Exam No. 726

Business Associations

Professor Michael Kang
Spring 2006

Return this exam and your answers before 3 p.m. today.

FINAL EXAM

This is an open-book examination. However, your answers must be entirely your own work. References to material that was not read or discussed in class will not strengthen your answer. You may not discuss the examination with anyone until the expiration of the exam period. These rules will be strictly enforced.

You are free to take this exam here in Room 5F, where you have picked up the exam, or you may leave the room and take the exam elsewhere. In either case, however, you must return the exam and your answers to Room 5F by 3 p.m. (or, if you return your exam before 2:30 p.m., you should return your exam and answers to Judith Taylor in Room G561).

- YOUR ANSWERS MUST NOT EXCEED 3500 WORDS, WITH ONE-INCH MARGINS IN TWELVE-POINT TIMES ROMAN FONT – *i.e.,* ABOUT FOURTEEN DOUBLE-SPACED PAGES. Double space your answers, begin each question on a new page, and paginate your answer. Feel free to use defined terms or abbreviations as appropriate.

- YOUR ANSWERS MUST BE SUBMITTED IN ELECTRONIC FORMAT ON THE DISK PROVIDED TO YOU.

- WRITE YOUR EXAM NUMBER OF EACH PAGE OF YOUR EXAM, YOUR EXAM ANSWERS, AND THE DISK ITSELF. In addition, write on the disk the electronic format in which your answers are written (Wordperfect, Word, Mac).

- RETURN YOUR EXAM AND THE DISK CONTAINING YOUR EXAM ANSWERS IN THE ENVELOPE PROVIDED TO YOU WITH THIS EXAM.

If you believe an important fact has been omitted, please make a reasonable assumption with respect to that fact, state that assumption explicitly, and answer the question on that basis. Similarly, if you believe the question is ambiguous, identify the ambiguity explicitly, make a reasonable assumption about how to resolve it, and answer the question on that basis. Please also discuss relevant, non-frivolous arguments that you ultimately decide to discard and state your reasons for discarding them.

There are three sections of the exam. I have denoted the points (out of 100 total points) allocated to each section. Unless otherwise indicated, you may assume that the Uniform Partnership Act (1914) and Model Business Corporation Act (1984) applies.

Exam No. ________________

Question 1 (30 points)

Frank is an irascible mechanic who restores old automobiles as a hobby and co-owns a run-down Chevrolet Camaro with his friend Sara. Sara eventually convinces Frank that they should "go into business" and restore their Camaro. Without putting anything into writing, Frank and Sara agree orally to call their business "Camaro Crazies," serve as co-presidents of the company, and share any profits. Sara tells Frank, though, that Frank must get Sara's approval for any purchase of greater than $500 on behalf of Camaro Crazies. Frank agrees and begins work on the Camaro.

Rich, another of Frank's friends, sees the Camaro and is impressed by the work in progress. Rich asks Frank if he would be interested in rebuilding Rich's Ford Mustang. Rich explains that the Mustang is a rare model, particularly valued by car collectors. Rich proposes that he and Frank "partner up" and rebuild the Mustang. Impressed with himself, and deep into his work on the Camaro, Frank realizes that Sara has done almost no work for Camaro Crazies. Frank demands that he receive 2/3 of the profit on resale of the Camaro. Sara ignores him and never responds to Frank's protestations. Frustrated by Sara, Frank secretly works on Rich's Mustang, which later ends up making tons of money. Frank also hires Mike as an assistant to help him finish the work on the Camaro.

In the course of working on both cars, Frank makes two significant purchases on credit. The first purchase is a $1000 purchase from Bederman Auto Shop for new tires to be added to the Camaro. The second purchase is a $500 purchase from Shanor Hardware for a set of Mustang-specific parts that Frank installs on the Mustang. For both purchases, Frank tells the vendors that he is purchasing for Camaro Crazies and signs the contracts as co-president of the company. Frank, however, never pays the bills from Bederman Auto Shop and Shanor Hardware. After giving up on obtaining payment from Frank, both vendors angrily pursue Sara for payment of the bills.

Frank completes work on the Camaro, but unfortunately, it sells for far less than expected. Even before accounting for the outstanding bills from Bederman Auto Shop and Shanor Hardware, Camaro Crazies suffers a $1000 loss on the Camaro and has no assets after the sale. Sara is angry with this outcome, but she is even angrier when she hears that while Mike was delivering the Camaro to the purchaser, he recklessly drives into and injures a pedestrian. Sara is so angry that she demands that Frank begin work right away on a new project—another old, run-down Camaro. Sara explains that we need to work quickly "if we're going to make Camaro Crazies a successful business." Frank, though, refuses to continue working with Sara and leaves the country.

Please identify and analyze the strengths and weaknesses of the potential claims by and against the various parties.

Exam No. ________________

Question 2 (45 points)

All-Star Drilling, Inc. ("All-Star") is a large publicly-traded company that specializes in drilling for oil. All-Star has been and continues to be very profitable. It developed a proprietary technique, called the All-Star Special, for detecting underground oil deposits that gives All-Star a competitive advantage over the rest of the oil drilling industry. Ozzie serves as All-Star's chief executive officer and chairperson of the board. His children Jenny and Bobby still serve on the All-Star board with Ozzie and worked as All-Star officers for many years.

Five years ago, Jenny and Bobby decided that they want to run their own company, Championship Mining, Inc. ("CMI"), specializing in the mining of Soxite, a very rare mineral. Jenny and Bobby, as the initial shareholders, agreed at the outset that they would always use their best efforts to keep each other as directors and officers of CMI, with Jenny as chief executive officer and chairperson of the board. Jenny and Bobby agreed to add their mutual friend and fellow All-Star director Freddy as the third director of the three-person board of CMI.

CMI quickly attracted investment and became a publicly-traded company on the New York Stock Exchange. At the time, the promising new industry of Soxite mining attracted investors to CMI. In fact, All-Star invested and holds 51 percent of CMI's shares. However, the entire industry, including CMI, stalled when no one was able to develop a reliable technique for detecting Soxite from above ground. While Soxite remains a valuable commodity, CMI has never attained profitability and now has thousands of unhappy shareholders. Under the strain of CMI's struggles, Jenny and Bobby drift apart personally. Bobby has been urging Jenny to expand CMI's operations beyond Soxite mining, which looks like a losing industry. However, Jenny and Freddy refuse to consider Bobby's arguments. They feel that their credibility as businesspeople is on the line and want desperately for their investments in Soxite mining to pay off. At Jenny's suggestion, Jenny and Freddy vote to remove Bobby as an officer, though Bobby remains as a CMI director.

On January 1, Jenny visits Ozzie at an All-Star worksite, and they make an amazing discovery. Workers have accidently unearthed a huge deposit of Soxite near All-Star's oil wells. After checking other drill sites, Jenny and Ozzie realize that the All-Star Special technique for detecting oil seems, inexplicably, to find oil deposits that also happen to have Soxite deposits in the vicinity. Jenny and Ozzie report this information to the All-Star and CMI boards, but otherwise the discovery is kept confidential.

On January 15, the All-Star board of directors quietly begins preparing a proposal for a cash merger with CMI. Jenny tells the other directors of All-Star that CMI's operations would "take off like a rocket" if the All-Star Special technique successfully helps to detect Soxite deposits. Jenny asks CMI senior officers to prepare an appraisal of CMI assets, and she passes along the appraisal to the All-Star board. On January 20, the All-Star board decides that CMI stock, which is trading at $10 per share, is worth $10 to $16 per share, but that CMI shareholders would approve the merger at $12 per share. Jenny agrees that $12 per share is "fair," but she realizes that Delaware law of fiduciary duty will apply and suggests that $13 per share "is safer and still a good deal for us." Jenny also hires Lamarr & Hoyt, an investment bank, to issue a fairness opinion for CMI to consider. On January 22, Lamarr & Hoyt confirms in its fairness opinion that $13 per share is a "fair price" for CMI shares.

On January 23, Jenny formally presents the All-Star merger agreement to the CMI board with a price per share of $13. Under the merger agreement, CMI's minority shareholders would receive $13 per share for their CMI shares, and CMI would merge into All-Star. Among other things, the merger agreement requires approval by a majority of the CMI shares not owned by All-Star or All-Star directors. The three-person CMI board immediately and unanimously votes to recommend CMI shareholder approval of All-Star's merger agreement.

Jenny works late on January 23 to prepare a public announcement of the merger agreement, to be released the following morning of January 24, at 9:00 a.m. CMI thus far had not disclosed anything to the public about Jenny's January 1 discovery or the possibility of a merger. Jenny calls her husband, a police officer named Harry, to let him know that she will need to miss dinner with him because she finishing work on the "secret merger." After getting off the phone with Jenny, Harry instructs his broker to purchase CMI shares at 9:30 a.m., the market opening, on January 24. After Jenny's public announcement, CMI's share price jumps to $12.75.

On January 25, CMI mails out proxy materials to its shareholders recommending approval of the merger agreement with All-Star. CMI's proxy statement explains that CMI's board, after careful consideration, recommends approval of the merger price offered by All-Star as "comparable to the highest trading prices ever obtained by the top companies in the industry." The proxy materials do not describe the CMI directors' relationships with All-Star. On May 1, CMI's shareholders vote overwhelmingly to approve the merger agreement.

Please identify and analyze the strengths and weaknesses of the potential claims by and against the various parties.

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Question 3 (25 points total; each pairing weighted equally)

The two majority opinions in each pairing listed below represent different approaches to issues of corporate law. Although there are important factual distinctions between the cases, the opinions of each pairing are based on divergent premises about the priorities and limitations of corporate law.

For the pairings of majority opinions below, (a) <u>identify the most important disagreement</u> between the legal approaches taken by the opinions in each pairing; and then (b) <u>identify which approach in each pairing you favor and justify your choice</u> (you may provide rationales not given in the opinions themselves).

Do not simply describe differences in the facts or holdings of these cases. Indeed, you need not describe the facts or holdings—you can assume that I know them.

Pairing A: *Litwin v. Allen* (casebook p. 670) &
Brehm v. Eisner (casebook p. 769)

Pairing B: *McQuade v. Stoneham* (casebook p. 418) &
Galler v. Galler (casebook p. 423)

Pairing C: *Bartle v. Home Owners Coop.* (casebook p. 254) &
DeWitt Truck Brokers v. W. Ray Flemming Fruit Co. (casebook p. 256)

Please complete your exam by filling out the following statement:

"I certify that my exam answer contains _______ words, as counted using Microsoft Word/WordPerfect/Other (specify) ____________________."

END OF EXAMINATION

Q1. Sara has claims against Frank within the partnership. Because partnership agreements do not have to be in writing, she likely can succeed in demonstrating that a partnership existed. Sharing of profits is prima facie evidence of the existence of a partnership. UPA§7(4). Sara has both the *power* and the *right* to petition a court dissolve the partnership, based on Frank's breach of the partnership agreement (plus his departure from the country makes it "not reasonably practicable to carry on the business in partnership with him," and likely worked a dissolution itself.) UPA§32(d). Dissolution, winding-up and termination would limit additional liability against Sara and the partnership.

When Frank agreed to work with Rich on the Mustang without Sara's knowledge, he violated his fiduciary duty to the partnership. *Cf. Meinhard*. The Mustang job resulted from Frank's work on the Camaro within the partnership, and Frank used the partnership to obtain credit to purchase parts for the Mustang. Frank incurred further partnership costs by hiring Mike to work for in the Camaro, likely because Frank was spending time on the Mustang. Thus, profits resulting from that transaction are held in trust for the partnership. UPA§21(1). Unfortunately, with Frank out of the country, likely with all his assets, it will be difficult to collect.

Sara *may* attempt a claim against Rich, as an inadvertent partner. Rich formally proposed "partnering" with Frank to renovate the Mustang. If Rich *knew* that Frank's work was conducted under the auspices of Camaro Crazies (which the facts do not state), this would create greater weight for Sara's argument that he became an inadvertent partner. Assuming also that Rich enjoyed a portion of the profits from the sale of the Mustang, this again provides prima facie evidence of a partnership. Since the profits would not be payment for any debt, or wages, or other such evidence rebutting the inference, Rich would have a difficult time refuting partnership. Finally, the fact that Frank used partnership resources to work on the Mustang is a strong count in Sara's favor. If Sara succeeded here, Rich must disgorge his portion of the profits to the partnership, and Sara may interplead him on other claims, described *infra*.

Both retailers have claims against the partnership, and Sara and Frank jointly and severally (and perhaps also Rich). UPA§15. While the $1000 purchase on credit was beyond Frank's actual authority, partnerships are nonetheless bound by acts as partners as agents as long as (a) the partner acts with the scope of his apparent authority, and (b) the third party has no knowledge of the limitations of the partner's authority. UPA§9. If Bederman lacked knowledge of the limitation, this applies. Although the $500 credit was within Frank's scope of authority, Sara might argue that since the purchase was for the Mustang, and thus outside the work of the partnership. However, if Sara argues *supra* that she is entitled to a portion of the profits from the Mustang as business of the partnership, she may be estopped from disclaiming the project for purposes of liability. Furthermore, the partners are jointly and *severally* liable for a partner's *misapplication* of partnership money or property, as long as the partner was acting within the scope of his apparent authority, which would apply the Mustang parts. UPA§14. Since Frank claimed that the purchases were on behalf of Camaro Crazies and signed the contract based thereon, the vendors likely will be successful in their claim. Finally, well after the purchases were made, Sara pressed Frank to work on a new Camaro to help "make Camaro Crazies a successful business." Thus, it was clear that the partnership was continuing at the time the purchases were made.

Since the partnership itself has no assets, Sara (assuming solvency) will be jointly liable for the entire claim, although suit must be against *all* partners as necessary parties. Likewise, the partnership and the partners are all jointly and severally liable for the pedestrian's injuries caused by Frank's wrongful act of reckless driving, as long as Frank's delivery of the car can be considered "within the ordinary course of business of the partnership." UPA§§13,15.

The facts do not state whether the partnership owes any back wages to Mike, the assistant (NOT a partner). The partnership could not disclaim such costs. Frank had apparent and actual authority to hire Mike, because the only restriction of his actual authority related to purchases on credit.

Although out of the country, Frank may attempt to defend any claim against him (if he left any assets back home). He may press the claim that he deserves 2/3 of the profits on the resale of the Camaro, since he did virtually all of the work for the company. The Camaro itself became partnership property, and by default was owned equally by all partners. Although the default rule is that profits are shared equally among partners, that rule can be contracted around by consent of the partners. Because the breakdown of profits remained unstated at the beginning of the partnership, the default rule applied. Frank's demand after the partnership had begun was a change in the terms of the partnership, which needs unanimous agreement by all partners. Frank could argue that Sara's silence was consent here. Frank would be unwise to do so, however, whereas Sara would likely profit from that claim—the default rule is that while profits are split 50/50, *losses* are allocated *the same way as profits*. Thus, Frank would be responsible for 2/3 of the losses, as well. It is unclear how Rich's addition to the numbers would affect this break-down.

Frank may also claim that he deserves compensation for all the work he contributed to the partnership, particularly since Sara contributed little to the partnership. Unfortunately for Frank, in the absence of an agreement otherwise, partners are not entitled to payment for services.UPA§18(f).

Q2. Bobby may sue Jenny for breach of a shareholder agreement for Jenny's vote to remove Bobby as an officer of CMI, albeit unsuccessfully. Both had agreed to use their best efforts to keep each other as directors and officers. While the agreement to vote for one another as officers is enforceable, their agreement to keep each other as *officers* likely is not, because it would restrain them, as directors, from acting in the best interest of the corporation. *McQuade*.

Shareholders may sue the directors derivatively for violations of fiduciary duty, and directly for proxy fraud under Rules 10 and 14. Each claim will be evaluated in turn, and the fact that some of the same facts apply to both common law and statutory claims does not prejudice any of them (*see SEC v. Nat'l Sec., Inc.*)

The first claim relates to the board's initial refusal to diversify CMI's operations. Assuming standing and after making a demand on the board (MBCA§7.41 et seq.), shareholders (including Bobby) may charge that the board violated its fiduciary duty by refusing Bobby's suggestions. Jenny and Freddy's concerns about their personal credibility appear to be personal, and not professional. However, courts are generally reluctant to probe deeply into a board's discretion, and wanting investments in Soxite to pay off may be a sufficient business purpose to justify a court applying the business judgment rule, thus defeating this claim.

A derivative action regarding the fairness of the merger, based on violations of the duties of care and loyalty, is likely to succeed. With regard to the duty of loyalty claim, All-Star was a majority shareholder, and Jenny was a director with both companies. Under Delaware law, self-dealing transactions can be validated *either* if they pass the rigors of § 144, *or* they pass the standard of fairness. Although the one independent director *did* ratify the transaction, this ratification was not undertaken with full disclosure by the conflicted party (*see infra*). The conflicts of interests between All-State, Jenny and Bobby, on the one hand, and CMI on the other, were not disclosed in the proxy materials to the shareholders. Delaware law does not create a true safe-harbor; rather, it creates a *presumption* of fairness, and shifts the burden to the shareholders to demonstrate that the transaction was *not* fair. The shareholders probably can meet this burden.

Under *Weinberger v. UOP*, the transaction must meet both prongs of the total fairness standard: fair dealing and fair price. Fair dealing includes a duty of candor from all conflicted directors to both companies. Jenny did not disclose to the CMI board that All-Star valued CMI stock at up to $16. While apparently shared the fairness opinion with the CMI board, there is no evidence that she disclosed that it took only two days to prepare, and it simply affirmed the price that All-Star had already proposed. Although directors are generally entitled to rely on the advice of outside experts, MBCA§8.30/Del.C.L.§144, here it was unreasonable to do so given the quality of the assessment. The CMI board simply reviewed and accepted the offer, without any attempt at negotiation. Neither the conflicts of interest nor the quality of the process were disclosed to the shareholders (in fact, the proxy statement indicated that there was "careful consideration" by the CMI board, which is belied by the facts.) Whether her statement to All-Star about CMI's operations "tak[ing] off" if the technology worked constituted insider information related to All-Star is a closer call; it was such a general statement of opinion, and so obvious based on her disclosures to *both* boards, that it likely didn't violate Jenny's duty of loyalty to CMI.

Finally, there is no indication that the proxy statement revealed that All-Star's technology may detect Soxite deposits as well. This fact would be material to shareholders' determination of whether $13 is a fair price for the shares.

Factors in CMI and Jenny's favor include (1) the appraisal of CMI assets was conducted by non-conflicted CMI insiders, (2) Jenny suggested a price of $13, rather than $12 per share; and (3) the price was supported by an outside appraisal. It is unlikely, however, that these simple facts will overcome violations of duty of loyalty, based on *Weinburger*.

Courts are even more interested to ensure that shareholders receive a fair price. All-Star itself determined that up to $16 would have been a fair offer based on CMI's own appraisal of its assets; thus, the price of only $13 was *not* the best price that shareholders could receive for their shares. The fact that shares immediately rose to $12.75 upon announcement of the merger agreement supports the idea that $13 was too low. CMI never counter-offered the price, which is an additional problem. Although Delaware law has abandoned the additional business purpose test, a court would likely order a new evaluation based on a multiplier of cash flow. Shareholders would be able to recover the difference between the price they received and the price that the court determined was "fair" for the transaction.

A duty of care claim would entail many of the same facts as those related to the poor process that the board used to approve the merger, detailed *supra*. The facts here are similar to those under *Smith v. Van Gorkom*, in which the court found that the board did not act with sufficient information adequately to make an informed business decision. By devoting insufficient time to agreeing to the buy-out, as well as not examining the process by which the price was set, the board likely violated a duty of care by its process. While one remedy may be rescission of the merger, a more likely settlement would be the same as above, which was how Jay Pritzker went about settling the precedent case—giving the shareholders more money.

Shareholders also have a private right of action under 14a-9 for proxy fraud. *Borak*. The proxy solicitation mailed out on Jan. 25 contained both false and misleading statements of material fact, as well as omissions of material fact. The assertion that CMI's board engaged in "careful consideration" suggests that it actually examined the offer and discussed the merits and demerits; instead, it immediately approved it the same day it was presented. There is a "substantial likelihood that a reasonable shareholder would consider [this fact] important in deciding how to vote" on the merger agreement, meaning that the fact was material. *TSC*. The statement that the price is "comparable to the highest trading prices ever obtained by the top companies in the industry" is likewise misleading. While CMI might suggest that this is merely opinion, it is similar to the statement in *Virginia Bankshares* that the Supreme Court said give a factual impression to the reader about the basis for this opinion. There is no evidence backing up the assertion; companies cannot simply make up "facts" or assert baseless opinions, without misleading shareholders. CMI was guilty of material omission by not disclosing CMI directors' relationships with All-Star. CMI may also be liable for omission if in fact the proxy statement did not indicate that a technology of All-Stars could help identify new Soxite deposits. Causation is clear because the misstatement was material to the shareholder vote, and the merger agreement required that a majority of non-All-Star shareholders approved it. *Mills*.

Shareholders also could claim a 10b-5 violation based on fraud (as there is also a private right of action under 10b-5). Standing is based on their sale of stocks. *Birnbaum*. As in *Basic*, CMI's proxy statements contained both material misstatements as well as omissions, and here CMI was under an affirmative duty to provide all material information. Thus, the omissions were also misleading, and therefore fraudulent. Causation is stronger than simply a fraud-on-the-market theory, particularly if *Mills* can be applied to 10b-5 cases. It would be fairly easy to make the claim that CMI's claims in the proxy statement led directly to shareholders' approval of the buy-out offer. Finally, scienter must be demonstrated (*Ernst & Ernst*). Jenny clearly *knew* that her statements regarding the trading prices were misleading, since she was aware that All-Star found up to $16 a fair price. Furthermore, she knew, or should have known, that the omissions were material.

The closest call comes with a claim of violation of 10b-5/14e-3 trading on confidential material information, the latter restricted to tender offers (which this was), with regard to Harry's instructions to buy CMI stock. Analyzed as a tipping case, there likely is *not* liability. Jenny did not reveal the information to gain any personal benefit, either pecuniary or reputational. While it may have been bad judgment to tell her husband the reason she would miss dinner, she did not violate a fiduciary duty by doing so (cases finding insiders liable for tipping to *mistresses* notwithstanding). Since tippee liability is derivative of tipper liability, neither could be found here.

Harry *may* have violated 10b-5 through misappropriation, however. As a family member, he is in a confidential relationship with Jenny. 10b-5(2). He may have violated that duty by telling his broker to buy shares at the opening of the market. Violation of fiduciary duty is unnecessary to make out a 14e-3 claim, which requires only that a recipient of confidential material inside information in advance of a tender offer must abstain from trading in either the acquirer or the target's stock. Harry knew that the information was confidential, as Jenny told him as much. Between Ginsberg's formulation and the SEC's later definition, causation is demonstrated simply by Harry's trading while aware of the information; the instructions to his broker were not standing ones. The biggest difficulty is timing. The trades *may* have taken place *after* the information had been effectively disclosed in a manner sufficient to insure its availability to the general public, since the announcement was made at 9:00am, 30 minutes before the markets opened. However, Harry had no way of knowing when the news would hit the market, and thus is likely still liable. It is unclear what damages would be, however; if Harry purchased at the same price that the rest of the market did upon learning of the merger, there would be no profits to disgorge.

Q3. A.

The biggest difference in legal approach between *Litwin v. Allen* and *Brehm v. Eisner* lies in the amount of deference and discretion the court is willing to grant a company in governing its internal affairs. In *Litwin*, the court does not even discuss the business judgment rule, but rather looks deeply into the *merits* of the business decision that the board of directors made. In *Brehm*, the court focused solely on the *process* by which the board undertook its decision.

While a shareholder would likely prefer the outcome in *Litwin* to that in *Brehm*, the approach in the latter is preferable in the end, at least based on the goals of corporate law. Looking behind a board's decision carries risks, such as hindsight bias; discourages risk-taking behavior, which corporate law is designed to promote; and may end up preventing good, well-qualified individuals from being willing to serve on corporate boards. Finally, judges and juries are usually not experienced enough in business matters adequately to undertake a sufficient analysis in place of that of the board. Looking solely at the process as in *Brehm* provides a more standard baseline for analysis, and ensures that the court does not replace the board's reasoned judgment with its own, or that of shareholders, who have no authority to make decisions based on the day-to-day running of the business.

This issue highlights some of the flaws of corporate law and the corporate structure in general, such as the principal/agent problem. While the shareholders are the ultimate owners of the company, they do not have the expertise or the information to understand and make the best decisions on behalf of the company, while at least in theory the directors do. Directors, however, often lack the *incentives* to undertake business decisions that are in the best interest of the company, in the absence of liability for bad decisions. A strongly deferential business judgment rule insulates the directors from liability in all but the most egregious cases.

Q3(B)

The courts in *McQuade* and *Galler* differed in the extent that they would uphold shareholder agreements in close corporations. The Court in *McQuade* refused to enforce any portion of the shareholder agreement that impinged on a director's discretion, as a violation of a director's fiduciary duty. In *Galler*, on the other hand, the Court recognized and held binding virtually all of the shareholder agreement, as a valid contract, despite any infringement on director discretion that certain of the provisions might have caused. The court justified its treatment because the corporation was closely held.

Limited to close corporations, the *Galler* court probably has a better approach, to the extent that such agreements do not jeopardize minority shareholder interests who are not party to the shareholder agreements in the company. The latter concern is minimized by corporate requirements to disclose fully in the Articles of Incorporation and any shares the extent of any limitations on the board that shareholder agreements entail. Furthermore, any investor in a close corporation likely will look carefully at the company's structure and management before investing in it.

Upholding reasonable shareholder agreements that do not harm the corporation upholds several important interests: freedom of contract, and investor expectations. Shareholders freely contract with one another in shareholder agreements. By definition, shareholders are investors; shareholder agreements define their expectations in affiliating themselves with a close corporation. Allowing a party to *violate* an agreement at will, knowing that a court will not enforce it, undermines the certainty that contracts provide and discourages private investment in close corporations.

Q3(C)

The majority in *Bartle* refused to look behind the company's business transactions and the lack of fraud therein into the way that it actually functioned to determine whether piercing was appropriate. *DeWitt* explicitly looked at "reality and not form, with how the corporation operated and the individual defendant's relationship to that operation." *Id.*

Although the facts make each case distinguishable (with fraud more evident in *DeWitt*), and arguably the cases are not incompatible, the latter court's willingness to look more deeply into corporate affairs to determine whether piercing is appropriate is a better approach for corporate law. Although the corporate form was created to insulate individuals from liability, and therefore to promote entrepreneurial risk-taking, its *abuse* through fraud undermines these same goals. The corporate form is merely a legal construct, and not an automatic, comprehensive shield. If it could be used to allow fraud, the corporate form would discourage trust and risk-taking in the marketplace, by forcing all economic actors to undertake risk analyses and extensive due diligence in order to avoid fraudulent transactions as well as derivative claims by shareholders. Furthermore, there is virtually no way to avoid actual fraud, regardless of the extent of due diligence that a party may exercise; the law must provide a remedy, and place the cost on the defrauding party, as a proper incentive.

I certify that my exam ***answer*** contains 3,492 words, as counted using Microsoft Word.

Exam No. 3714

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Professor Michael Kang
Spring 2006

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Question 1 (30 points)

Frank is an irascible mechanic who restores old automobiles as a hobby and co-owns a run-down Chevrolet Camaro with his friend Sara. Sara eventually convinces Frank that they should "go into business" and restore their Camaro. Without putting anything into writing, Frank and Sara agree orally to call their business "Camaro Crazies," serve as co-presidents of the company, and share any profits. Sara tells Frank, though, that Frank must get Sara's approval for any purchase of greater than $500 on behalf of Camaro Crazies. Frank agrees and begins work on the Camaro.

Rich, another of Frank's friends, sees the Camaro and is impressed by the work in progress. Rich asks Frank if he would be interested in rebuilding Rich's Ford Mustang. Rich explains that the Mustang is a rare model, particularly valued by car collectors. Rich proposes that he and Frank "partner up" and rebuild the Mustang. Impressed with himself, and deep into his work on the Camaro, Frank realizes that Sara has done almost no work for Camaro Crazies. Frank demands that he receive 2/3 of the profit on resale of the Camaro. Sara ignores him and never responds to Frank's protestations. Frustrated by Sara, Frank secretly works on Rich's Mustang, which later ends up making tons of money. Frank also hires Mike as an assistant to help him finish the work on the Camaro.

In the course of working on both cars, Frank makes two significant purchases on credit. The first purchase is a $1000 purchase from Bederman Auto Shop for new tires to be added to the Camaro. The second purchase is a $500 purchase from Shanor Hardware for a set of Mustang-specific parts that Frank installs on the Mustang. For both purchases, Frank tells the vendors that he is purchasing for Camaro Crazies and signs the contracts as co-president of the company. Frank, however, never pays the bills from Bederman Auto Shop and Shanor Hardware. After giving up on obtaining payment from Frank, both vendors angrily pursue Sara for payment of the bills.

Frank completes work on the Camaro, but unfortunately, it sells for far less than expected. Even before accounting for the outstanding bills from Bederman Auto Shop and Shanor Hardware, Camaro Crazies suffers a $1000 loss on the Camaro and has no assets after the sale. Sara is angry with this outcome, but she is even angrier when she hears that while Mike was delivering the Camaro to the purchaser, he recklessly drives into and injures a pedestrian. Sara is so angry that she demands that Frank begin work right away on a new project—another old, run-down Camaro. Sara explains that we need to work quickly "if we're going to make Camaro Crazies a successful business." Frank, though, refuses to continue working with Sara and leaves the country.

Please identify and analyze the strengths and weaknesses of the potential claims by and against the various parties.

Exam No. ________________

Question 2 (45 points)

All-Star Drilling, Inc. ("All-Star") is a large publicly-traded company that specializes in drilling for oil. All-Star has been and continues to be very profitable. It developed a proprietary technique, called the All-Star Special, for detecting underground oil deposits that gives All-Star a competitive advantage over the rest of the oil drilling industry. Ozzie serves as All-Star's chief executive officer and chairperson of the board. His children Jenny and Bobby still serve on the All-Star board with Ozzie and worked as All-Star officers for many years.

Five years ago, Jenny and Bobby decided that they want to run their own company, Championship Mining, Inc. ("CMI"), specializing in the mining of Soxite, a very rare mineral. Jenny and Bobby, as the initial shareholders, agreed at the outset that they would always use their best efforts to keep each other as directors and officers of CMI, with Jenny as chief executive officer and chairperson of the board. Jenny and Bobby agreed to add their mutual friend and fellow All-Star director Freddy as the third director of the three-person board of CMI.

CMI quickly attracted investment and became a publicly-traded company on the New York Stock Exchange. At the time, the promising new industry of Soxite mining attracted investors to CMI. In fact, All-Star invested and holds 51 percent of CMI's shares. However, the entire industry, including CMI, stalled when no one was able to develop a reliable technique for detecting Soxite from above ground. While Soxite remains a valuable commodity, CMI has never attained profitability and now has thousands of unhappy shareholders. Under the strain of CMI's struggles, Jenny and Bobby drift apart personally. Bobby has been urging Jenny to expand CMI's operations beyond Soxite mining, which looks like a losing industry. However, Jenny and Freddy refuse to consider Bobby's arguments. They feel that their credibility as businesspeople is on the line and want desperately for their investments in Soxite mining to pay off. At Jenny's suggestion, Jenny and Freddy vote to remove Bobby as an officer, though Bobby remains as a CMI director.

On January 1, Jenny visits Ozzie at an All-Star worksite, and they make an amazing discovery. Workers have accidently unearthed a huge deposit of Soxite near All-Star's oil wells. After checking other drill sites, Jenny and Ozzie realize that the All-Star Special technique for detecting oil seems, inexplicably, to find oil deposits that also happen to have Soxite deposits in the vicinity. Jenny and Ozzie report this information to the All-Star and CMI boards, but otherwise the discovery is kept confidential.

On January 15, the All-Star board of directors quietly begins preparing a proposal for a cash merger with CMI. Jenny tells the other directors of All-Star that CMI's operations would "take off like a rocket" if the All-Star Special technique successfully helps to detect Soxite deposits. Jenny asks CMI senior officers to prepare an appraisal of CMI assets, and she passes along the appraisal to the All-Star board. On January 20, the All-Star board decides that CMI stock, which is trading at $10 per share, is worth $10 to $16 per share, but that CMI shareholders would approve the merger at $12 per share. Jenny agrees that $12 per share is "fair," but she realizes that Delaware law of fiduciary duty will apply and suggests that $13 per share "is safer and still a good deal for us." Jenny also hires Lamarr & Hoyt, an investment bank, to issue a fairness opinion for CMI to consider. On January 22, Lamarr & Hoyt confirms in its fairness opinion that $13 per share is a "fair price" for CMI shares.

On January 23, Jenny formally presents the All-Star merger agreement to the CMI board with a price per share of $13. Under the merger agreement, CMI's minority shareholders would receive $13 per share for their CMI shares, and CMI would merge into All-Star. Among other things, the merger agreement requires approval by a majority of the CMI shares not owned by All-Star or All-Star directors. The three-person CMI board immediately and unanimously votes to recommend CMI shareholder approval of All-Star's merger agreement.

Jenny works late on January 23 to prepare a public announcement of the merger agreement, to be released the following morning of January 24, at 9:00 a.m. CMI thus far had not disclosed anything to the public about Jenny's January 1 discovery or the possibility of a merger. Jenny calls her husband, a police officer named Harry, to let him know that she will need to miss dinner with him because she finishing work on the "secret merger." After getting off the phone with Jenny, Harry instructs his broker to purchase CMI shares at 9:30 a.m., the market opening, on January 24. After Jenny's public announcement, CMI's share price jumps to $12.75.

On January 25, CMI mails out proxy materials to its shareholders recommending approval of the merger agreement with All-Star. CMI's proxy statement explains that CMI's board, after careful consideration, recommends approval of the merger price offered by All-Star as "comparable to the highest trading prices ever obtained by the top companies in the industry." The proxy materials do not describe the CMI directors' relationships with All-Star. On May 1, CMI's shareholders vote overwhelmingly to approve the merger agreement.

Please identify and analyze the strengths and weaknesses of the potential claims by and against the various parties.

Exam No. ________________

Question 3 (25 points total; each pairing weighted equally)

The two majority opinions in each pairing listed below represent different approaches to issues of corporate law. Although there are important factual distinctions between the cases, the opinions of each pairing are based on divergent premises about the priorities and limitations of corporate law.

For the pairings of majority opinions below, (a) <u>identify the most important disagreement</u> between the legal approaches taken by the opinions in each pairing; and then (b) <u>identify which approach in each pairing you favor and justify your choice</u> (you may provide rationales not given in the opinions themselves).

Do not simply describe differences in the facts or holdings of these cases. Indeed, you need not describe the facts or holdings—you can assume that I know them.

Pairing A: *Litwin v. Allen* (casebook p. 670) &
Brehm v. Eisner (casebook p. 769)

Pairing B: *McQuade v. Stoneham* (casebook p. 418) &
Galler v. Galler (casebook p. 423)

Pairing C: *Bartle v. Home Owners Coop.* (casebook p. 254) &
DeWitt Truck Brokers v. W. Ray Flemming Fruit Co. (casebook p. 256)

Please complete your exam by filling out the following statement:

"I certify that my exam answer contains _______ words, as counted using Microsoft Word/WordPerfect/Other (specify) ____________________."

END OF EXAMINATION

QUESTION 1

The first issue relevant to the claims at issue is that this looks to be a partnership. They agree to share profits and this is prima facie evidence of a partnership (UPA §7). This does NOT look to be a creditor-debtor arrangement, both look to have some form of management rights (although Sara has a veto/approval power), and from the outset it looks like both will be compensated in the form of profits rather than interest payments. What is also important to point out is that this is an oral agreement and there is no written partnership contract involved. Although partnership agreements do not have to be written down, oral agreements subject the partners to the default rules of the state's partnership law and there is a good chance that these provisions are NOT what they intended. Additionally, this does NOT look to be a limited type of partnership because there was no discussion of limiting liability by either of these parties when they contracted. This is definitely NOT a corporation because nothing filed and they did NOT think they filed anything. They both look to be putting in capital (co-owners of Camaro) and there is no value assigned to Frank's labor (some partnership agreements will treat labor as a capital contribution).

Sara has a potential accounting/fiduciary duty claim against Frank under UPA §21. Frank derived benefit, without the consent of Sara, from "partner[ing] up" with Rich on the Mustang project. The issue in §21 will be whether this was a "transaction connected with the...conduct" of the partnership. *Meinhard* is instructive. One argument Frank will have is that this was outside of the scope of his partnership with Sara. Their partnership was called Camaro Crazies ("CC's") and this is a Mustang. He might also argue that the term of CC's was for their co-owned Camarao's restoration and was to terminate thereafter (this is a weak argument since further camaro projects thereafter). What is most troubling is this separate project with Rich fell within the time frame of Frank's partnership with Sara and unlike *Meinhard* was NOT a plan to commence when the partnership ended (this is going to cut against Frank). Furthermore, we want default rules to force the person with more information to bring up "contracting-around." Although they are co-president's, Frank's expertise as a mechanic, being relevant to the business they are in, might causep projects to come his way first. Because Sara is just a contributor it might be more appropriately to place the duty to disclose on Frank. Another fact that cuts against Frank is that both he and Sara had management power (she actually had more because of a veto). Based on this, he will likely be unsuccessful in arguing he was running the show and she was more of just a financer.

There are likely going to be suits by Shanor/Bederman for the purchases made by Frank. The issue is whether the partnership is bound by Frank's actions. The first thing here is Frank did NOT have *actual authority* to make these purchases because he needed to get Sara's approval for purchases above $500. The inquiry does NOT end here because a partnership can be liable based solely on a third party reasonably believing a partner had *apparent authority*. It was probably reasonable for Bederman to believe Frank, a partner of CC's, had the authority to make a purchase of tires to be added to a Camaro. The only way the partnership would NOT be liable would be if Bederman was aware of the restriction placed on Frank's actual authority (maybe Sara had put auto-part dealers on notice of partnership agreement). The trickier purchase is Frank's purchase from Shanor of Mustang-specific parts. Was Shanor reasonable in believing CC's would be purchasing Mustang parts? This will probably depend on if the partnership had purchased stuff other than Camaro parts in the past and this does NOT look to be the case. There is also the possibility that Sara had gotten the word out of restriction on Frank's authority. If there is no actual authority and no apparent authority (say by notice of their partnership agreement) then his actions would NOT bind the partnership.

On one end, it is more reasonable here for Sara give notice of the restriction of Frank's authority than if they were bargaining for something. However, it's probably hard for her to do this since her "right to approval" is NOT written down in a partnership agreement (it was oral). One other thing to point out is Shanor/Bederman might have some trouble suing Sara individually. The partnership might be liable under UPA §9(1), but because this is a contract claim and §15 might require joinder of all partners (several liability only for torts). If Sara was sued individually, she would seek indemnification under §18(b).

The loss to the partnership is $1,000. It is fair to say that they both put in capital because they co-owned the initial Camaro. Frank did NOT get any value assigned to his labor so that is NOT factored in as a capital contribution . They will probably split this loss according to share in the profits ($1000/2=$500 each). If you add in the money the partnership owes to Shanor/Bederman, partnership is now on the hook for $2500 (each pay $1,250). Frank argued for more of the profits (2/3) and if Sara's silence is seen as an assent by the court then he will actually have to foot more of the bill on the partnership's losses.

Frank hired Mike as an assistant. Question as to whether he had authority to do this. Could he act unilaterally or did this need to be done by majority vote (§18(h))? Partnerships are liable for the torts of individual partners (§ 13), but Mike is NOT a partner. Nevertheless, if Mike is seen by a court as an employee (need to assume Frank had authority to hire him), then the partnership will probably face a respondeat superior claim because Mike was an employee, acting in the scope of his employment (delivering a Camaro to a purchaser), and committed a tort (Restatement Agency §2.04).

Frank withdrew from the partnership (dissolution) and question as to whether this is wrongful. His contract was NOT for specified term and there is some weight to the argument that their partnership was formed just to "restore their Camaro." Depending on how a court construes their agreement will bear on whether Frank has the right to dissolve (a partner always has the power but may be liable for breach of contract – *Collins*). If his withdrawal was wrongful, he will get his partnership interest under §38 but he could NOT compel winding up. If he was NOT wrongful and just "retiring" § 42 would govern. This seems irrelevant for two reasons: (1) No money in the partnership to fight over; (2) Sara really can't continue the business without Frank because he is the mechanic. But if he wrongfully withdrew this helps her suit for "damages for breach of agreement" (§38).

Question 2

The agreement by Jenny and Bobby, to vote themselves as directors, is between them as shareholders. Voting agreements are okay between shareholders, but NOT between persons if in their capacity as directors (*McQuade*). The more troubling part of the agreement is agreement to keep themselves as officers. Directors appoint officers. So this agreement, assuming they become directors, is tying their hands. We don't want to tie the hands of Board members (might allow in close-corp. context or if qualifying language). At the beginning the company was small (so close-corp. might apply), but CMI quickly became a public traded company and the presence of a traditional "minority" makes their agreement as directors more of a concern.

MBCA §8.43 says an officer can be removed with or without cause. Jenny and Freddy as directors can remove Freddy (as officer) – assuming two of three directors meets quorum.

All-Star ("A-S") owns 51% of CMI (this is a Parent-Sub relationship). A Parent generally owes a fiduciary duty to the subsidiary in Parent-Subsidiary dealings. In analyzing the duty of loyalty of the Parent-Sub relationship, Jenny as a common director on CMI and A-S seems to violate the fair dealing concept advanced in *UOP*. She asked CMI directors to prepare an appraisal and then she gave this to the A-S Board (potential acquirer). Normally, we do NOT ask parties to reveal their bargaining positions in arms-length transactions. But as *UOP* instructs, since A-S is taking advantage of CMI's info without disclosing any of their own, this is NOT "fair dealing." It did NOT seem like the CMI Board knew what they were preparing this appraisal for since Jenny was driving the transaction. Additionally, no information was passed back to CMI as to what type of transaction was in the works or how much it might be worth to A-S (and A-S knew what CMI was worth).

Although there was more process here (bringing in I-Bank) than in *VanGorkum*, giving a "fair price" is NOT sufficient based on *UOP* (also this fairness opinion looks fairly rushed –just days). Since A-S used CMI's own appraisal info to come up with its range, the fairness opinion is inadequate in that the disclosure should have been of A-S's range of what they would have payed. Normatively speaking, when a minority stockholder has some agent of his company "sell out" the company's bargaining position by disclosing all relevant info to a potential acquiring Parent Company, we should demand that the minorities of the subsidiary be offered the "best price" rather than one that just appears "fair."

Not all self-dealing transactions will be set-aside. The fact pattern says Del. Fiduciary Duty Law applies so Jenny will probably try to sanitize this with § 144. The first part of 144 fails because none of these directors are really disinterested (Jenny and Bobby are on A-S Board and Freddy is their close friend). The second part definitely fails because there was NOT disclosure of the conflicts of interest to shareholders. Since in this case (compare to *Marciano*) there is no deadlock, the third part of 144 might be good. Nevertheless, 144 is not a true safeharbor but just a burden shifter. Even if Jenny gets this within 144, she will just be presumed fair and then shareholders will likely be able to rebut this. They would probably make the argument that the proxy materials should have disclosed affiliations and they would also point that CMI's info was taken advantage of by Jenny. This analysis is somewhat different than what would be under the Model Act because §8.61 is more of a true safeharbor while 144 is a burden-shifter.

One other argument Jenny might try to make is that this is NOT self-dealing under Del. Law (*Sinclair*). Although somewhat of a stretch, this is NOT a Parent receiving something to the exclusion of the subsidiary's minority shareholders. Although the parent is receiving some benefit, so are the shareholders (they are being cashed out for their stock, which is currently trading at $10/share) for a higher price ($13). If no self-dealing, use business-judgment rather than intrinsic fairness (*Sinclair*).

Conflicts of interest aside, there is also a process problem (CMI's Board immediately approving the merger). Just because it will be sent to shareholders does NOT excuse a Board's "fast shuffle" (shareholders often listen to a Board's suggestion). Although there were I-Banks involved on A-S's side, we would probably want CMI to get their own fairness opinion and to think about this decision a little more. Although this looks like *VanGorkum* in some respects, the fact that there are gross self-dealing problems here, the lack of process/informed consent is probably not as much an issue.

The proxy materials sent to shareholders are another concern. Under 14a-9 these materials look to be misleading because they do NOT describe CMI's directors' relationships with A-S. There is a private right of action for shareholders here (*Borak*). 14a-9 requires materiality (*TSC*). There is a substantial likelihood a reasonable investor would consider a conflict of interest to alter the total mix of information that they use to vote (this is exactly what happened in *TSC* and people today are very suspicious about white collar crime). Additionally, unlike *Virginia Bankshares*, which required a plain majority for shareholder approval, this transaction requires approval from a majority of shares NOT owned by A-S/A-S directors. Therefore, under *Mills*, there is causation because the votes of the CMI minorities are an *essential link* to getting this transaction approved.

Jenny's husband Harry buying stock of CMI raises some insider trading issues. The information looks material because Harry, upon hearing it, immediately put in instructions with his broker. Also, the stock price jumped when this info hit the market. First, he is probably liable under *O'Hagan*. No longer does he need a duty to the target to be liable (there was this duty requirement in *Chiarella*), he just needs a duty to *some source* and the abstain/disclose rule kicks in. Here, there is a duty of trust based on his familial relationship with Jenny (10b-5-2). Under 10b-5-1 since he was aware of the information when he made the trade, he is "trading on the basis of insider information (does NOT meet the qualified-preplanned safeharbor). One other argument he might make is that his broker purchased the CMI shares after Jenny's public announcement. Although it's tough standard because it almost penalizes individuals with good info, the court would probably reject Harry's argument and say that persons with nonpublic material info must to trade until that info is *widely-disseminated* to the public (*TGS*).

Assuming the materiality above, another scheme for liability may be *Dirks*. This seems somewhat more of a stretch because it requires a breach of fiduciary duty to the corp. by the tipper and the tippee must know/should know of the breach. In my opinion, Jenny telling her husband that she will miss dinner because of a "secret merger" does NOT look to be an egregious violation of fiduciary duty. It would be one thing if she called him and told him to trade on this info, but it appears this was unintentional. Because unintentional, I think this does NOT satisfy *Dirks'* first requirement (breach) and Harry's conduct is more culpable under *O'Hagan*'s missapropriation theory.

Jenny's conduct does raise some Regulation-FD concerns. She is disclosing information selectively (to her husband). Because unintentional, she would have to disclose to the market *promptly*.

One other cause of action here is the minority shareholders who sold their stock might go after Jenny or CMI in a 10b-5 action. As noted earlier, she did NOT disclose her or other conflicts of interest in the transaction. Although this is arguably an omission and these Ps would have standing under *Blue Chips* (once they sell the securities they agreed to in the cash out merger), it is likely the this will NOT be considered an omission/misrepresentation for 10b-5 purposes (*Sante Fe* makes clear that fiduciary duty is for state law and not actionable under 10b-5).

Another concern in this set of facts is Jenny's self-dealing in respect to corp. opportunity although this looks somewhat attenuated. As an A-S Board member at an A-S project site, did Jenny cross any lines by reporting this development to CMI? Although NOT standard corp. opportunity/self-dealing because she is taking NOT usurping this personally, she is certainly taking a corp. opportunity from A-S without first offering it to them. For example, as a A-S Board member she could have suggested they market the drilling technique to all firms engaging in Soxite mining (and take highest bidder/best opportunity) rather than reporting the availability of this technology directly to the CMI Board (might be derivative form of corp. opportunity doctrine).

Question 3

Pair-A

The divide between *Litwin* and *Eisner* is a disagreement over whether mere process should be enough to support deference to a Board or whether a court should take a more paternalistic role and require some degree of "good judgment" even if adequate process was fulfilled. In *Litwin*, there was strict analysis imposing liability on directors who, after taking adequate process, made a decision that was grossly negligent. *Eisner*, although in the waste/spoliation context, takes a very opposite approach in stating that a Board need *NOT inform themselves of every fact*, but only become "reasonably informed" to be looked at deferentially. *Litwin* places some emphasis on outcome while *Eisner* seems to only require the bare-bones on input.

Normatively, the standard to which a Board is held, much like federal securities laws, strengthens the confidence in our capital markets. People might NOT invest if they have fears about recklessness or fraud in boardrooms. Nevertheless, I favor a standard that is NOT outcome-focused, but one just requiring process. First, there is the tough-luck concept saying that shareholders elect these Board members (they should be forced to live with the decisions made by the people they elect). The Wall St. rule allows shareholders to sell their stock if they are unhappy. A different set of standards might be necessary if shareholders were locked in. There is some weight to the argument that shareholders don't always elect the Board (shareholder might buy into a company). However, Easterbrook argues that we don't need corporate law (the market will regulate the decisions made by management). If a director continues to make bad decisions, smart investors will sell their stock. Ultimately, the co.'s stock price goes down and the company is more prone to takeover. This poses a threat to directors –

there is a good chance they will be replaced. Although there is some concern directors might be operating under the radar, this is why we mandate process – to make them accountable for their actions!

Pair-B

McQuade and *Galler* come out different on whether directors can make agreements which essentially "tie their hands." *McQuade* says shareholders can do this, but directors can NOT. *Galler* disagrees with *McQuade* and this probably has to do with the fact that *Galler* relies the *close-corp.* distinction (in close-corp., no traditional minority, so no one really hurt).

I support *Galler*'s more flexible approach contingent on the presence of certain safeguards. First, close-corp.'s should be able to restrict board members because there is no traditional minority (third party) being hurt by this. I would require these close-corp.'s to follow statutory formalities (see *Zion* and *Nixon*) because potential investors should have notice that these agreements may exist when deciding to invest in these companies. Allowing directors, in the public company context, to tie their hands is a little more risky. I support such permission if there are some prophylactic measures such as a requirement of qualifying language. This safeguard targets the very concern *McQuade* has in prohibiting agreements between directors – that the director is going to work against the corp.'s best interest. In addition, and similar to the requirement I place on close-corp.'s, I would require these agreements between directors in public companies to be filed publicly. This gives potential investors transparency in the corp.

As long as the directors' interests are aligned with that of the corp. and there is some transparency, there is no reason to disallow these agreements. By taking incentives out of play, the potential agreements between directors now look very much like the agreements that we allow shareholders to enter into.

Pair-C

Bartle and *DeWitt* both appear to require some type of *fraud/injustice* to pierce the corp. veil (*Bartle* – doctrine is "to prevent fraud" and *DeWitt* – "must present an element of injustice"). Nevertheless, it is how they characterize this fraud that leads to their differing outcomes. The basic premise in *Bartle* is that although you have an undercapitalized subsidiary that is out there doing business for the Parent's profit, it is NOT fraud. The *DeWitt* opinion puts forth that simply having an undercapitalized subsidiary for which the Parent would NOT be liable, but which it makes money from is fraud/unjust. *Bartle* seems to be searching for a more affirmative sense of fraud/injustice (it uses words like *misrepresentation* and *illegality* -- so essentially the subsidiary would have to defraud the plaintiff is some way). *DeWitt* more or less characterizes this structural relationship, premised on profit by Parent without any liability, as fraud in itself.

I favor *DeWitt*'s characterization of fraud and thus its decision to pierce. I believe our concern here is not the affirmative fraud of the subsidiary itself, but the overall structure of this arrangement that enables some shareholder or parent corp. to get all the benefits of business without having any liability. This is a misuse of the corp. form and we need some safeguard against this conduct. *Bartle* is too tough because it requires a misrepresentation/illegality. In many cases, a person can set up a Parent-Sub structure, which is totally legal (procedurally/technically), and use to make profit yet NOT liable to third parties. This insulation of the shareholder is the true inequity we are trying to get at and this is why the DeWitt definition of fraud fits more soundly with the overall requirements for piercing.

EXACTLY 3500 words.