judgment rule.
 - d. John cannot be liable – ratification by the outside directors renders him immune from suit.

(B) is correct. Under Delaware law, the effective ratification by a majority of disinterested directors modifies a duty of loyalty claim against John by shifting the burden to plaintiff.

Questions 11-13 stand alone.

11. Marge N. O’Verra, a statistician and accountant by trade, has formed an accounting firm she calls Count de Monet, Inc. Marge has made herself CEO, sole director, and sole shareholder of Count de Monet. As she makes an outlandish number of errors, however, she thought it wise to secure some reliable source of White Out® correction fluid. For this purpose she formed a company with her friend Bob to provide this and other office supplies, which they call Supply, Inc. Bob was just a passive investor. He took 49% of Supply, Inc.’s stock and allowed Marge to act as CEO and sole director. If Bob were to sue Marge to challenge a contract for White Out® between Count de Monet, Inc. and Supply, Inc., which of the following facts, if true, would be most helpful to Marge in defending herself?

- a. In her capacity as CEO and director of Count de Monet, she observed all “corporate formalities.”
- b. In her capacity as CEO and director of Supply, Inc., she observed all “corporate formalities.”
- c. The contract’s terms were comparable to those offered to other companies on similar supply arrangements.**
- d. She really should not worry too much about such a suit, because it will be governed by the business judgment rule.

(C) is the correct answer. Marge is an officer and controlling shareholder of both companies, and she therefore owes them both fiduciary duties. The contract between the two of them makes their relationship adverse, and so her involvement with it puts her in conflict of interest. She will therefore be open to duty of loyalty challenge, and so evidence of substantive fairness will be important to carrying her burden to show intrinsic fairness.

12. A corporate vice president who is also the Treasurer of the corporation makes a loan of company funds to his best friend, subject to a stated rate of interest to be paid by the friend, to help the friend start a new business. The vice president:

- a. Has violated a fiduciary duty.
- b. Has probably violated a fiduciary duty if he did not disclose the loan to the company.

- c. Has violated a fiduciary duty unless the loan was rationally related to the best interests of the company.
- d. May not have violated a fiduciary duty if the interest is comparable to market rates.**

(D) is correct. The VP acted in conflict of interest, but if he can carry the burden of showing that the loan was intrinsically fair, and not in excess of his authority (in which case it would breach his duty of care), it does not breach his fiduciary duties.

13. In Delaware, informed, disinterested shareholder ratification of *ultra vires* board action renders the action:
- a. Void.
 - b. Voidable at the election of the corporation.
 - c. Subject to duty of care scrutiny under the business judgment rule.
 - d. Impervious to legal challenge.**

(D) is the correct answer.

Chapter 20: Further Problems in the Duty of Loyalty: Good Faith and Disclosure

Test Yourself Answers with Explanations

1. Meds for Feds, Inc., a Delaware corporation, is one of the prescription medicine insurers from among which federal employees may choose. Its directors receive a report from a whistleblower that the company is paying kickbacks to certain federal benefit administrators to push for employees to elect Meds for Feds coverage. They reason that, although the practice clearly is illegal, it is resulting in great success for Meds for Feds and that any fine the company might have to pay would be less than the amount the kickbacks earn. They therefore decline to implement any program to detect or prevent kickbacks. Which of the following is most true?

- a. **The failure to implement a program to detect or prevent kickbacks may be a breach of the directors' duty of good faith.**
- b. Whether or not a company should have a program to detect or prevent kickbacks is entirely within the business judgment of the directors.
- c. The directors have satisfied the duty of good faith because they are aware that kickbacks are being paid.
- d. The directors are in violation of their duty of good faith and are required to disclose that violation to the shareholders.

This is a difficult question, but the correct answer is (A). The duty of good faith requires that the directors avoid conscious dereliction of duty. Answer (A) merely says, then, that the failure to implement such a program *might* be derelict, which seems correct. Failing to monitor for on-going, known wrongdoing seems like dereliction, even though the directors might not ultimately be liable for any damages. (B) is framed in the abstract, and is too broad. If the directors have reason to believe that kickbacks are being paid and that the corporation might suffer as a result, failure to monitor would be conscious dereliction. (C) is incorrect because if the directors know kickbacks are being paid they might be required to respond; failure to do so could be dereliction. (D) is incorrect because it is too conclusive.

2. Theo, a director of Hypoxico, a New York corporation that is publicly traded, learns that Fidel, the Chief Financial Officer, has been “cooking the books” to make Hypoxico appear much more profitable than it really is. Which of the following is most true?

- a. Theo must disclose the information he has acquired to the public.
- b. **Theo must disclose the information he has acquired to the rest of the board of directors.**
- c. Theo has no obligation to disclose the information he has acquired unless he is engaged in a transaction involving Hypoxico or its shares.
- d. Theo has no obligation to disclose the information he has acquired.

(B) is correct. Theo, as a director of Hypoxico, has a fiduciary duty to it and is expected to disclose important information to the person or body who has the authority to react in the best interests of the corporation. **(A) is incorrect** because the public is not a corporate decision-maker. **(C) is incorrect** because **(B) is correct.** While federal insider trading laws might not require disclosure by Theo if he abstains from trading, those laws would not have any relevance to his duty of disclosure to the corporation as a matter of the state law of corporations. **(D) is incorrect** because **(B) is correct.**

3. At least in Delaware, breach of the duty of good faith
- a. Is a breach of the duty of care.
 - b. Is a breach of the duty of loyalty.
 - c. Can give rise to an award of monetary damages.
 - d. **Answers b and c are both correct.**

(D) is correct. The duty of good faith now is generally classified as a matter of loyalty. Plaintiffs can therefore recover monetary damages even if the corporation has adopted a “raincoat” provision.

4. The intentional failure of a fiduciary to disclose material information
- a. **Makes ratification of a transaction ineffective.**
 - b. Will give rise to an award of monetary damages.
 - c. Cannot stand alone as a breach of fiduciary duty but may make ratification of a transaction ineffective.
 - d. Is prima facie evidence of a breach of the duty of care.

(A) is the best answer. Clearly, failure to disclose information will render any attempted ratification ineffective. **(B) is incorrect** because it says failure to disclose *will* give rise to monetary damages. Damages would have to be proven. **(C) is incorrect** because failure to disclose material information can stand alone as a breach of fiduciary duty. **(D) is not a bad answer**, because failure to disclose is both a breach of the duty of care and a breach of the duty of loyalty, but there is no case law saying it is “prima facie” evidence. It simply is a breach.

5. The duties of good faith and disclosure:
- a. Give rise to actions for monetary damages.
 - b. Do not give rise to actions for monetary damages.
 - c. Are subsumed in the duty of loyalty.
 - d. **Are traditionally recognized fiduciary duties.**

(D) is the most correct, since, as Chapter 20 indicates, both are traditionally recognized duties. The duty of good faith is, at least in Delaware, regarded as part of the duty of loyalty, but some disclosure obligations are not. Thus, **(C) is incorrect.** **(A) is incorrect** because duty of care recoveries for lack of disclosure would not give rise to monetary liability if the

relevant corporation had a “raincoat” provision in effect. Similarly, (B) is incorrect since lack of good faith and, in some cases, lack of disclosure in the loyalty context will give rise to monetary damages.

Chapter 21: Exculpation, Indemnification, and Insurance

Test Yourself Answers with Explanations

For each of the following questions, assume that the corporation's articles of incorporation provide for indemnification to the fullest extent permitted by law.

1. A director of a Delaware corporation found guilty of materially misleading statements or omissions in communications with shareholders, in violation of a federal securities law, likely:
 - a. Must be indemnified by the corporation for any fines, costs and attorney fees.
 - b. Can be indemnified by the corporation for any fines, fees or costs, at the corporation's election.
 - c. Must be indemnified by the corporation for attorney fees and costs, but cannot be indemnified for any fines.
 - d. **None of the above.**

(D) is correct. (B) is tempting, since under §145(a), a Delaware corporation has the power to elect indemnification of its officers, directors, employees, and agents for liabilities that arise “by reason of the fact” of that person’s position. (Note that §145(a) does not cover *fiduciary* claims or other actions “by or in right of the corporation.” They are subject to somewhat different rules under §145(b).) There must, however, be a finding that the person seeking indemnification acted in good faith and in a manner not reasonably believed to be in the corporation’s best interests (and without reason to believe the person’s conduct was criminal), so (B) is too broad. Just as importantly, the SEC takes the position that indemnification against liability under the federal securities laws is against public policy. Under §145(c) indemnification is mandatory only where the person was “successful on the merits or otherwise,” so (A) and (C) are incorrect. Note, however, that the articles provide for indemnification to the fullest extent permitted by law. This would create a mandate of indemnification for the expenditures that are left discretionary by §145(a) – so if the state of mind requirements were satisfied and the public policy concern absent, (A) would be correct.

2. The reason a Delaware corporation is not permitted to indemnify a “director, officer, employee or agent” who loses a fiduciary cause of action is that:
 - a. Defendants must be “successful on the merits or otherwise” to be indemnified.
 - b. Indemnification is never permitted with respect to fiduciary causes of action.
 - c. **Where defendant loses, indemnification would cost the company more than the funds it recovers in money damages.**
 - d. In fact, Delaware corporations are permitted to indemnify such persons under such circumstances.

(C) is correct. Under §145(b), a corporation is legally prohibited from indemnifying a person sued “by or in right of” the corporation, for any costs, if that person is “adjudged to be liable,” with an exception only for cases in which the Chancery Court can be convinced it

would be equitable. This is so because if the person is adjudged liable, they have injured the corporation. If the corporation then indemnifies the person for the judgement *and costs*, the corporation is worse off than from the injury alone, defeating the purpose of fiduciary litigation.

3. Which of the following statements is most true?
- a. A Delaware corporation must not indemnify its fiduciaries against third party claims if the fiduciaries acted in conscious violation of law.
 - b. A Delaware corporation must not indemnify its fiduciaries against third party claims if the fiduciaries acted in conscious violation of criminal law.**
 - c. A Delaware corporation must indemnify its fiduciaries against third party claims unless the fiduciaries acted in conscious violation of law.
 - d. A Delaware corporation must indemnify its fiduciaries against third party claims unless the fiduciaries acted in conscious violation of criminal law.

(B) is correct. See §145(a) and (c). (A) is incorrect because outside the criminal context the test is one of good faith and reasonable belief the act is not contrary to the corporation's best interests. (C) and (D) are incorrect because mandatory indemnification is available only in the event of success on the merits.

Chapter 22: Derivative Litigation

Test Yourself Answers with Explanations

1. Joe, a shareholder in a large consumer products manufacturer called ABC, Inc., is planning a derivative lawsuit. The company is incorporated in a state following the Model Business Corporations Act. First Joe calls ABC's Consumer Complaints Department and speaks with a consumer help representative named I. Kent Bebothered. Joe explains to Mr. Bebothered, in some detail, why he believes that fiduciary duties have been breached. Which of the following most accurately describes Joe's situation?
- a. Joe's phone call probably constitutes effective shareholder "demand" because there is no required form in which demand must be made.
 - b. Joe's phone call probably does not constitute effective shareholder "demand" because of Mr. Bebothered's position within the company.
 - c. Joe's phone call does not constitute effective shareholder "demand" because it is not in writing.
 - d. **Answers b and c are both true.**

(D) is correct. An effective demand must be "on the corporation," meaning addressed to a person with authority properly to act on it. In a Model Act jurisdiction, it must also be in writing. Here, Kent is just an employee and the communication was not in writing. Therefore, the demand is not effective.

Questions 2-5 rely on the following set of facts:

Paul Plaintiff owns one share of stock in DotBomb, Inc., a publicly held Delaware company that launched a briefly successful internet service that since has failed and gone through bankruptcy. Paul, who is not the sharpest knife in the drawer, bought his share shortly after DotBomb emerged from those bankruptcy proceedings, not knowing that the company had gone through difficult times. In fact, at the time of his purchase, Paul was under the impression that DotBomb's website was still active and profitable, and accordingly he bought his share at the high price of \$15. At that point, however, DotBomb was actually engaged in no business whatsoever, and Paul has discovered that if he were try to sell his share of stock, it would be worth something more like 5¢. Paul has also learned that the company has given up any plans to resume its business, and in fact its board has already voted to recommend to the shareholders that they dissolve the company.

Frustrated, Paul decides legal action is required. First, he makes a number of telephone calls to the company's board and management, and manages to speak with a few of the company's directors and senior officers. To each of these persons Paul states his complaint, and insists that if

the board votes in favor of dissolving the company either he or someone within the company should sue the board members for breach of fiduciary duty. Some days later Paul received a letter from DotBomb's General Counsel which stated in polite but firm language that the company had considered his views and had decided to take no legal action.

Paul immediately files suit, naming each member of the board of directors and all of the senior officers of DotBomb, alleging that their failure to exercise adequate care caused the drop in value of his stock price. DotBomb's board directs the company's General Counsel to file a motion to dismiss.

2. Which of the following best characterizes Paul's lawsuit?
- a. **On only the facts as given, it is a derivative suit as to which demand is required.**
 - b. On only the facts as given, it is a derivative suit as to which demand is futile.
 - c. Paul need not make demand because the harm he alleges is loss of his share value, which is a personal injury.
 - d. None of the above.

(A) is correct. The nature of this claim would require Paul, as a shareholder, to sue through derivative action. Demand is required because these facts alone are not sufficient to raise a doubt that the majority of the Board are disinterested and independent, or that the transaction is protected by the business judgment rule.

3. What risk did Paul take by communicating directly with DotBomb's management?
- a. That he will have admitted as a matter of law that his demand was inadequate.
 - b. That he will have admitted as a matter of law that demand was futile.
 - c. **That he will have admitted as a matter of law that the suit should be dismissed unless the board's motion was irrational, uninformed, or conflicted.**
 - d. None at all – in fact it was wise for him to do so, since demand plainly is required in this case.

(C) is correct. By communicating directly with the management, Paul implicitly admits that the matter is a question for management to resolve, meaning that a demand is required if he wishes to pursue a derivative lawsuit. If a demand is required, a corporation's motion to dismiss will be granted unless the motion violates the business judgment rule, which is to say that it is not rational, informed, or without conflict.

4. In considering the board's motion, what standard will the court most likely employ to decide whether or not to dismiss Paul's complaint?
- a. As in other majority jurisdictions, this court will apply *Alford v. Shaw*.
 - b. **The *Zapata* rule for demand-required cases.**
 - c. The *Zapata* rule for demand-excused cases.
 - d. None of the above.

(B) is correct. In Delaware—unlike in Model Act and other jurisdictions—demand need not take any particular form, and does not have to be in writing. Paul’s communications with board members and senior officers seem likely sufficient that he could allege with particularity that he made demand under Delaware Chancery Rule 23.1. By making demand, Paul will be held to have conceded that demand was required. Therefore, the board’s motion to dismiss will be judged under the *Zapata* rule for demand-required cases.

5. Could Paul have brought a derivative action to challenge the decisions that led the company into bankruptcy in the first place?
- a. Yes, though he would be unlikely to win because the relevant conduct would likely be judged under the business judgment rule.
 - b. Yes, and he would be likely to win, since business choices leading to bankruptcy were likely so bad as not to be “rationally related to the best interests of the corporation.”
 - c. No, because on these special facts he could not possibly make out a substantive cause of action.
 - d. **No, for procedural reasons.**

(D) is correct. When the business filed for bankruptcy, Paul was not yet a shareholder. Therefore, he would not have standing to bring a derivative action.

6. ABC, Inc., a Delaware corporation, owns 65% of the voting stock of another company, XYZ, Inc. Another twenty-five percent of the shares are owned by the California Public Employees Retirement System (“CalPERS”), a major pension fund, which is not otherwise affiliated with either company. An XYZ bylaw provides that board candidates will be nominated by any shareholder with more than 50% of XYZ’s voting stock.

CalPERS has brought suit against ABC and against XYZ’s entire board. CalPERS seeks money damages against ABC and injunction against the XYZ directors, all to remedy what CalPERS believes was an improperly motivated distribution of dividends to XYZ’s shareholders. CalPERS puts on uncontroverted evidence that: (1) at the time of the dividends, ABC was in great need of ready cash, and (2) the dividends in question exceeded XYZ’s entire revenues for the year.

The CalPERS suit is:

- a. **Entirely derivative in nature.**
- b. Necessarily direct as to the XYZ defendants.
- c. Entirely direct in nature.
- d. Direct as to ABC.

(A) is correct. The lawsuit alleges indifference to the interests of XYZ and, presumably, breach of duty of loyalty. CalPERS presumably received a pro rata share of the dividends and thus did not suffer a “personal” injury. Therefore, the lawsuit is derivative in nature. (Though it’s not strictly relevant to answering the question, note that under *Sinclair v. Levien* the Delaware courts would actually hold that there is no conflict of interest in this case, since

all shareholders were presumably paid the same dividends per share. CalPERS' claim would therefore be for breach of the duty of care. But the claim would still be fiduciary and derivative.)

7. Jenny, a shareholder in the Delaware holding company known as BigCo, Inc., believes that a recent, spectacularly failed investment by BigCo was the fault of the company's bumbling board of directors, and she sues each of them for breach of fiduciary duty. Among many other things, her complaint alleges the following: "Internal remedies would be ineffective because the entire board are incompetent, and because they each only do the bidding of BigCo's chief executive officer, who is also named as defendant herein." Jenny has one share of BigCo's one million shares of stock, and the lawsuit is the first that anyone within the company has ever heard of her. On only these facts, Jenny's failure to seek intra-corporate remedies:

- a. Is irrelevant in this particular case.
- b. Does not really matter, because the CEO and each of the directors are all named defendants.
- c. Is fatal to her lawsuit because of the manner in which she pleaded the facts.**
- d. Automatically triggers the first prong of *Zapata*.

(C) is correct. Demand futility requires pleading with particularity facts that create serious doubts about the board's fitness to manage the firm, and *Aronson* itself held that facts like those that Jenny plead are inadequate.

Chapter 23: Corporate Control Transactions, Part I: Introduction, Negotiated Transactions, and Sales of Control

Test Yourself Answers with Explanations

1. In Model Act jurisdictions, which of the following states the difference in consequences between mergers and share exchanges?

- a. **In mergers, the acquiring company takes on the target company's pre-acquisition liabilities.**
- b. Share exchanges do not trigger appraisal rights.
- c. Answers a and b are both correct.
- d. Neither answer a nor answer b is correct.

(A) is correct. The Model Act requires both boards' approval in share exchanges and share exchanges will trigger appraisal rights, so (B) and (C) are incorrect. However, share exchanges will not require an acquiring company to take on the acquired company's liabilities.

2. Myron is a shareholder in a closely held corporation called XYZ, Inc., which has one class of common voting stock. Myron is annoyed that 51 percent of the shares of the company were recently voted in favor of a one-for-one share exchange for the stock of ZYX, Inc. ZYX is a publicly held company the shares of which are trading at \$10 per share. Myron believes that his stock is worth more than that, so he should wait and try to sell it at a higher price. True or false?

- a. True. The pendency of a share exchange would likely give rise to a "control premium" and the value of Myron's stock to a third party is probably quite high.
- b. True, but only because ZYX is a publicly held company.
- c. False, because close corporation stock is illiquid and therefore Myron could probably not sell it for much.
- d. **False for some other reason.**

(D) is correct. A share exchange means all of XYZ's shares will be exchanged for shares of ZYX. Although Myron does not like the exchange plan, it has been approved and he cannot retain his shares or refuse to engage in the exchange. However, if XYZ is in a Model Act jurisdiction, Myron will be able to invoke his right to an appraisal, alleging that the consideration received is not sufficient.

3. XYZ, a Delaware diversified holding company, owns a number of subsidiaries, including ABC, which is incorporated in a Model Act jurisdiction. XYZ owns 92 percent of ABC's voting stock. If XYZ desires to merge ABC into itself, ABC's shareholders need not be offered the right to vote on the plan. True or false?

- a. False, unless ABC's articles will not be amended and its shareholders will retain the same number of shares with the same rights and attributes.
- b. False for some other reason.
- c. **True.**
- d. This question cannot be answered without knowing the requirements for short-form merger under Delaware law.

(C) is correct. XYZ owns 92% of ABC's voting stock, more than 90% of control in ABC. To merge ABC into XYZ itself, XYZ does not need shareholder approval. The two boards' approval is sufficient. (D) is incorrect because the rights of ABC's shareholders are determined by law of ABC's state of incorporation (which is a Model Act jurisdiction), not XYZ's.

4. Appraisal is a dissenting shareholder's exclusive remedy following a tender offer. True or false?
- a. True. This rule is required by statute law governing corporate acquisitions.
 - b. True. This rule is required by common law governing corporate acquisitions.
 - c. False. The shareholder will have other remedies in addition to appraisal if he or she can prove some fraud or other misconduct in connection with the tender offer.
 - d. **False. A tender offer is not an event triggering appraisal rights.**

(D) is correct. Tender offers are regulated by federal and state law, but unlike friendly change-in-control transactions (that is, mergers, share exchanges, and asset purchases), tender offers do not trigger appraisal rights. Because it merely entails buying shares directly from shareholders, and each individual sale is voluntary, the prices paid are set by market and are unlikely to be inadequate.

Questions 5-8 relate to the following facts:

A leading maker of vision care equipment that is not very concerned with its consumers' personal desires, C. F. Eyecare, Inc., is incorporated in a Model Act jurisdiction. C. F. Eyecare has 4000 outside shareholders who hold between them about 35 million shares. Those 35 million shares in total have a market value of about \$350 million. Another corporation, the large diversified holding company known as XYZ, Inc., enters into an agreement with the management of C. F. Eyecare under which XYZ will purchase all the assets of C. F. Eyecare in exchange for shares of XYZ. Following the purchase, C. F. Eyecare agreed that it would distribute its XYZ stock as an in-kind dividend to its shareholders, and then it would dissolve. This plan was recommended by C. F. Eyecare's board to its shareholders, and they approved it by a vote of more than 70%. The plan was not submitted to XYZ's shareholders, but 75% of XYZ's stock is owned by one man who favored the plan.

John is a former shareholder of C. F. Eyecare who voted against the plan and is now unhappy with his shares of XYZ stock. He thinks the shares he received did not reflect the fair market value of the C. F. Eyecare stock that he formerly held, and he brings a lawsuit against C.F. Eyecare and XYZ seeking payment of the fair market value of his stock.

5. Defendants move to dismiss John's lawsuit, alleging that he is not entitled to this kind of relief. How should a court rule on this motion?
- Grant it, because John no longer holds any shares and therefore lacks standing.
 - Grant it if John failed to make demand on the board of directors of either company.
 - Grant it for some other reason.
 - Deny it. In Model Act jurisdictions, appraisal is an appropriate remedy in cases such as this and that is essentially what he is seeking.**

(D) is correct. In Model Act jurisdictions, merger, share exchange, and sale of substantially all assets can trigger appraisal. This was a sale of substantially all assets in exchange for XYZ stock.

6. In a jurisdiction that recognizes the "de facto merger" doctrine, the transaction between XYZ and C. F. Eyecare could be described as a "de facto merger." True or false?
- True, because the nature of the business in which C.F. Eyecare's former shareholders now own stock has changed.
 - True, because C.F. Eyecare's former shareholders now have a very different relationship with the management of the company in which they own stock.
 - True, because C. F. Eyecare's shareholders were entitled to vote as to the transaction.
 - All of the above answers are correct.
 - Answers "a" and "b" are both correct.**

(E) is correct. To determine whether a transaction is a *de facto* merger, a court will not only look at the agreement itself but also the consequences of the transaction. Whether or not the shareholders of the company that ceases to exist were allowed to vote is not determinative. The schemes giving rise to *de facto* merger litigation often are attempts to avoid shareholder votes as well as appraisal rights.

7. If this transaction were held to be a "de facto merger," how would John's situation be changed?
- He would be entitled to appraisal.
 - He would be entitled to voting rights.
 - Answers "a" and "b" are both correct.
 - His situation would be unchanged.**
 - None of the above.

(D) is correct. Here, because this was a Model Act jurisdiction, John was in fact entitled to vote and to appraisal rights, which are all he would get by proving *de facto* merger.

8. Failure to submit the transaction to vote by XYZ's shareholders is:

- a. Relevant to whether they will enjoy appraisal rights.
- b. Relevant to whether XYZ's controlling shareholder breached any fiduciary duties.
- c. **Likely irrelevant to the legal soundness of the transaction itself, since even in Model Act jurisdictions acquiring-firm shareholders are normally not entitled to vote on purchases of assets.**
- d. All of the above.
- e. Answers "b" and "c" are correct.

(C) is correct. (A) is incorrect because acquiring firm shareholders would never enjoy appraisal rights. (B) could be relevant if the transaction involved a conflict of interest on the part of XYZ's controlling shareholder. For example, if he caused the purchase of some asset in which he had a pecuniary interest, the transaction would expose him to challenge for breach of his duty of loyalty. In that case, had the transaction been open to approval by the outside shareholders, approval by a majority of them would have constituted a ratification and modified the standard under which any fiduciary claim against him would be brought. But in this case there does not appear to be a conflict, and so any claim against him would already be under the business judgment rule. Ratification by the minority would not modify that standard.

Chapter 24: Corporate Control Transactions, Part II: Tender Offer Defenses, and Special Fiduciary Duties in Hostile Take-Over Situations

Test Yourself Answers with Explanations

Questions 1-5 relate to the following facts.

Sitting Duck, Inc., is a publicly traded Delaware corporation. Shortly after the company was formed, its board of directors received a presentation from an outside investment banker, advising them that because of the nature of the company's business, it was likely to enjoy large cashflows and might have a large amount of cash on hand at any given time. The banker's advice was that Sitting Duck was therefore at a serious risk of hostile takeover.

Fortunately, Sitting Duck's outside law firm specializes in making companies frustratingly difficult to would-be acquirors. The firm, Ima, Paine, LLP, advised Sitting Duck to adopt a plan under which, upon the acquisition by any person of more than 20% of Sitting Duck's outstanding stock, all shareholders would be entitled immediately to exchange each share of stock for a Sitting Duck corporate bond. The bonds would have a \$100 principal value, 1 year maturity period, and would pay 17.5% interest. The plan was explicitly made revocable at the board's election. The board referred this "Rights Plan" to a committee of its outside directors, who adopt it unanimously.

Recently Sitting Duck's management was dismayed to learn that Greedy McGreederson, a notorious corporate greenmailer, had already acquired 5% of the company's outstanding stock and that he would shortly initiate a tender offer for the rest. McGreederson soon announced a front-loaded, two-tier tender offer, in which he would first acquire another 46% of the company's stock and then merge Sitting Duck into his own holding company. Pursuant to the plan of merger, McGreederson's holding company would acquire the remaining 49% of Sitting Duck by exchanging them for junk bonds, which McGreederson claims will be equal in value to the Sitting Duck shares so acquired. On the same day that he announced his tender offer, McGreederson filed suit in Delaware Chancery Court seeking injunction of the Rights Plan.

Now at wit's end, Sitting Duck's board contacts WiteNite Industries, Inc., another publicly traded company, to negotiate a friendly merger plan. The two companies quickly strike an agreement under which Sitting Duck will be merged into WiteNite. The parties agreed that if Sitting Duck were to breach the contract, WiteNite would receive a cancellation fee of \$100 million.

1. In McGreederson's challenge to the Rights Plan, to what standard should Sitting Duck's outside directors be held?
 - a. Reasonable care, because no tender offer was pending when the plan was adopted.
 - b. The business judgment rule, because no tender offer was pending when the plan was adopted.
 - c. The *Cheff* standard.

- d. **The *Unocal* standard.**
- e. The *Revlon* standard.

(D) is correct. The provision is a poison pill to respond to threat of hostile takeover. Therefore, it should be subject to the *Unocal* standard, pursuant to which the Board should (1) have a reasonable belief there is a threat to corporate policy and effectiveness and (2) tailor a reasonable response. It does not matter that no hostile takeover effort was pending when the plan was adopted. *Unocal* applies to any actions meant to defend against takeover.

- 2. Even without the defenses adopted by Sitting Duck's board, Greedy McGreederson could not go forward with the takeover transaction that he proposed. True or false?
 - a. True. A transaction of this nature would require approval of Sitting Duck's shareholders.
 - b. True. The second tier McGreederson's plan involves a merger, which would call for board approval.
 - c. False. Despite the board's refusal to cooperate with McGreederson's takeover, on these facts he would likely be able to get a court order requiring the board to cooperate.
 - d. **False for some other reason.**

(D) is correct. While it is true that the second tier of McGreederson's plan is a merger, and therefore would require approval by both the board and shareholders of Sitting Duck, he will control both bodies by the time he undertakes the second tier. By acquiring majority voting control in the first tier of his plan, he will be able to replace the Sitting Duck board with directors who will approve the merger that is the second tier. And since he holds majority control of the Sitting Duck voting shares, he can rest assured that the plan will be approved at a shareholder meeting where it is presented.

- 3. Why would Sitting Duck adopt the Rights Plan as a way to deter a hostile takeover?
 - a. Because it will increase the number of voting shares McGreederson will have to buy to secure control.
 - b. Because it will decrease the number of voting shares McGreederson will have to buy to secure control.
 - c. **Because it will tend to make Sitting Duck more expensive to purchase.**
 - d. None of the above.

(C) is correct. Service of the high-interest bonds will be very expensive and put the firm under substantial pressure if McGreederson acquires it.

- 4. Assume that the initial adoption of the Rights Plan is subject to the *Revlon* standard. Would it be consistent with the board's duties under that standard?
 - a. Probably, as shown by the fact that a hostile tender offer in fact was made, and it was highly coercive in nature.

- b. **Probably, because the Rights Plan was revocable at the board's election.**
- c. Probably not, because the Rights Plan plainly was not "proportional" to any "threat to corporate policy and effectiveness."
- d. No, because there is no evidence that the board in good faith determined that there was a "threat to corporate policy and effectiveness."

(B) is correct. The question assumes applicability of *Revlon*, not *Unocal*. (C) and (D) relate to *Unocal* and therefore are incorrect. *Revlon* applies when it is a foregone conclusion that the company will be taken over or broken up; it then is the duty of the Board to maximize value to the shareholders. If *Revlon* applies, then keeping the company intact is no longer a valid consideration, and any threat to corporate policy and effectiveness becomes irrelevant. The fact that a "highly coercive" tender is made does not really suggest that the directors are doing their best to auction off the company, so (A) is incorrect. The fact that the directors could still call off implementation of the rights plan provides a bargaining chip, so (B) seems best.

- 5. If one of WiteNite's shareholders sues WiteNite's outside directors in connection with the WiteNite merger agreement, under what standard should the court judge their liability?
 - a. *Revlon*, because the huge cancellation fee renders the merger "inevitable."
 - b. *Unocal*, because Sitting Duck and WiteNite are both publicly traded; there will be no "change of control."
 - c. Intrinsic fairness.
 - d. **Business judgment rule.**

(D) is correct. Here, WiteNite is the acquiring company, and, on these facts at least, it is not facing any threat of takeover or taking action defensive to takeover. Therefore, its board is not subject in this case to *Revlon* and *Unocal*. There is likewise no indication of self-interest.

6. A purchase of a company financed by debt is known as a **leveraged buyout**.

7. [Short Answer] When does the *Revlon* duty attach?

When a change in corporate control or break up of a company becomes inevitable, *Revlon* attaches and the sole duty of the company's Board is to maximize shareholders' interest. *Paramount v. QVC*.

Chapter 25: Special Considerations in the Close Corporation Context, Part I: Planning for Control

Test Yourself Answers with Explanations

1. Joe, John and Jim are three shareholders of XYZ, Inc., and together they own 45% of its shares. They know that voting together they can control a large portion of the company's board of directors. They also know that Joe is brightest among them and most involved in the company's affairs, so they provide in a written agreement among them that they will each vote all of their shares at each annual shareholders' meeting exactly as Joe directs them to do. The arrangement is for an indefinite term and can be revoked only by the parties' unanimous agreement. This arrangement is legally unenforceable because:

- a. It is void as against public policy.
- b. Its term exceeds 10 years.
- c. It is unsupported by consideration.
- d. **There is no obvious reason on these facts that this arrangement would be legally unenforceable.**

(D) is correct. (A) is incorrect because, at least on these facts, there is no interference with the board's authority. (B) is incorrect because this agreement is not a "voting trust"—it does not separate the right to vote the shares from beneficial ownership—and so need not be limited to 10 years in duration. *Lehrman v. Cohen*. (C) is incorrect because it plainly is supported by the consideration of the parties' mutual promises.

Questions 2 - 6 rely on the following facts:

Bernie and his twin brother Bart, now in their seventies, founded a grocery store long ago, and have operated it together ever since. Immediately upon its founding Bernie and Bart incorporated their business, and called it B&B Grocery, Inc. They have each always served as the two members of B&B Grocery's board of directors, and they each own 50% of the company's outstanding stock. Shortly after the company's incorporation they executed a shareholder's agreement between them, which they intended to help them avoid problems in the management of the business.

As parties to the shareholder's agreement, Bernie and Bart agreed that they would always vote for themselves as the two members of B&B Grocery's board. They also included the following provision, under the heading "Designated Tiebreaker":

"In any case, as to a matter for which either board action or shareholder action is required, if the board or the shareholders reach unresolvable disagreement, the matter shall be referred to the Designated Tiebreaker, who shall be the person designated herein, and whose decision as to such matters shall be final."

The shareholder's agreement included another provision appointing B&B Grocery's outside attorney, Bob Shady, as the "Designated Tiebreaker." Bob has agreed so to act.

Finally, pursuant to the shareholder's agreement Bernie and Bart promised that as the company's directors, they would each always vote for an annual payment of dividends in the amount of \$500 per share.

2. If Bernie chose to vote for someone other than Bart for the position of director, could Bart enforce the shareholder's agreement against him?
 - a. No. Although shareholders may normally agree as to whom they will vote for, they are not permitted to make board elections a foregone conclusion.
 - b. No, because proxies may not be given by shareholders in close corporations.
 - c. No, because irrevocable proxies may not be given by shareholders in close corporations.
 - d. **None of the above.**

(D) is probably correct. Voting agreements are generally enforceable except where void as against public policy. Here there is actually a significant public policy concern with the parties' agreement, because they constrain themselves with respect to votes they will cast as director. (Namely, they agree to authorize specified dividends.) However, the agreement with respect to the election of directors is probably still enforceable. Moreover, *Galler* and similar caselaw suggests that concerns with agreements with respect to action of the board are lessened where all shareholders are parties to the agreement. See also *McQuade v. Stoneham*. And, in any case, the other answers are incorrect. (A) is simply false, and (B) and (C) are incorrect because the agreement in this case does not involve the giving of any proxies. The parties to the agreement vote their own shares.

3. If B&B Grocery, Inc., were incorporated in Delaware, would Bernie and Bart's agreement constitute an illegal voting trust?
 - a. Yes, because it is irrevocable.
 - b. Yes, because it separates voting from ownership.
 - c. Yes, because it is for an indefinite term.
 - d. Answers "a," "b" and "c" are all correct.
 - e. **No.**

(E) is correct. The agreement did not separate voting power from the shares.

4. If it were not for the "Designated Tiebreaker" provision in their shareholder's agreement, Bernie and Bart would each be at a significant risk of oppression. True or false?
 - a. True. They are both effectively minority shareholders – neither holds a majority.
 - b. True, if they are both dependent on their salaries and/or dividends from B&B Grocery.
 - c. True. "Oppression," as a practical matter, is a risk in all closely held corporations.

- d. **False, as a practical matter.**

(D) is correct. They each have 50% of the shares, and if they do not agree on certain things, there will be deadlock. Neither has power to coerce or oppress the other one, because neither of them is majority.

5. Which of the following best characterizes the enforceability of the provision of the shareholder's agreement concerning the payment of dividends?
- a. Enforceable, because shareholders are permitted to bind themselves as to any matter on which they are entitled to vote.
 - b. Enforceable, because directors are permitted to bind themselves as to any matter on which they are entitled to vote.
 - c. Unenforceable, because as a matter of statute law dividends must be approved by board vote.
 - d. **It is hard to say, though if B&B were publicly traded the answer would likely be that it is unenforceable.**

(D) is correct. (A) is incorrect because shareholders are not the ones who are supposed to approve dividends. (B) and (C) are incorrect for the reasons given in the answer to question 2, above.

6. What risks has Bob Shady undertaken by agreeing to act as "Designated Tiebreaker"?
- a. None.
 - b. Probably none, because the nature of his duties as attorney are so unlike to conflict with his duties as Designated Tiebreaker.
 - c. **He may risk conflict of interest, since he also acts as the company's attorney.**
 - d. Probably none, since his is not an officer or director and therefore will not owe any fiduciary duties.

(C) is correct. As an attorney, the company is Bob's principal; as an arbitrator, Bob can be influenced by factors that may impact his ability to serve the company's interest best. For example, Bob may be tempted by his own pecuniary interest if a question is raised about whether he should be retained for specific legal work.

Chapter 26: Special Considerations in the Close Corporation Context, Part II: Fiduciary Duty and Oppression

Test Yourself Answers with Explanations

1. Hypo, Inc., a closely held company, is incorporated in Massachusetts. Adam, who owns 15 of Hypo's 100 shares, was recently fired by the company and is now the only one of its shareholders not employed by it. At the same time, the company discontinued the dividend payments it traditionally had made, and reverted instead to annual employee "bonuses," based on the number of shares held by each employee. Adam likely will be entitled to a recovery from the other shareholders. True or false?

- a. **True, because there probably is not a business reason for linking employee bonuses to the number of shares held.**
- b. False, because dividend decisions are within the business judgment discretion of management.
- c. False, because employee termination decisions are within the business judgment discretion of management.
- d. False, because the "equal opportunity" rule no longer applies, even in Massachusetts.

(A) is correct. In Massachusetts, majority shareholders owe an utmost good faith and loyalty duty to minority shareholders, and this duty extends to minority shareholders' employment. Accordingly, changes in employment that disproportionately affect the minority must be justified for reasonable business reasons. *Donahue v. Rodd Electrottype*. Here, we know of no showing with respect to such business reasons, either with respect to the firing or the linkage of bonus to shares.

2. Joe is considering taking a new job as CEO of a closely held Massachusetts corporation. Joe is unsure whether he should accept all the comforting promises concerning the job made to him by the company's Chairman, Hugh Lyon. He is also annoyed by a company bylaw prohibiting company officers from owning the company's stock. Anyway, which of the following is the best reason for Joe to insist on an employment contract with employment and salary protections?

- a. The *Donahue-Wilkes* rule is not recognized in Massachusetts.
- b. The *Donahue-Wilkes* rule contains doctrinal uncertainties.
- c. ***Donahue-Wilkes* protection would be unavailable to Joe.**
- d. It is often uncertain when a corporation is "close" within the meaning of the *Donahue-Wilkes* rule.

(C) is correct. *Donahue-Wilkes* protects only shareholders. Here, Joe is not a shareholder; in fact, he is banned from owning any of the company's stock. Therefore, the doctrine will not be available to Joe.

Question 3 relies on the following facts:

Ever since John and Jerry incorporated their business as a Massachusetts corporation, about eight years ago, they've managed the company's affairs together. Though they don't have official job titles, they've always paid themselves annual salaries. Until recently they had never held either a shareholder or board meeting, and there had never been an election of directors. Strictly speaking, John has voting control of the company. Since John invested quite a bit more money, they agreed that he would take 60% of the shares and Jerry would take 40%. Several years ago, John hired two employees to work for the company, and they are still in its employ.

Last month Jerry got a letter signed by John, indicating that he was signing on behalf of the company as "controlling shareholder." The letter announced that the company would hold a shareholder meeting, the only listed agenda item being the election of a board of directors. In his own handwriting, John included the following note at the bottom of the otherwise typed letter: "Hey, bud, don't worry about this shareholder meeting business. You know we're in this together." Relying on John's words, Jerry neither attended the meeting nor gave his proxy to anyone to vote his shares.

At the meeting, John cast his entire 60% for himself as director. His first act as director was to hire himself as CEO. His first act as CEO was to fire Jerry as an employee and terminate any future right to salary. Jerry files suit to challenge the manner of his termination, and John immediately moves to dismiss.

3. John's actions violated his fiduciary duties as a shareholder in a closely held corporation. True or false?
- True, because the business has only two shareholders, is not publicly traded, and the shareholders are directly involved in management.
 - False. John's actions could not violate any such duty because of the state in which the business is incorporated.
 - True, if there was no valid business purpose for the termination.**
 - False. John's actions could not violate any such duty because corporate fiduciaries owe their duties to the corporation, not to individual shareholders.

(C) is correct. This Massachusetts company will qualify as a "close corporation" for *Donahue-Wilkes* purposes, and that special fiduciary rule will apply. It is not breached, however, if there is some valid business purpose for the action complained of and there are no plausible, less-harmful means to accomplish it.

Questions 4-6 relate to the following facts:

Arno, Benny and Chuck form a Massachusetts corporation that they call ABC, Inc. They themselves are the company's sole shareholders; Arno owns 10 of the company's 100 shares, and Benny and Chuck each own 45. They verbally agreed, upon formation of the corporation, that they would employ themselves in the company, and would pay themselves each a salary.

Following a recent personal disagreement, Benny and Chuck voted as two of ABC's three directors to eject Arno from the board and to fire him from his job at ABC. They then voted to discontinue ABC's traditional annual dividends.

Arno sues Benny and Chuck, alleging that his termination violated their fiduciary duties.

4. Is ABC, Inc. a "close corporation" within the meaning of *Donahue v. Rodd Electrottype*?
- a. **Yes, because its shareholders are involved in its management.**
 - b. Yes, but only until Arno left, since at that point it was no longer true that all of its shareholders were involved in management.
 - c. Yes, but only if at least some of its shareholders are related or have close personal relationships.
 - d. All of the above are correct.
 - e. Answers "a" and "b" are both correct.

(A) is correct. A close corporation under *Donahue* has 1) a small number of shareholders, 2) substantial shareholders involvement in management, and 3) no ready market for its shares. (B) is incorrect because you cannot change the character of the corporation by freezing one of the shareholders out of management. (C) is incorrect, because personal relationships among the shareholders are not part of the *Donahue* test.

5. Chuck, who happens to be an attorney, files a motion on behalf of ABC to dismiss Arno's claim, alleging that Arno does not adequately represent the other shareholders. Which of the following most likely describes how the court will rule on this motion?
- a. Grant it because Arno is now the only shareholder not employed by ABC.
 - b. Grant it because Arno is the only shareholder who has suffered this particular injury.
 - c. **Deny it because of the nature of Arno's cause of action.**
 - d. Deny it for some other reason.

(C) is correct. Arno's claim under *Donahue-Wilkes* is direct and his representativeness is irrelevant.

6. Which of the following best explains why Arno's cause of action differs from a claim for breach of the fiduciary duty of loyalty?
- a. Arno's claim is derivative in nature.
 - b. Because in duty of loyalty claims the defendant normally bears the burden of proving material facts.
 - c. **Because of the kinds of facts that trigger the underlying duty.**
 - d. Because in duty of loyalty claims the basic question, in essence, is whether the challenged transaction was "legitimate" from the company's perspective.

(C) is correct. Duty of loyalty claims require proof of conflict of interest, but *Donahue-Wilkes* claims, in principle, do not. (Often *Donahue-Wilkes* claims will involve conflict of interest, but it is not necessary to prove that there is one.) In *Donahue-Wilkes* what is key is that there be some *different* access to liquidity or other benefits, whether or not the individual challenged decision itself creates conflict of interest. In Arno's case, for example, the decision to fire him does not in itself create or involve a conflict of interest on the part of Chuck or Benny. They already had conflicts of interest with respect to their own jobs and salaries, but that was not changed by the decision to fire Arno. It did however exclude him from agreed-upon access to the firm's assets. So it would not expose them to duty of loyalty liability, but it would expose them to *Donahue-Wilkes* liability.

Chapter 27: Special Considerations in the Close Corporation Context, Part III: Deadlock and Dissolution

Test Yourself Answers with Explanations

1. Nellie owns 50% of the shares of the N&N Corporation. Nancy owns the other 50%. Nancy is the President and the sole officer of the corporation; Nellie is not employed by N&N. Nancy has refused to attend shareholders meetings for some years, and therefore Nellie has been unable to vote to replace Nancy as a director, a great desire for Nellie because the company has also refused to pay any dividends, thus rendering Nellie's shares largely without value to her. Nellie's best remedy is probably:

- a. To sell her shares.
- b. An action for a writ *quo warranto* removing Nancy as an illegal holdover director.
- c. An action for an injunction ordering a new shareholders' meeting.
- d. **As a practical matter, none of the above will be effective remedies.**

(D) is correct. (A) is incorrect because there is no ready market for this stock, and no outside buyer is likely to pay a fair price to replace Nellie as minority owner of a highly illiquid stock. (B) and (C) are of no value to Nellie because, even if a court were willing to grant them, she would still be in the same position. Either of them would just necessitate a shareholder meeting that Nancy could refuse to attend, thus defeating quorum, or at which, if she did attend, the two would vote their shares differently and thus be deadlocked.

2. Hypo, Inc., is a closely held corporation. Adam, who owns 15 of Hypo's 100 shares, was recently fired by the company and is now the only one of its shareholders not employed by it. At the same time, the company discontinued the dividend payments it traditionally had made, and reverted instead to annual employee "bonuses," based on the number of shares held by each employee. Adam likely could seek judicial dissolution of ABC. True or false?

- a. **True.**
- b. False, because dividend decisions are within the business judgment discretion of management, and are unlikely to constitute "oppression."
- c. False, because employee termination decisions are within the business judgment discretion of management, and are unlikely to constitute "oppression."
- d. False, because he does not own at least 20% of ABC's stock.
- e. False, because there is no evidence of fraud or other misconduct.

(A) is correct. Judicial dissolution by statute is available in cases of "oppression," which courts define as the frustration of reasonable shareholder expectations. Here, based on the parties' traditional behavior, Adam may well have had a reasonable expectation of continued employment or access to firm assets.

3. Arno, Benny and Chuck form a New York corporation that they call ABC, Inc. They themselves are the company's sole shareholders; Arno owns 30 of the company's 100 shares, and Benny and Chuck each own 35. They orally agreed, upon formation of the corporation, that they would employ themselves in the company, and would pay themselves each a salary.

Following a recent personal disagreement, Benny and Chuck voted as two of ABC's three directors to eject Arno from the board and to fire him from his job at ABC. They then voted to discontinue ABC's traditional annual dividends, even though the company is very profitable. Arno seeks judicial dissolution on the grounds of oppression. Which of the following is most true?

- a. Arno does not own sufficient shares to have standing.
- b. Arno cannot obtain dissolution because the corporation is making money.
- c. Arno cannot make out grounds for oppression.
- d. **The most likely outcome is a buy-out of Arno's shares.**

(D) is the best answer. Arno can request dissolution on grounds of oppression, as Arno's substantial reasonable expectations are defeated. However, as a practical matter, the two parties will most likely settle and Benny and Chuck will buy out Arno's shares.

4. [Short Answer] Assume that the two 50 percent shareholders of a corporation are deadlocked and unable to elect directors. Under what circumstances would you expect a judge to grant a petition for dissolution?

Among the various grounds for judicial dissolution, deadlock will be sufficient only if it seriously frustrates the ongoing operation of the firm. In Model Act jurisdictions, for example, it is appropriate only where "irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders."

5. One test for whether a shareholder is being oppressed is whether her **reasonable expectations** are being defeated.

Chapter 28: Introduction to Federal Securities Regulation: The Statutory Framework, the Definition of a “Security,” Registration Requirements, and Exemptions from Registration

Test Yourself Answers with Explanations

1. Think for a moment, about what the word “security” means for purposes of the Securities Act of 1933.

Which of the following is most true?

- a. A limited partner’s limited partnership interest is always a security.
- b. A limited partner’s limited partnership interest is never a security.
- c. **A limited partner’s limited partnership interest is usually a security.**

(C) is correct. An LP’s interest is a passive investment the returns from which arise solely from other people’s efforts. It would be incautious, however, to say that it is *always* a security.

2. The promoter of a viatical settlement fund collects money from investors and uses it to purchase from persons diagnosed as terminally ill (“investees”) the right to be named beneficiary of the investees’ life insurance contracts. Thinking, again, about what the word “security” means for purposes of the Securities Act of 1933, which of the following is most true?

- a. The arrangement described is not likely to be deemed an investment contract because the significant efforts are those of the investees.
- b. The arrangement is not likely to be deemed an investment contract because life insurance policies are not securities.
- c. The arrangement is not likely to be deemed an investment contract because it is not what someone commonly would think of as a security.
- d. **The arrangement is likely to be deemed an investment contract.**

(D) is correct. The promoter’s efforts in selecting the pool of insureds are the managerial or entrepreneurial efforts on which the profitability of the scheme relies.

3. Thinking, yet again, about what the word “security” means for purposes of the Securities Act of 1933, which of the following is most true?

- a. The interest of a member of a limited liability company is not a security.
- b. **The interest of a member of a limited liability company is a security.**

- c. **More information would be required before a determination could be made whether the interest of a member in a particular limited liability company is a security.**
- d. The only information required before one could determine whether the interest of a member in a particular limited liability company is a security is the state in which it is formed.

(C) is correct. The real question is whether the LLC is member-managed or manager-managed. Because securities generate returns from the efforts of others, only a manager-managed LLC's interest is likely a security. Whether an LLC is member-managed depends on the state only if the members have chosen to allow default rules apply; otherwise, it is a matter of their agreement.

4. New Company's shares of common stock are closely held. It proposes to conduct an initial public offering, as the result of which it will (for the first time) have in excess of \$10,000,000 of assets and more than 500 holders of its common shares. It expects that these shares will not be traded on a registered stock exchange but will be thinly traded over the counter. It also has a class of preferred shares outstanding in the hands of 50 holders. No shares of preferred will be issued in the proposed offering.

With respect to the preferred shares, which of the following is most true?

- a. **There is no reason to think that the preferred shares must be registered under the Securities Exchange Act of 1934.**
- b. If the common shares are registered under the Securities Exchange Act of 1934, so must the preferred shares.
- c. Registering the common shares will automatically register the preferred shares.
- d. It is not classes of shares but the issuer itself that is registered under the Securities Exchange Act of 1934 once a triggering event has occurred.

(A) is correct. Where a firm is not listed on a national securities exchange, but nevertheless has assets in excess of \$10 million and a class of equity securities owned by more than 2000 persons or more than 500 unaccredited investors, then it must register that security under the Securities Exchange Act of 1934 - but *only* that security.

5. Referring again to the facts of Question 4, which of the following is most true?

- a. There is enough information to determine whether registration under the Securities Exchange Act of 1934 must occur.
- b. There is not enough information to determine whether the common shares must be registered under the Securities Exchange Act of 1934.
- c. There is not enough information to determine whether the shares of either class must be registered under the Securities Exchange Act of 1934.
- d. **There is enough information to determine whether the preferred shares must be registered under the Securities Exchange Act of 1934.**

(D) is correct. There are only fifty holders of the preferred and so the class need not be registered (it is inconceivable that a class held by fifty holders would be exchange traded). (A) is almost as good, but not quite as clear. Since the offering of common was public, New Company will not know if the more-than-500 holders are accredited and thus should be advised to register the shares under §12(g) of the '34 Act.

Chapter 29: Proxy Regulation

Test Yourself Answers with Explanations

1. Achmed is a shareholder of Alpha Corporation. (You may assume this corporation is subject to Section 14 of the Securities Exchange Act of 1934.) He owns approximately 2 percent of the corporation's outstanding common stock. Achmed has learned that the management of Alpha intends to send out proxy solicitations to its shareholders for the purpose of obtaining their votes to reelect the present board of directors. Achmed makes a written demand on the board to include the following proposals in their solicitation materials: (1) that Percy be appointed president and (2) that the employee restrooms in Alpha's manufacturing facility be updated.

Based on the foregoing, which of the following statements is most likely to be true?

- a. **Management is not required to include either proposal in its solicitation materials.**
- b. Management must include the first proposal (pertaining to Percy), but not the second one (pertaining to the restrooms), in its solicitation materials.
- c. Management must include both proposals in its solicitation materials if Achmed has owned his shares for at least one year.
- d. Management must include the second proposal in its solicitation materials, but not the first one.

(A) is correct. Achmed has more than 1% share, and nothing indicates that his request was untimely or that he has not held the shares long enough. However, neither proposal would be a proper subject for shareholder action under state law since they both purport to directly call for interference by shareholders in management matters.

2. Berto is a shareholder of Beta Corporation. (You may assume this corporation is subject to Section 14 of the Securities Exchange Act of 1934.) He owns approximately 2 percent of the corporation's outstanding common stock. Berto has learned that the management of Beta intends to send out proxy solicitations to its shareholders for the purpose of obtaining their votes to reelect the present board of directors. Berto makes a written demand on the board to include the following proposals in their solicitation materials: (1) that a woman be appointed president and (2) a recommendation that transgender employees be permitted to use the employee restrooms of their choice in Beta's manufacturing facility.

Based on the foregoing, which of the following statements is most likely to be true?

- a. Management is not required to include either proposal in its solicitation materials.
- b. Management must include the first proposal (pertaining to appointment of a woman), but not the second one (pertaining to the use of restrooms), in its solicitation materials.
- c. Management must include both proposals in its solicitation materials if Berto has owned his shares for at least one year.

- d. **Management must include the second proposal in its solicitation materials, but not the first one.**

(D) is correct. The first proposal would be improper for shareholder action as a matter of state law. The election of the president is a matter for the board, not the shareholders. The second proposal, however, is framed as a recommendation, which is appropriate as a matter of state law. Moreover, it relates to a policy matter and thus does not fall under the ordinary operation of the business and *de minimis* exclusion grounds, and therefore should be included in the proposal.

3. Chunhua is a shareholder of Gamma Corporation. (You may assume this corporation is subject to Section 14 of the Securities Exchange Act of 1934.) She owns stock in the corporation that has a value of \$2,000, and she has been a shareholder for 14 months. Chunhua wants to submit an advisory proposal to the stockholders of Gamma, urging the corporation to expand its operations into the solar energy field. Gamma was formed for the purpose of developing energy sources, but has not previously been involved in solar power.

Based on the foregoing, which of the following statements is most likely to be true?

- a. Management must include Chunhua's proposal in its proxy solicitation materials, because of its significance, regardless of its length.
- b. Management must include Chunhua's proposal in its proxy solicitation materials if it does not, with any supporting statement, exceed 500 words.**
- c. Management must include Chunhua's statement in its proxy solicitation materials if it does not, with any supporting statement, exceed 500 words, but may charge Chunhua for the reasonable costs associated with mailing her proposal to Gamma's shareholders.
- d. Management is not required to include Chunhua's proposal in its solicitation materials, but must provide her with a mailing list of Gamma's shareholders, or else independently mail her proposal to the shareholders at Chunhua's expense.

(B) is correct. Chunhua has owned the share for more than 12 months and the shares have a value of at least \$2,000. In addition, if phrased in terms of social policy the topic is significant enough to overcome the common hurdles to putting the proposal in the material. However, the proposal must be no more than 500 words.

4. Dre is a director of Delta Corporation. (You may assume this corporation is subject to Section 14 of the Securities Exchange Act of 1934.) The board of Delta solicited proxies for their reelection. Although other members of the board had, from time to time, heard rumors of Dre's criminal background, no conclusive proof of this background had ever been brought to their attention. However, a reasonably thorough investigation would have disclosed that, before his first election to the board, Dre had been convicted of several crimes involving breach of trust.

The proxy solicitation failed to make mention of Dre's prior contacts with the criminal justice system, and Dre was elected. Following the election, Pru, a shareholder with less than 1 percent of Delta's stock who did not want Dre to sit on Delta's board, commenced an action to

rescind the proxy votes obtained by Dre immediately before the election. (You may assume Pru gave her proxy to reelect the board and that Dre would not have been elected but for the proxies obtained via the solicitation.)

Based on the foregoing, which of the following statements is most likely to be true?

- a. **Pru should be successful.**
- b. Pru's suit will not be successful because she lacks standing (i.e., she owned less than one percent of Delta's stock).
- c. Pru is not likely to be successful because she did not commence her action until after Dre's election.
- d. The omission of Dre's past criminal background was probably not material because his convictions did not involve his conduct as a director of Delta.

(A) is correct. Pru's suit is not derivative, and so any rules about number of shares that must be owned to bring such a suit would not be relevant. The timing (after Dre's election) should not be relevant, as an election is something easily undone. Moreover, Dre's past conduct involved breach of trust and would be considered material. Pru need not show causation as the proxy solicitation was an essential link in bringing about Dre's election.

5. Edith is a shareholder of Epsilon, Inc. (You may assume this corporation is subject to Section 14 of the Securities Exchange Act of 1934.) Epsilon is in the solar energy field. The board of Epsilon solicited proxies for the approval of the merger of Epsilon into Zeta Corp., even though a single shareholder (not Zeta Corp.) owned sufficient shares to compel the merger. Zeta Corp. is in the energy field, but has concentrated on coal and gas. The directors of Epsilon expressed the opinion that the merger will "in no way change the nature of the enterprise in which our shareholders have invested." Edith does not agree and seeks to enjoin the merger, claiming that the directors' statement is false and misleading.

Based on the foregoing, which of the following statements is most likely to be true?

- a. Whether Edith has standing depends on how many shares she owns.
- b. The statement of the board is unlikely to be material.
- c. Edith will be unable to prove that the solicitation is an essential link in accomplishing the transaction.
- d. **Answers b and c are both correct.**

(D) is correct. The statement is unlikely to be material, as the nature of the two businesses is public information and is unlikely to change a shareholders' voting behavior. It is also hard to prove the essential link, because a single shareholder (who was not the merger partner) owned enough shares to compel the merger.

Chapter 30: Fraud and Related Issues Under Rule 10b-5

Test Yourself Answers with Explanations

Questions 1- 7 rely on the following facts:

Dora is the president of El Dorado, Inc., a mining company. She is told by Edgar, an engineer for the company, that he has located a major ore strike. Unfortunately, it is on land that El Dorado does not own. He suggests that Dora attempt to acquire the land without disclosing to anyone, including El Dorado's board, the extent of the strike. Dora comes up with the idea of telling the board that the land simply will be a good real estate investment. The board balks at paying cash, but authorizes Dora to negotiate to acquire the land in exchange for shares of the company.

Unfortunately, Edgar has a drinking problem, and talks freely about the strike at a local bar. Word begins to spread and Paul, the owner of the land for which Dora is negotiating, gets wind of it. He asks if the rumor is true, but Dora denies it. As a result, he accepts shares worth \$100,000, which is what he believes to be the fair market value of the land. After the strike subsequently is announced, his shares double in value.

1. Is Edgar liable under Rule 10b-5?
 - a. No, because he is not a purchaser or seller of El Dorado shares.
 - b. No, because he is not an officer of El Dorado.
 - c. **No, because no misrepresentation is attributed to him.**
 - d. Probably so because he intentionally participated in Dora's scheme.

(C) is correct. Liability under Rule 10b-5 requires attribution of misrepresented information and Edgar told only the truth.

2. Is Dora liable under Rule 10b-5?
 - a. No, because she was acting on behalf of El Dorado.
 - b. No, because she was under no obligation to tell Paul anything about the value of his own land.
 - c. Not unless El Dorado has registered shares under the Exchange Act.
 - d. **Probably so because she engaged in intentional misrepresentation in connection with the sale of a security.**

(D) is correct. Dora's statement to Paul was false, and it was "in connection with the purchase or sale" of a security. (C) is false because Rule 10b-5 applies to purchases or sales of any security, not just those registered under the Exchange Act.

3. Is El Dorado liable under Rule 10b-5?

- a. **No, because the board did not know about the ore strike.**
- b. Not unless it has registered shares under the Exchange Act.
- c. Probably so because Dora's misrepresentation may be attributed to it.
- d. No, because Paul's shares increased in value.

(A) is most correct. Although Dora's action is within the scope of employment and therefore arguably attributed to El Dorado, El Dorado is a "control person" and probably could establish an appropriate defense under Section 20 of the Exchange Act. [NOTE: This question will be difficult to answer if the material in the online supplement about secondary liability has not been assigned.]

4. Assuming, for purposes of this question, that Dora is liable under Rule 10b-5, which of the following best describes the parties who might successfully sue her?

- a. Only the SEC.
- b. **Both the SEC and the Department of Justice.**
- c. The SEC, the Department of Justice, and Paul.
- d. Only Paul.

(B) is correct. The SEC and the Department of Justice both can sue Dora (in the Department of Justice's case because Dora's act clearly was willful). It does not appear that Paul would be able to prove causation of an injury.

5. Assuming, for purposes of this question, that El Dorado is liable under Rule 10b-5, which of the following best describes the parties who might successfully sue it?

- a. **Only the SEC.**
- b. Both the SEC and the Department of Justice.
- c. The SEC, the Department of Justice, and Paul.
- d. Only Paul.

(A) is the most correct. Given Dora's misrepresentation to the board it probably would be difficult for the Department of Justice to demonstrate willfulness on the part of the corporation. Paul would, once again, have a problem satisfying the causation requirement.

6. If you were advising Paul on the likelihood that he would prevail in a suit against Dora, you would say:

- a. He would satisfy the purchaser or seller requirement.
- b. He would satisfy the requirement that he prove reliance.
- c. **Answers a and b are both correct.**
- d. Neither answer a nor answer b is correct.

(C) is correct. Paul clearly purchased a security and he seems to have specifically factored Dora's representation about the land into account. It is, of course, loss causation that will be a problem for him (see question 7).

7. If you were advising Paul on the likelihood that he would prevail in a suit against Dora, you would say:

- a. It appears that proof of scienter would be the greatest impediment.
- b. It appears that proof of materiality would be the greatest impediment.
- c. It appears that satisfaction of the "in connection with" requirement would be the greatest impediment.
- d. It appears that satisfaction of the requirement that he prove loss causation would be the greatest impediment.**

(D) is correct. Paul's shares have increased in value and now seem to be equivalent to what he would have charged for his land had he known about the ore strike. (C) is incorrect because the in connection with requirement is easily satisfied.

Chapter 31: Trading by Insiders: Rule 10b-5

Test Yourself Answers with Explanations

Questions 1-4 are objective questions.

1. Section 10(b) of the Exchange Act
 - a. is relevant only with respect to purchases or sales of securities traded on a national securities exchange.
 - b. is relevant only with respect to purchases or sales of securities registered under the Exchange Act.
 - c. **is relevant with respect to purchases or sales of any security.**
 - d. is relevant only with respect to purchases or sales of securities registered under either the Securities Act or the Exchange Act.

(C) is correct. Section 10(b) section covers purchases or sales of any security, not just those registered under the Exchange Act.

2. P is the president of Testex, Inc., which manufactures a variety of products out of Flarp. Testex does not make Flarp itself; rather, it purchases Flarp from whichever of the three Flarp manufacturers is offering it at the best price. P has, for some times, owned a significant number of the shares of each of the three Flarp manufacturers. Testex scientists have now determined that Gloop, rather than Flarp, could be used to manufacture all Testex products. Gloop is cheaper and more resilient than Flarp, and is produced by different companies than those that produce Flarp. These findings have not been publicly announced. P suspects that once they are, other companies relying on Flarp will quickly come to similar conclusions. P immediately sells all of his shares of the Flarp manufacturers. Which of the following positions is most likely to be taken by the SEC with respect to P's activities?

- a. P has violated his duty to disclose or abstain from trading under §10(b) and Rule 10b-5 of the Exchange Act because he is a “traditional” insider of Testex.
- b. P has violated his duty to disclose or abstain from trading under §10(b) and Rule 10b-5 of the Exchange Act because he is a tippee of information relating to the Flarp manufacturers.
- c. **P has engaged in deceitful conduct in violation of §10(b) and Rule 10b-5 of the Exchange Act because he has misappropriated proprietary information belonging to Testex.**
- d. P has not violated §10(b) and Rule 10b-5 of the Exchange Act.

(C) is correct. Here, P is employed by Testex but traded in Flarp manufacturers' stocks, so he is not a traditional insider. However, based on his employment relationship with Testex, P is a fiduciary in a relationship of trust and confidence precluding him from using Testex's information for his personal benefit. Thus, P breached his fiduciary duty in connection with the sale of a security and he will be liable for insider trading.

3. Continuing the factual assumptions of Question 2, which of the following is most true?
- Persons purchasing Flarp shares on the days P sold his shares will be able to recover only if they can establish a causal connection between their purchase and his sale.
 - Persons purchasing Flarp shares on the days P sold his shares will not be able to recover, even if P violated a duty to disclose or refrain from trading.
 - Persons purchasing Flarp shares on the days P sold his shares will be able to recover, assuming he violated a duty to disclose or refrain from trading.**
 - Persons purchasing Flarp shares on the days P sold his shares will be able to recover.

(C) is correct. Section 20A of the Exchange Act provides an express private right for “contemporaneous” traders against those who violate the Act by trading in possession of material non-public information. It is not a very important provision, but it does exist. (D) is less correct than (C) because trading on material non-public information alone does not give rise to a cause of action – it has to involve a violation.

4. The liability of a tippee under §10(b) and Rule 10b-5 is
- dependent on whether the tipper was a traditional insider or a misappropriator.
 - dependent on whether the tipper breached a duty in making the tip.**
 - dependent on whether the tippee conferred a benefit on the tipper in exchange for the tip.
 - none of the above.

(B) is correct. The liability of a tippee is derivative – a tippee cannot be found liable unless the tipper breached a fiduciary duty by making the tip and for personal benefit. The personal benefit, however, need not come from the specific tippee, because once a tipper becomes liable, all tippees, either tipped by the tipper or other tippees, can be liable.

Question 5 is an essay question.

5. Jetco, a corporation whose stock is traded on a national stock exchange, has 200,000 shares of \$25 par value common stock outstanding. Dan, who owns 100 shares of Jetco stock, is a director of Jetco. Five months ago, Dan learned that Jetco had developed a secret new invention to convert organic waste to commercial fuel and that a public announcement of the invention was soon to be made. Dan immediately emailed three of Jetco’s shareholders who, Dan knew, had previously announced their willingness to sell their shares for \$22 per share, a price that was \$3 a share above book value. Dan offered them \$25 per share. They accepted his offer and sold a total of 4,200 shares to Dan. At this time, Dan also accepted, and immediately exercised, stock option rights to purchase 1,000 authorized, but previously unissued, shares from Jetco, for which he paid the option price of \$21 per share. A week later, the invention was announced, and the market value of Jetco stock rose substantially. A few days ago, Dan sold, for \$50 per share, the 4,200 shares he had

acquired from the three dissatisfied shareholders. Please devote approximately fifteen minutes to discussing Dan's potential liabilities, and to whom, as a result of the above transactions.¹

To Jetco: Dan is liable for insider trading under Rule 10(b)-5 as a traditional insider. Here, the information about the invention was non-public at the time of trading, and it was likely material as the technology was revolutionary and certain. As a director, Dan also owed a duty not to use Jetco's information for personal benefit. Dan's purchase of the 4200 shares and the option constituted a breach of his duty to Jetco by trading without disclosure.

To the three shareholders: the three shareholders may seek remedies from Dan as well. In addition to the elements discussed above, the three shareholders must show that they are the actual sellers of the stock (which they were). Since the trading was face-to-face, they would be assisted by the *Affiliated Ute* presumption with respect to causation in fact. One might think this would be overcome by Dan's showing of their earlier willingness to sell at a lower price. Most probably, the fact that he is a fiduciary trading at an informational advantage would preserve the ability of the three shareholders to invoke *Affiliated Ute*. Thus, Dan's failure to disclose the new invention and purchase of the 4200 shares also made him liable for the three shareholders' damages.

To the Securities and Exchange Commission and the Department of Justice: Because he violated Rule 10b-5 with respect to Jetco and the three shareholders, it is easy to conclude that he also could be sued by the SEC and, because his violations were willful, the Department of Justice.

¹ This question is based on one originally appearing in Siegel's *Corporations and Other Business Entities* (Theresa Gabaldon, ed., 5th ed., 2012).

Part 7 of the Supplemental Materials (Formerly Chapter 32 of the Main Text)

Trading by Insiders: Short-Swing Trading Under §16(b)

Test Yourself Answers with Explanations

1. Short-swing trading under §16(b) is:
 - a. Criminal.
 - b. Criminal only if it is willful.
 - c. Only a civil violation of the Exchange Act.
 - d. **Not a violation of the Exchange Act.**

(D) is correct. Section 16(b) does not make short-swing trading illegal, but only makes profits from short-swing trading forfeit to the issuers.

2. Trades that must be reported under §16(a):
 - a. **Include only trades of the equity securities of an issuer that has registered a class of equity securities under the Exchange Act.**
 - b. Include only trades of the securities of an issuer that has registered a class of securities under the Exchange Act.
 - c. Include only trades of the equity securities of an issuer that has registered a class of any securities under the Exchange Act.
 - d. Include only trades of the securities of an issuer that has registered a class of equity securities under the Exchange Act.

(A) is correct. Section 16(a) obligations are triggered by the registration of an equity security but relate to trades in all the issuer's equity securities, not just those that are registered.

3. For purposes of §16:
 - a. "Equity security" includes an instrument convertible into an equity security.
 - b. "Equity security" includes an option to acquire an equity security.
 - c. **Both answer a and answer b are correct.**
 - d. Neither answer a nor answer b is correct.

(C) is correct. Equity security, for purposes of §16, includes derivative securities, such as options, and instruments convertible into equity securities.

4. If a trade is reported under §16(a):

- a. It is exempt from matching for §16(b) purposes.
- b. It will result in the disgorgement of profit for §16(b) purposes.
- c. It is eligible for matching under §16(b).
- d. **It is not necessarily eligible for matching under §16(b).**

(D) is correct. A registered trade under §16(a) generally will be eligible for matching, but this is not the case for a transaction that results, for the first time, in reporting by a holder of more than 10% of the relevant security.

5. Quizco, Inc., owns nine percent of the common stock of Exam Corp. The class is registered under the Exchange Act. Veronica, one of Quizco's vice presidents, sits on the board of directors of Exam Corp. Which of the following is most true?

- a. Quizco does not have to file reports under §16(a).
- b. Quizco does have to file reports under §16(a).
- c. Whether Quizco has to file reports depends on whether Veronica owns at least one percent of Exam Corp.'s common stock.
- d. **Whether Quizco has to file reports depends on whether Veronica is representing its interests when she sits on Exam Corp.'s board.**

(D) is correct. Quizco, as a beneficial owner, does not have a reporting duty under §16(a) unless it owns at least 10% of Exam Corp.'s equity stock. However, if Veronica is acting as Quizco's "deputy," Quizco is regarded as itself a director and thus must report.

6. On January 2, 2018, Priscilla purchased five percent of the shares of Hypoxico. The shares are part of a class registered under the Exchange Act. On February 1, 2018, Priscilla, who previously had no position with Hypoxico, is elected as its president. On March 1, 2018, she purchases an additional six percent of Hypoxico's shares. On April 1, she sells two percent. On May 1, she is fired. On June 1 she sells all of her remaining Hypoxico shares. Which of her transactions are subject to matching under §16(b)?

- a. All of them.
- b. None of them.
- c. **All transactions after she became president of Hypoxico.**
- d. All transactions while she was president of Hypoxico.

(C) is correct. Any transactions before Priscilla became the president would not be subject to the reporting requirement because she only had 5% of the shares. Her reporting duty started when she became the president. Because sales after she is fired may also involve use of nonpublic information, they are regarded as matchable for six months.

7. Which of the following best describes the rule for when a shareholder may sue under §16(b)?

- a. She must have been a shareholder at the time the transactions giving rise to §16(b) liability occurred.

- b. She must have been a shareholder at the time at least one of the transactions giving rise to §16(b) liability occurred.
- c. She must have been a shareholder at the time at least one of the transactions giving rise to §16(b) liability occurred and at the time her lawsuit is filed.
- d. **She must be a shareholder at the time the lawsuit is filed.**

(D) is correct. Courts have been taking a liberal approach and allow individuals to sue even if they purchased shares after the short-swing trading occurred. In other words, as long as the individuals have the stock at the time of filing the lawsuit, they have standing.

8. Which of the following best describes the method for calculating the amount of §16(b) profit a defendant has earned within a less than six month period?

- a. Whichever method results in the highest figure.
- b. **Matching the lowest purchase price with the highest sales price until all available matches are made.**
- c. Matching actual shares when possible, then matching the lowest purchase price with the highest sales price until all available matches are made.
- d. Calculating the total sales price for the period and deducting the total purchase price for the period.

(B) is correct. It also generally represents the method that results in the highest figure, so (A) is the second best answer.