QUESTION 1

Sox News is the most trusted name in news—and more importantly for its shareholders, the most profitable name in news. Sox’s superstar broadcaster, Anderson O’Maddow, has long been the lynchpin of its advertising strategies, with his name and likeness blazoned on every billboard, bus, and commercial in sight. His show “Morning O’Maddow” airs five days a week and is the highest-rated show on cable news. The full name of Sox News is Sox News, Inc., and it is a public company incorporated in the state of Delaware. Its annual revenue is approximately $2 billion, about $250 million of which is directly or indirectly linked to O’Maddow’s show, whether through advertising money or through fees paid to the network by local affiliates throughout the country.

On March 7, 2017, however, a huge news story broke. It turns out that O’Maddow had engaged in a long course of horrific conduct toward pretty much everyone unlucky enough to catch him on a bad day. From screaming vicious insults at staff members who failed to polish his cufflinks, to throwing hot coffee onto interns who failed to ensure his milk was steamed properly, O’Maddow egregiously misbehaved since the day he stepped onto set at Sox News studios ten years ago.

What is more, the network’s directors approved massive payouts over the years—in the neighborhood of $35 million total—in order to settle the many lawsuits threatened by those whom O’Maddow assaulted, insulted, harassed, or otherwise abused. O’Maddow was well-connected with the Sox board, all of whom he had introduced to the CEO and advocated for when they joined the board. Of the seven directors of Sox, two were wealthy former fraternity brothers of O’Maddow; one was an alumnus of his high school who graduated a few years after him; one was a professor to whom the Sox director stipend of $50,000 is the difference between having to keep driving his old Prius in perpetuity and getting to purchase a stylish new minivan instead; one was Dean David Brennen to whose law school O’Maddow had promised a very large gift; one was O’Maddow’s second cousin whose college tuition had been paid by O’Maddow but was now financially independent; and one was O’Maddow’s ex-partner who still received large alimony payments. These settlements were protected by ironclad confidentiality clauses, and as a result of the efforts of Sox, its public relations staff, and its lawyers, the public was unaware of what was going on. Sox wanted to keep it that way, because throughout this ten-year period it had fought numerous proxy fights seeking to maintain its current corporate form and fending off would-be acquirers of the company. Most recently, the company sent proxies to its shareholders for the 2017 annual meeting, but of course said nothing about the O’Maddow allegations or settlements.

It turns out that this whole effort was also advised and approved by the law firm of Dewey Cheatem & Howe, LLP (“DCH”), whose motto is, “You got problems? We fix ‘em without anyone knowing.” DCH has been sued many times by unhappy clients, landlords, employees, delivery-people, caterers, interns, etc., etc., and has been frequently investigated by regulators. Working alongside the equally disreputable investment bank, Gringotts Financial LLC, the law firm produced hundreds of pages of analysis (with extensive footnotes, charts, etc.) asserting (a) that the settlement payments of $35 million were easily worth it in order to keep O’Maddow at Sox, and (b) that no U.S. securities laws or fiduciary duties would be breached by
the actions of Sox in paying off the various aggrieved parties and keeping the course of action completely under wraps. The lawyers also noted (accurately) that the Sox articles of incorporation provide that “all officers and directors of this corporation shall be protected from suit and liability based on alleged breaches of their fiduciary duties, as well as being indemnified for all expenses (including attorney’s fees) and liabilities, all to the fullest extent permitted by Delaware law, as it exists now or may come to exist in the future.”

As a result of the O’Maddow scandal’s becoming public, Sox stock dropped precipitously, losing more than a quarter of its value (from $40 at opening bell on March 7, 2017, the day that the story broke, to $28 on March 14, 2017, the day after O’Maddow was fired). Sox has taken significant efforts at damage control, culminating in the firing of O’Maddow and procuring the resignations of several top Sox officials.

Several Sox shareholders whose stock values have been damaged by this scandal have retained you. Please consider the materials within the scope of this course, and answer the following questions: Whom, and under what theories, do you advise your clients to sue? Do you recommend taking any preliminary steps prior to the suit, and why or why not? What do you think of your clients’ chances of success? [My suggestion is that you use section headings and structure your answer as well as possible.] (90 minutes)

STUDENT SAMPLE ANSWER

[Note: Just because the answers given below are samples doesn’t mean I necessarily agree with them on all points, nor does it mean they mentioned every issue that could garner you credit. For instance, the answer below doesn’t mention making a shareholder request, which would be a good way to get more information about the possibly conflicted directors. What a “sample answer” means is that in the context of the group of exams, the analysis was good enough and thorough enough to receive full or nearly full credit.]

Derivative Action
Sox shareholders should bring a derivative suit. A derivate suit is a suit brought by shareholders on the corporation’s behalf. In a derivative suit, the cause of action belongs to the corporation as an entity because it arises out of injury done to the corporation as an entity. Here, a derivative suit is appropriate because the Sox shareholders would be bringing the suit on behalf of the corporation because it arises out of injury (i.e. the board's decision to cover up O’Maddow's egregious behavior and making settlements) to Sox.

Demand Futility
The general rule is that before a shareholder can bring a derivative suit that they must make a presuit demand on the directors to bring the action. This is because it is typically the job of directors to make such decisions. Therefore, requiring the demand prevents shareholders from taking management power that they are not supposed to have. Therefore, Sox shareholders will have to make a demand on the board unless they show that such a demand would be futile. Sox shareholders may be excused from making a demand on the board if they can prove that such a demand would be futile. The test to determine if demand would be futile is the Aronson test. Under this test, the plaintiff (i.e. the shareholders) must plead particularized facts that raise a reasonable doubt about (1) the board's independent or interest in the matter OR (2) whether the
challenged transaction was a product of business judgment.

The first prong looks to the disinterestedness of the board -- looking at whether the board has a financial, personal, or familial relationship with O’Maddow. The second prong is looking at the board failed to follow reasonable process (i.e. waste).

The relationship between O’Maddow and several of the board members is questionable. Two of the board members were wealthy fraternity brothers of O’Maddow’s. The facts do indicate how close they were. It is possible that this is a large fraternity and that they never met in the scope of the fraternity. But it also possible that they were really “brothers.” Therefore, depending on other facts, demand may be futile of the two fraternity brother directors. But, if the sole fact pled is that they were fraternity brothers, this is probably not enough.

The analysis for the director that went to O’Maddow high-school is similar. It is possible that O’Maddow never met him. He did, in fact, graduate a few years after him, but it also possible that they were best friends while they were in high-school. I think whether demand would futile in this case depends on the extent of this relationship. The fact that they went to high school together with nothing more is probably not enough.

Demand would probably be futile for the professor who receives a $50,000 stipend because $50,000 is very material to a law school professor because as the facts indicate, it is the difference between driving an old Prius and a stylish vehicle. Therefore, this is significant and probably raises a reasonable doubt as to the disinterestedness of the professor.

I think there may also be a reasonable doubt raised as to the disinterestedness of the law school dean. The school that the dean works was promised a large gift from O’Maddow. The law school may be disinterestedness because he feels like he owes O’Maddow because of the gift and he may seek his approval so that the school can get more gift. Furthermore, in The Limited, there was a board member who had was a president of a university and that had solicited very large gifts for the university and the Court held that there was a reasonable doubt as to his disinterestedness.

Another board member was O’Maddow’s second cousins. The second-cousin is probably not disinterestedness on the sole basis of being O’Maddow’s cousin because in Shapiro, (even though this is not a demand futility case), the Court remanded the issue as to whether a sister board member was interested. However, the fact that O’Maddow paid for the second cousin's tuition may make her feel like she owes him and may make her disinterested. The facts indicate that she is financially stable now but it can certainly be argued that regardless she may feel obliged to make decisions that O’Maddow wants. Therefore, there also may be a reasonable doubt as to her disinterestness.

Another board member is the ex partner of O’Maddow. Of coarse, it is possible that an ex-partner would be more critical than anyone on earth, this is still a very close relationship and they may have a great relationship especially considering the alimony payments. I think there may be a reasonable doubt as to the ex-partners disinterestness as well.
Even if a Court were to determine that demand was futile, the Court may still find that the board could elect a special litigation committee (SLCs) to decide whether the shareholder derivative suit should continue. There are three approaches to SLCs. One is in *Auerbach* -- under this approach, an SLC's determination is entitled to business judgment protection. If the court follows this approach, it is most likely that the Sox SLC would determine that it was not in the best interest of the company to continue with the derivative suit and the derivative suit would be dismissed. Another approach that a court might follow is the *Miller* approach. Under this approach, an SLC is not protected by the business judgment rule because it is as conflicted as the board. If the court were to follow this approach, Sox shareholders would be more likely to be able to continue with their derivative suit. The last approach is the *Zapata* approach. [NOTE: This is probably the only relevant approach in Delaware, right? Generally speaking, this answer goes on a bit too long explaining legal principles rather than going directly to their application.] Under this approach, the Court will evaluate the SLC's decision by (1) looking at the independence and good faith of the board and (2) the Court will exercise its own business judgment about whether the suit should be dismissed. Under this approach, whether the suit was dismissed would depend on the facts of the independent and good faith of the SLC and it would come down to the business judgment of the court. Therefore if the Court follows this approach, it could go either way.

**Fiduciary Duties**

I think that demand would probably be excused as futile. For now, I will ignore the SLC issues that I described in the previous paragraph and explain the claims that I think Sox shareholders would have against the board and O’Maddow for a breach of their fiduciary duties. One thing I will note is that entering into confidential settlements seems like a very smart and effective business strategy. Not disclosing the information and engaging in a cover up and doing nothing to prevent it from happening again seems to be the relevant actions leading to liability which will be discussed in greater detail below.

**Duty of Care:** The duty of care basically prohibits gross negligence. Shareholders could argue that the board was grossly negligent because they continued to let O'Maddow act this way for 10 years! One procedural duty of care issues that shareholders could bring is the failure to inform. It is true that a director may rely on person/experts that they reasonably believe to be reliable and competent and this will constitute satisfaction of the duty of care. However, I think that shareholders can argue that it was not reasonable to rely on Dewey, Cheatham, and Howe and Gringotts Financial. The facts indicate that these are very disreputable institutions so I think that shareholders can make the argument that it reliance was not reasonable and therefore they breached their duty to inform themselves of the consequences of their decisions. I think that shareholders may also be able to bring a duty of care violation against O'Maddow himself. He continued to act in this egregious manner for 10 years. I think the argument can be made that this constitutes gross negligence.

I will note here that people are always liable for their own violations of the law. Therefore, O'Maddow is would also be personally liable for his torts.

**Duty of Loyalty:** The duty of loyalty test looks at whether a director or officer is on both sides of a transaction and if the director receives a benefit to the exclusion of shareholders. I think an
argument can be made that board members put their interest above the corporation’s because they may have made these decisions to please O'Maddow and many of them were receiving personal benefits from O'Maddow and therefore they were receiving a benefit to the exclusion of shareholders.

Duty of Good-Faith: The duty of good-faith is a part of the duty of loyalty. There are two kinds of bad faith. One is the failure to act in the face of a known duty. I think there may be claims against the Board and O'Maddow for this. I think that O'Maddow had a duty to not do egregious things like throw coffee on people. This may even rise to the level of subjective bad faith -- probably not because you would have to prove intent to harm but I think the argument could be made. Also, I think the board had a duty to ensure that such torts (like having hot coffee thrown on employees) did not occur and after 10 years of such conduct, they were on notice therefore, I think the board failed to act in the face of a known duty. [NOTE: Maybe also a duty to ensure good-faith compliance with securities laws, including by making appropriate disclosures and not covering things up.]

Exculpation
Another issue prevented by these facts is that there is an exculpation provision that protects directors and officers from being prosecuted for the breach of fiduciary duties. An exculpation provision will be held valid but it only has the ability to exculpate for the duty of care. Therefore, because of the exculpation provision, O’Maddow and the board will not be able to prosecuted for their duty of care violations. However, exculpation is not allowed for duty of loyalty violations and good-faith violations. Therefore, those claims can still be made.

Indemnification
Another issue presented by the facts is that there is an indemnification provision. If O’Maddow and the board are successful in defending the suit against the shareholders, the corporation will have to pay for the reasonable expenses involved in defending the suit. If the suit is not successful, if they acted in good faith. As under Owens Corning, the articles may put a presumption of good faith and then the presumption would have to be rebutted. Good-faith cannot be waived but you can make it a presumption. Therefore if they are successful, Sox will pay their fees incurred and if they are not successful, Sox will pay if there is good-faith.

Fraud in the Issuing of Securities
Another issues presented in these facts is the fraud in the issuing of securities. Rule 10b-5 generally prohibits material misrepresentations and omissions in connection with the sale of securities. In Basic, the Court held that the standard for determining whether statements are material is where there is a substantial likelihood that a reasonable shareholder would consider the facts important enough in deciding how to vote. If the company made statements that implied how great the company was doing, then the omission of these statements may qualify. If they didn't make any statements, then they may have not had the duty to disclose. If they did have the duty to inform, I think that reasonable shareholders would find these settlements and cover-up material. I think the material prong is met. The statements must also be intentionally misleading, meaning that the person made the statements with the intent to mislead, i.e., scienter. In Tellabs, the Court held that to show a defendant acted with the required scienter, the plaintiff must show that the facts give rise to a strong inference and it must be at least as compelling as any opposing
inference of non-fraudulent intent. [NOTE: Some answers made the point that the advice of counsel, depending on what you think of that advice, might have been relevant in counteracting the apparent scienter.] The fraud on the market theory of Basic and Halliburton should take care of the loss element for those that held stock at relevant times. Causation will be swept along with that. Therefore, I think as long as the omission is considered material, that they are guilty of fraud in the issuing of securities.

Misleading Proxy Statement
Another issue presented by these facts is that Sox sent proxies to shareholders that omitted the O’Maddow allegations or settlements. Shareholders who have been misled by info sent out in proxies can sue management directly for the harm caused. SEC Rule 14-a of the 1934 Act prohibits management from making (1) false or misleading statements; (2) that are material; (3) upon which a shareholder or proxy relied (4) that causes harm to the shareholder or proxy. In TSC Industries, the Court found that statements are material when there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. In this case, shareholders were not told about the settlements and the cover-up. If this was a material omission that the shareholders relied upon that caused harm to the shareholder, the shareholder is entitled to a private direct cause of action. [NOTE: Bit thin here at the end—see my comments below for more elaboration on this issue.]

PROFESSOR ANSWER AND COMMENTS

Securities laws (this category was worth about 36 of the 90 available points). Do the shareholders (your clients) have causes of action for breaches of federal securities laws? These would be direct not derivative claims, because the wrongdoing is by the corporation itself (unlike a derivative suit where the indirect wrongdoing is to the corporation, usually by an officer or director). The injury resulting from the corporation’s action is to the price of stocks, and to the voting rights that would have been exercised differently by shareholders.

* Rule 14a9. This issue is hinted at by the part of the fact pattern that alludes to repeated proxy statements including with respect to a recent shareholder meeting, some of which were clearly decisive in maintaining the corporation as-is.
  - Most of the elements are easily here. The precipitous drop in stock price will suffice to show loss for those who held shares at the relevant times (i.e., those who have standing, an issue we really didn’t deal with in class and therefore you didn’t need to worry much about).
  - Causation will be likely met because proxy votes appear to have been causally related to the business remaining in its current form, so courts will presume that shareholders holding shares at the relevant times relied on these misleading statements in making their voting decisions. (Several answers mistakenly said that shareholders would have to prove reliance, which is not the case and would be hard to do for most shareholders.)
  - Is the information that was omitted material, in the sense that there was a “substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”?
    - The board might argue that the information wasn’t material, given that the company was still really profitable despite having to pay out these
settlements, the money paid out is small compared to Sox’s overall revenue, and keeping the company’s biggest performer happy was important.

- On the other hand, clearly investors on the markets thought that it was material, based on the drop in stock prices. And this kind of defect can cause a public relations fiasco for a media company (particularly if covered up), even if the actual liability for individual incidents is manageable from a purely economic perspective. Note that the problem here isn’t the fact of making confidential settlements of employment matters per se, but rather the lengthy cover-up of O’Maddow’s persistent and morally reprehensible behaviors.

- **Rule 10b5.**
  - This is the catchall provision that prohibits fraud in connection with purchase or sale of securities. At a minimum, this would include Sox’s public statements and regular securities filings that misled purchasers or sellers of its stocks throughout the long history of the cover-ups that the fact pattern lays out.
  - Again, here, most of the elements are easily met: materiality is met; the “fraud on the market” theory of Basic and Halliburton should take care of the loss element for those who held stock at the relevant times; causation will be swept along with that under these facts.
  - As far as the element of scienter, the standard from Tellabs is that the inference of deception has to be at least as plausible as the alternatives. That too seems easily met here—unless DCH’s advice immunized them from this standard? (As one student explained, “the management should have known that hiring firms with such poor reputations was reckless.”) I think that’s an open issue given the questionable nature of the legal advice (see more below).

**Fiduciary Duties (remainder of the points).** These would be derivative claims, because the alleged breaches directly harmed the corporation; thus the claims belong to the corporation even though the shareholders are going to bring them initially.

- **Duty of Care.**
  - There is no substantive duty of care in Delaware.
  - The exculpation clause should apply in any case, to bar the duty of care claim.
  - In light of those facts, I’m not sure it’s worth doing too much DoC analysis, but if you want to be safe, you could note that what courts look for is the general Van Gorkom type of procedural due care—making a reasonably informed decision. The law firm’s advice is relevant on that, for what it’s worth; see more on that issue below. We don’t have much else relevant to the DoC analysis in light of the exculpation clause

- **Duty of Loyalty.**
  - Note that the exculpation clause doesn’t take this away. DGCL § 102(b)(7).
  - Several potential angles:
    - Is there a conflict of interest claim based on the fact that many of the directors have personal relationships with O’Maddow (see below for more conflict analysis)? Your argument would be that they entered these settlements and then covered them up because their loyalty to O’Maddow
trumped their loyalty to Sox. It’s certainly plausible given the facts we have here.

- This would be a good issue on which to make a shareholder’s request for records. The purpose of investigating potential conflicts/directorial independence would be a legitimate one for breach of duty of loyalty grounds and for demand futility grounds.

  - Is there a Caremark-type good faith claim that they should have monitored or trained O’Maddow better? They appear to have been precisely aware of what was going on, which weighs against this claim. On the other hand, can it really be reasonable to let him run amok like this without making him take some compulsory anger management courses or otherwise protecting the interns and other staff members from him? What about simply trying to diversify their program offerings so as not to be so dependent on this ticking time bomb? Aren’t these repeated incidents “red flags” that a bigger and better “fix” is needed here? Can directors simply put their heads in the sand on this kind of course of conduct and still be acting in good faith?

  - Also, is there a good faith claim on the basis that they should not have engaged in a blatant cover-up—in violation of, at a minimum, federal securities laws? In other words, are they consciously disregarding their known duty to comply with federal securities laws?

  - These all seem like important angles and potentially good bases for claims.

- Demand Requirement. Do your clients have to make demand?
  - Presumably Aronson applies; although the fact pattern states that there have been “resignations of several top Sox officials,” we have no reason to think a majority of the board has changed, which is what would trigger Rales.
  - So, under Aronson step 1, can you raise a reasonable doubt as to whether there is a disabling conflict of interest or lack of independence?
    - As in The Limited, director-by-director analysis required. If you go director-by-director, you can probably see a lot of parallels to The Limited case and our other cases in this area, including the university leader who has been promised donations, the academic to whom the money is helpful, etc. Although you could keep this fairly minimal if you were pressed for time, I did award points for those who dug in at least a little bit, exploring the various facets of this.
    - As noted above, this would be a good reason for your clients to exercise their rights as shareholders to seek records/information from the company concerning more specifics of O’Maddow’s relationships with each board member.
  - In my view, demand is probably excused because more than half of the directors are probably not independent, but I gave credit to those who applied the correct tests, argued well on the basis of the cases, and reached a different conclusion.
  - If you moved to Aronson step 2, I’m not sure there was much to say, except that maybe you repeat some of your doubts about good faith and about the process followed by their law firm and investment bank in providing the board with
advice.

• **Is the board insulated by Delaware General Corporation Law § 141(e)?**
  o **This is a big issue under the facts as given.**
  o Boards are protected from allegations of breach of fiduciary duty by “relying in good faith ... upon such information, opinions, reports or statements presented to the corporation ... by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.”
  o **This would seem to protect the board, but: Have these experts been selected with reasonable care? Can they reasonably believe this matter is within the competence of these professionals? I tried to load it up to suggest that maybe the advice of these professionals wouldn’t be worth much.**
  o **Also, although I don’t know that we emphasized this in class, this will not protect them from a conflict of interest in any case.**

• **Other issues.** Although this covers the major issues I saw in the question, I awarded some points for people who discussed other relevant points, including the following:
  o **Special Litigation Committees with respect to the demand question,**
  o **Indemnification,**
  o **Malpractice claims against the law firm** (although I will note whether such an action can be brought derivatively is far beyond the scope of this course),
  o **Breach of duty or other claims against O'Maddow,** and
  o **Waste.**

• **Note that veil-piercing really isn’t relevant here, since the plaintiffs (your clients) are specified to be shareholders, whose suits will either be direct for the securities violations or derivative for the fiduciary duty violations.**

The average score on this question was 69% (62 points out of 90). This is the kind of question that rewarded true issue-spotting. Even with 90 minutes there wasn’t enough to fully discuss all the issues, so one of the keys was to make sure to touch on as many of the major ones as possible. Citing to case law can be helpful in that regard, as it quickly indicates that you realize what the key issues are.
QUESTION 2

The largest shareholder of Sox is Elon Tusk; while he has never served as officer or director of Sox, he owns 30% of Sox’s outstanding stock. Tusk is disgusted by the turn of events described above, and he has decided that he wants to “cash out” from Sox as much as possible to focus his money and time on his various tech startups.

Based in part upon his lobbying, and in order to try to appease other angry shareholders, the board of Sox declares a massive dividend—nearly the largest it is allowed to make under governing Delaware law. The planned Sox dividend is so large that it will essentially stop any efforts on the part of the network to expand further; the board has admitted that this move will “narrow the company’s focus to its existing business and limit future expansion.”

Tusk also successfully pressures the board of Sox to enter into a contract to purchase technological consulting services—“at a great friends and family rate, I promise!”—from one of his start-up companies, a Delaware entity named CrowdNews LLC, which has developed several fancy technological means of collecting and promulgating “crowdsourced” news. The board agreed to the CrowdNews deal to help modernize what it perceives as Sox’s “old school” news operation.

Some news reports have suggested that CrowdNews has struggled to get clients, and that Tusk is actually just seeking to bolster the startup by garnering it a high-profile client (essentially getting free advertising). (Tusk says these are “fake news.”)

News reports have also noted that Tusk supposedly had the idea for the start-up while chit-chatting with some Sox employees at the Sox annual shareholder meeting a couple of years before about problems faced by bigger media companies like Sox and potential technological solutions to them.

Your clients are back in your office (which you’ve spruced up thanks in part to the previous round of fees you charged them). They like the idea of the dividend but hate the idea that Sox would be limiting its opportunities for future expansion. They also think Tusk’s actions “just can’t be right.” Because you did such a good job before, they want you to prepare another lawsuit, “against CrowdNews, Sox, the board, whoever—but definitely focus on that jerk Tusk!!!”

Please consider the materials within the scope of this course, and answer the following questions: Whom, and under what theories, do you advise your clients to sue? Do you recommend taking any preliminary steps prior to the suit, and why or why not? What do you think of their chances for success? [Again I suggest using section headings for clarity and organization.] (30 minutes)

STUDENT SAMPLE ANSWER

Dividend Policy

Although the clients seem to like the dividend policy now, they may change their mind when it is

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1 This is from the highest-scoring exam in the class; I left all the typos in place to show that while the clarity of the writing does matter (and this person is an excellent writer), as does organization (notice all of the section headings), a high degree of “polish” isn’t required on timed exams (although it is required in legal practice!!). As you can see from my comments below, I also disagree with several of the conclusions stated here.
found out that they likely cannot challenge the decision of expansion because of the business judgment rule. However, since the dividend is not received to the detriment of any minority shareholder, it seems to be ok. Facts do not suggest the Elon is in a different class of shares. Since the dividend policy is stated to be in compliance with Delaware law, an equity test/balance sheet approach is probably not likely. However, if it is shown that the payment was made in violation of the capital requirement, there could be liability. In any event, After Klang, companies can refigure their balance sheet, and the facts say the dividend complies with the law.

**Decision to Limit Expansion**

This will be very hard for the shareholders to challenge, as substantive decisions are protected by the business judgment rule. In Ford, the question to expand was not to be judged by the courts. Logically speaking, the decision to not expand could be given the same protection. However, if the board has acted in bad faith, then they will not get the protection of the business judgment rule, and this claim could be more easily made.

**Document Request**

Documents could be requested to help prove some of the allegations we are making, for example, records of payoffs, acquiescence, corporate policies, etc. Chevron is the case on this pointmm as well as DGCL 220(b). Records can be requested, and should be given, if there is a proper purpose. A proper purpose includes investigating corporate mismanagement, or getting a stockholder list, so these records should be requested, and we will likely get them. The point of this would be to get a stockholder list to find out if Elon is a majority stockholder.

**Suit Against Elon: Majority Stock Holder**

A majority stockholder owes fiduciary duties to minority stockholders. Thus, assuming that 30% is a majority share (it likely is, but you will find out for sure from the documents you have requested), you could potentially sue Elon for a breach of those duties.

**Elon Breach of Duty of Loyalty**

The shareholders' best bet for voiding the Elon deal is to allege that he has breached his duty of loyalty to the minority shareholders. This is a self-dealing action, that would violate the duty of loyalty. Here, Elon stands on both sides of the deal, he is a large shareholder in Sox, and is in control of the start up. It appears that Elon is receiving corporate assets to the exclusion of the minority. Although this transaction could be protected if it was approved by a majority of disinterested shareholder or board members, or was otherwise fair, the facts do not implicate this. Because a majority stockholder is receiving something to the detriment of the minority, Sinven says to apply the intrinsic fairness test. Thus, the burden will be on the defendant to prove the transaction is actually fair. Although the facts suggest that Sox is getting a "family price", the fairness is debatable. Further, if the deal was only entered into to appease Elon and help his company, it is hard to see how the transaction would be deemed fair. It is likely that Elon has breached his duty. If the deal was actually bad for the company and Elon did not tell anyone, like in Globe Woolen, he could potentially be liable for violating his duty of candor.

**Board Breach of Duty of Loyalty**

The board could potentially be liable for a conflicted transaction, if it can be proven that the board was dominated by Elon, and he essentially pressured them into the deal. Thus,
the deal has the potential to be voided. If it could be proved that the board acted in bad faith, by consciously disregarding a duty, that could lead to a violation as well. However, the facts do not indicate any bad faith, this would be speculation. This is a possible claim, but not a great one. However, if the deal was actually bad for the board, and they knew it, liability could arise.

**Corporate waste**
this is an unlikely claim against the board, as it does not appear that no reasonable business person would enter into this deal. But, if Elon's services are totally worthless, then they possibly could be.

**Proposal**
This isn't the best option, but the shareholders could submit a proposal to stop this deal, or to not stop expanding. Normally, this would be a violation of the rule that shareholders cannot interfere with the operation of the business, but if they phrase it in a precatory way, it could pass muster. However, the board could ultimately just ignore this under BJR protection.

**Remove Directors**
Once the shareholders have the information from the documents requested, they could attempt to remove board members that were not acting favorably to their cause. The extent of director protection could be different depending on the structure of the board and the by-laws, so this is murky as of now.

**Duty of Care-Board**
If the board somehow violated their duty of care in this decision making process the board could face liability. However, because of the exculpation clause and the business judgment rule, they will have only violated their duty of care if they acted in bad faith. This was discussed earlier, and is a possibility. This would be analyzed under a Van Gorkom analysis, where they see if the board was grossly negligent in the amount of information they gathered for making the decision. This is a high hurdle to jump, but is possible.

**Corporate Opportunity**
It is possible that Elon Usurped a corporate opportunity. More facts would be needed for this claim, but it says that he got the idea from chatting with employees at the shareholder meeting. It would matter if he presented this opportunity to the board, and if they consented or not to it, which is unknown from the facts.

**PROFESSOR ANSWER AND COMMENTS**

- **Tusk is the biggest target.**
  - As discussed in class, 30% is more than enough of a stake to be a “controlling shareholder” under most circumstances, in a public company, particularly where, as you are told here, he is the largest shareholder.
    - There were several major actions that the fact pattern presents that are
questionable:

- What about the dividend, which will change corporate focus and limit future expansion? This is a pretty straightforward Sinclair Oil issue. He is within his controlling shareholder rights to advocate for this sort of decision. Even if, as in Sinclair Oil itself (also in the Ford case), this corporate action will limit future expansion.
  - As a side note, be aware that (as the sample answer notes) the fact pattern explicitly states that the dividend was lawful. Thus that’s not an issue worth spending much time on.
- What about the contract with Tusk’s CrowdNews? Well, that’s a lot closer call. Since it’s a conflicted transaction and he is almost certainly a controlling shareholder, he might have the duty of showing the “intrinsic fairness” of the process. This again is paralleled in Sinclair Oil and our related discussion.
- Did Tusk steal a corporate opportunity?
  - He heard about the CrowdNews idea at a Sox meeting, and from a Sox employee. So Sox is the but-for cause, and it might be within the scope of Sox’s business, and Sox might well have had the resources to pursue the idea.
  - Usually you would say that he doesn’t have a duty as a shareholder—even as a controlling shareholder—to bring opportunities to the company. But here, he heard about it at a shareholder meeting in a conversation with a Sox employee, so it’s closer than normal to the line. We don’t have a case squarely on point, although several cases are relevant. I awarded points freely for thoughtful answers.
  - An interesting exception where a court might find a duty would be if Tusk were to be having a special meeting with the management by virtue of his special role as controlling shareholder, and they revealed something to him there; in such a case, I would think a duty might arise. But here we have no sense of such facts, and so I think the usual answer governs.

- There is potentially a derivative claim against the board of directors of Sox.
  - Duty of care has been done away with by the exculpation clause.
  - Even without the exculpation, generally these look like business decisions that will be protected by BJR, see Ford; Wrigley; Sinclair.
  - Duty of loyalty might be a possibility: Is the board conflicted, such that they can’t do this deal with Tusk’s other company, CrowdNews? Some people confused Tusk with O’Maddow from the previous problem; unlike their connections with O’Maddow, we don’t know about their background connections with Tusk, although since the fact

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2 Some exams misunderstood the fact pattern to suggest that there was a merger taking place between Sox and CrowdNews, but the fact pattern just says that Sox was becoming a client of CrowdNews with the purchase of consulting services, not of the company itself. In keeping with my usual grading practice, I didn’t take off points for this per se, but including a bunch of stuff on shareholder votes and merger law was a waste of time.
pattern explicitly says he’s the largest shareholder, we would assume he has a lot of influence.

- We don’t have any facts to specify one way or the other (unlike the previous question).
- As mentioned, as the largest shareholder, presumably Tusk would have had a role in appointing board members.
  - If there is a conflict, your clients might be excused from demand
  - If majority of disinterested board approved the transaction, that might of course be enough to “cleanse” any duty of loyalty issue
  - This is a plausible claim but we just don’t have enough to assess it, in my view
  - So again, maybe a shareholder request for records would help!
- What about a claim for corporate waste? Worth mentioning, but it doesn’t seem like anything here reaches that standard, in all likelihood
  - I don’t really see a suit against CrowdNews (also, would your shareholder clients have standing for such a suit?).
  - I don’t see a suit against Sox itself.

The average score on this question was 66%.
QUESTION 3

The way the O’Maddow story broke on March 7 was this.

Bright and early that morning, O’Maddow had unleashed yet another cloud of obscenities at an intern for some (perceived) offense. As the crushed intern left the set, the Sox “fixers” on hand for this sort of thing scurried behind. Senior Executive Producer Richelle Ricardo witnessed it yet again; and yet again, she was disgusted. Of course she understood why interns take the deal that is offered; it is rational to do so; she had advised interns who had confided in her that she thought they should do so. And yet she had had enough of this guy, and this corporation.

Ricardo got up, walked into her office and to her computer. She pressed “publish” on a Facebook post that she had drafted previously. It outlined O’Maddow’s horrific behavior and stated that it had long been covered up by the powers that be at Sox. It also linked to a shared folder that she had created that included a large number of relevant documents (with identifying information about the victims redacted).

Ricardo knew she would be fired for making this Facebook posting, but she felt great about her decision. She immediately called her therapist (with whom she had often discussed this plan). She told her therapist what had happened—that the whole plan had been carried out. Now it was only a matter of time.

After Ricardo hung up the phone, the therapist, Siggie Freud, went out for a coffee with one of her other therapist friends, Carlie Jung. She couldn’t help but describe to Jung what had just happened; although Freud was careful not to supply any names, Jung quickly put the pieces together as to which personality’s and which company’s actions were likely about to be exposed. And as it happens, Jung’s hobby was being a day trader on the stock market; she logged onto her online brokerage account and bought a large number of out-of-the-money put options on Sox—in other words, she placed a large bet that Sox’s stock price was about to drop significantly. The bet proved highly profitable, of course.

But Jung wasn’t the only one who was trading in those fateful moments. As part of their cover-up, Sox had hired an independent security firm, Silence the Whistles LLC, to keep tabs on certain executives about whom it had concerns—concerns, in specific, that they might blow the whistle on the O’Maddow problem. Ricardo had been the target of some of this monitoring, and in fact, a security officer with Silence the Whistles, named Officer Pitino, had listened in on Ricardo’s phone call with Freud. Pitino immediately notified his supervisors of what had happened; but he also at the same time pulled open his own brokerage app and also made a large purchase of put options amounting to a bet against Sox. He too profited handsomely.

Can anyone in the story above be prosecuted for inside trading? (30 minutes)

STUDENT SAMPLE ANSWER

Ricardo

(a) Classical Theory. Under the classical theory of insider trading Ricardo has little to nothing to worry about. While she may face an enormous lawsuit from Sox for breaching some contractual obligation of confidentiality, she does not appear to have benefitted in any way for the disclosure or "tip" when it was posted on Facebook, or when she spoke to her therapist. Ricardo did not receive a benefit or give a give to a sufficiently close person in order to meet the improper purpose requirement under the classical insider trading theory. This case is similar to
Dirks in that regard. Whistleblower.

(b) Misappropriation. Under the misappropriation theory a misappropriator is a person who uses confidential information in order to trade stock or other securities in violation of a duty of confidentiality. O’Hagan. In this case, Ricardo did not trade on the information and is thus not liable for insider trading.

Freud

(a) Classical Theory. Under the classical theory tippee liability is explained above. Freud got no personal kickback, and did not intend the information, which she tried to guard, as a gift to Jung. Freud should not face liability for insider trading under the classical theory.

(b) Misappropriation. Like above, Freud did not trade on the ill-gotten information so likely will not face liability.

Jung

(a) Classical Theory. According to Dirks v. SEC the tippee must have known or should have known that the information was provided in violation of the insider's duty to the corporation. This case resembles Chiarella in that the tippee discovered the information although it was pieced together from intentionally vague information. The Chiarella court would have said that Jung was innocent. Currently we would have to see if Jung had inherited Ricardo's duty. This would require that Jung had knowledge of the duty which depends on the substance of her conversation with Freud. Based on the facts it seems like she almost certainly would have known that something was not right. Since Freud described the actions, she would have known for sure.

(b) Misappropriation. Jung clearly violated a duty of confidence to Freud in this situation and traded on it. If the classical theory failed she would very likely face liability under the misappropriation theory.

(c) General. Jung is a stupid inside trader. Buying out-of-the-money put options is like putting a big target on your back that says “prosecute me.”

Pitino

(a) Classical Theory. Clear liability. He knew of the duty and breach (and inherited it) on the part of Ricardo and traded on it. [NOTE: I would say something a little different, as per below; I think rather than being a “tippee” he’s arguably a constructive insider who found out this information in the course of his work for the company.]

(b) Misappropriation. Pitino violated a duty to Silence the Whistles, as well a duty to Sox, and traded on it. Definitely liable under misappropriation.

All of this is contingent on the idea that insider information is still insider information even after posting on Facebook. While we did not cover a case on it, how long after posting something as viral as this would be would it no longer be insider information but rather public information? If it is the first news story on it, then Jung would likely be in the clear as the news would likely beat him to the punch.

PROFESSOR ANSWER AND COMMENTS

• There is obviously a tough chain of facts here, and there are some uncertainties about the outcome given the uncertainty of insider trading law as the Supreme Court and the lower
courts have bequeathed it to us. I gave a lot of credit for analysis that made sense, whether or not I agreed with it. The key, again, was issue spotting. But here is the breakdown as I see it.

• The first issue to get out of the way is that it is simply not the case that only those who trade can be liable for insider trading, as some answers argued. In fact the Dirks case involved the prosecution of an individual (Dirks), who had not himself traded but had passed the info on to others. Some of the defendants in the TGS case were prosecuted under similar theories. Tippers can certainly be prosecuted, under the right circumstances.

• A second issue is this: For there to be liability, the knowledge that was the basis of trading has to be “material non-public information.” Materiality here seems fairly obvious. But once the post is made on Facebook, is the information still “non-public”?  
  o A lot of people noted that it might depend on her privacy settings on Facebook, and that’s a fair point.
  o Also, I gave some credit to people who said that if the information had already become public by the time of trading, maybe no one is guilty. But the facts made clear that these people traded very quickly, and that the information was still non-public, which after all is the only reason why they could have made so much money, as the fact pattern indicates.
  o Although we didn’t read this part of the opinion, the TGS court actually dealt with this issue, with respect to insiders who had traded in the moments after the news was technically “public,” and we discussed this a bit in class…Remember the picture of the “ticker tape”? Anyway, the TGS court said the insider had to wait some sort of reasonable amount of time before trading to their advantage.
  o As an aside, I recently came across a case where a lawyer was attending a board meeting and insider traded on the information he discovered in that board meeting while he was still in the meeting. Truth is stranger than fiction.

• Richelle Ricardo: Does she have liability as tipper? No—she lacks an improper purpose. She discloses the information, in two ways:
  o (1) on Facebook, but this is as a whistleblower, which is like the original tipper in Dirks; and
  o (2) to a friend, but it is within the context of a confidential therapy relationship and not as giving a trading tip, so there is neither a financial quid-pro-quo nor an implied “personal benefit” as in the Salman case.
    ▪ It’s similar in structure to the executive who was discussing the merger at the game with his wife when Barry Switzer overheard them in the Switzer case. Even the aggressive prosecutors who tried to get Switzer didn’t go after the executive who accidentally tipped him.

• Siggie Freud: The liability here would betipper liability for providing a “tip” to Carlie that was traded on.
  o Classical theory. If you disagreed with me on Ricardo, you might find some “classical” liability here, but since I think Ricardo lacked an improper purpose, that theory won’t ensnare Siggie here under any circumstances.
  o Misappropriation theory. This would be under the general heading of the misappropriation theory, based on the duty she owes to Richelle as her therapist. Siggie for that reason has a duty not to trade. Of course, she didn’t trade, but
what about her liability as tipper? The question is whether her disclosure violated a duty of trust that she owed to Ricardo. This is somewhat borderline, I think. My view is that she probably did not violate a trust in “passing the tip” on to Carlie; after all, she tried to keep the names confidential (albeit negligently) and based on the facts we were told doesn’t seem to have thought Carlie would trade before the information became public (which wouldn’t take long, presumably). Although we don’t know much about her relationship with Carlie, it’s also possible that she had a reasonable expectation that Carlie would keep it all confidential herself. In sum, I don’t think she breached her duty in the securities law sense (although it is of course possible that she breached some ethical duty she has as a licensed therapist). But this conclusion is contestable.

- **Carlie Jung:** This is “tippee” liability.
  - **Classical:** Again, I think there can be no liability here, where the initial insider (Ricardo) had no improper purpose.
  - **Misappropriation:** This would be either (1) based on the duty she owes to Siggie to keep their conversations confidential; and/or (2) as the “tippee” based on the duty that Siggie owed to Ricardo not to pass on the information.
    - As far as (2), I am skeptical (as mentioned above) that Siggie breached a duty to Ricardo. If she didn’t, then I don’t think there’s “tippee” liability for Carlie here on that basis.
    - As far as (1), the question of whether such a duty exists is the key. If there is sufficient relationship of confidentiality, and/or if there was an explicit agreement to keep it secret, then Carlie is liable. See Cuban; McGee.
  - The therapist-to-therapist conversation might support this, since there could well be a pattern between these two that supports the imposition of such a duty. See Rule 10b-5: Misappropriation: liability will lie where there is a “[h]istory, pattern or practice of sharing confidences, such that recipient knows or reasonably should know that tipper expects recipient to maintain confidentiality.”
  - But maybe this was just chatting over coffee with a friend who happened to be a therapist—not a professional consultation of any sort.
    - If so, then what do we think? Is this just a case where Carlie gets away with it because her friend, while innocent of intention, was too negligent to ensure proper secrecy?
    - That’s kind of what the jury ended up finding in the Cuban case; the executive failed to get a proper agreement from Cuban to keep the info confidential, and so Cuban didn’t breach a duty.
    - In sum, it could be a fact issue for the jury on this.
  - My view is that Carlie has taken on significant risk here, and is probably guilty, but it could come out either way.

- **Officer Pitino:**
  - Some people construed Officer Pitino as a “tippee” of Ricardo, in which case you might think he can’t be prosecuted given Ricardo’s lack of improper purpose. But
to me, it’s more likely just to view him as having received the information directly from Sox itself, since it did come to him by virtue of his surveillance of a Sox employee (even one who was trying to sock it to Sox), which was part of his employment arrangement and was done at Sox’s request. The analysis below assumes that is correct.

- **Classical**: Is Pitino a “constructive insider” of Sox? Unlike a lawyer or investment banker, a security investigator might not take on fiduciary duties. On the other hand, he works for a firm that has been specifically retained to investigate secrets—so we might expect there to be knowledge of lots of secrets, and a duty not to trade on them, just like a lawyer or banker. This is quite plausible, but not certain.

- **Misappropriation**: A security investigator very likely owes a duty to his own employer, who puts him into regular contact with highly confidential information, not to trade on that information. Probably he also owes a similar duty to the firm’s client, Sox. So I think misappropriation is extremely likely to be effective here.

Insider trading law is complicated and indeterminate, so as mentioned I awarded a lot of partial credit for analysis that was properly tied to the law we studied and made some analytical sense. Perhaps for that reason, this question had the highest average score in the exam, 80%. 
QUESTION 4

Despite Tusk’s efforts, the CrowdNews venture hasn’t gone as well as intended. The actual managing member of the LLC is yet another Delaware entity, Tusk Investments LLC, of which Tusk is the sole and managing member. Through Tusk Investments, Tusk is the majority owner of CrowdNews. Of course, given his charm, charisma, and omnipresence in the media, he is also unquestionably the “public face” of CrowdNews.

At this point, the situation is thus:

• As cash flow has dwindled, Tusk and the staff of CrowdNews (who, needless to say, are cowed by their celebrity boss and do whatever he tells them to) have become more desperate, and have taken the following actions:
  o In order to secure supplies and equipment for their business, they have promised vendors many payments that they know the company probably won’t, absent a miracle, be able to make (Tusk will himself sometimes take the lead by telling the vendors that “of course you know I’m good for it”);
  o They have cut corners on things like insurance, of which they now purchase only the legally required amount and no more, leaving them unable to pay for certain tort claims that they anticipate as a result of their rather lax and unsupervised business operations (e.g., defamation claims due to their “crowdsourced” news site being used to settle personal grudges);
  o They have regularly distributed to their investors (including Tusk) the maximum amounts permitted by law; Tusk has been unwilling to invest any more funds in the business even as, for instance, the likelihood of the tort claims mentioned above has become more pronounced due to certain changes in the company’s focus and operations.
• Tusk has also lost his cool repeatedly—in one particularly bad incident, he screamed and shoved one potential investor into the wall when that investor decided not to help fund CrowdNews. The investor has threatened to sue.
• Minority investors in the business feel that Tusk is at fault for the failure of the business and the loss of most of their capital due to his inattention to the business and his poor strategy choices. The investors have threatened to sue.
• Although there has been no vote of the other members (and unanimity is required for such a decision), Tusk has been negotiating for a sale of all of the assets of the firm. In fact he even struck a deal—and signed an agreement purportedly on behalf of CrowdNews—with a would-be purchaser of the company’s assets. When, after signing the contract, Tusk consulted with his lawyers and realized that he would need to convene a member vote in accordance with the LLC Operating Agreement, he confessed that to the buyer, and the buyer has threatened to sue for enforcement of the contract. (The other members do not in fact support the sale.)

Tusk’s attorneys have brought you in as a specialist in corporate law to discuss potential liability for their client. They are confident that anything done by Tusk will be protected by one or both of the layers of corporate “veil” that they have put in place. Do you share their confidence? What are the consequences of Tusk’s attempted sale of the company?

(30 minutes)
This question presented a lot of difficulties for almost everyone, perhaps because of time pressure at the end of the exam. Thus, rather than present a model answer that might be misleading for people, here is my discussion.

- First, importantly, Tusk will be liable for his own torts, most obviously the shoving. People are always liable for their own torts; no veil-piercing needed there.
- Is there a piercing claim based on purported undercapitalization and/or inadequate insurance? Probably not. They appear to have maintained the legally required amount of insurance; that’s all that’s required most of the time. See Consumer’s Co-op or Arrow Bar. In context, these may all be factors that start to make this look like a set up for fraud or inequity... Also, note that the payment of dividends—while they are explicitly said to be lawful in themselves, so that’s not worth discussing—add to a picture of money being siphoned off while liabilities are built up.
- What about running up liabilities you can’t pay, both tort and contract? That starts to look like Western Rock. And promising payments you know you won’t be able to make can be construed as fraud. Even if Tusk’s statement that he’s “good for it” isn’t taken as an actual guarantee, it certainly sounds inequitable to let him off the hook after saying it. These seem to be likely reasons that veil piercing will probably be permitted in favor of the various suppliers and vendors.
- Can the minority investors sue Tusk—that is, can an insider sue other insiders through the veil—for mismanagement? No, veil piercing usually won’t work. Investors have other remedies like fiduciary duty claims, most importantly duty of loyalty claims against Tusk. The crucial case here is Feeley. (As for the fiduciary duty claims, I gave points for them, but they obviously weren’t the focus of the question.)
- What about the purported sale of the company? Tusk clearly didn’t have actual authority to sell the company (and this will be one of the things that get him sued for breach of fiduciary duties). Did Tusk have the apparent or inherent authority to sell the company? Given his position, he certainly has general management authority over the company. But this is a sufficiently significant decision, probably, that anyone would be on notice that they needed more than just one person’s signature, and/or some more demonstration of his authority (e.g., a resolution or a copy of the operating agreement, etc., showing that the requisite authority is present here). See General Overseas Films. So I don’t think the company would have liability for the sale, and I’m not sure how exactly the would-be buyers would be able to sue Tusk either.
- Does the “second layer,” i.e., Tusk Investments LLC, help Tusk? My answer is probably not. Lake Craig is a good place to go here, as is Best Foods. It seems likely to me that since the second-layer entity seems not to have any real substance, a court is going to find that anything fraudulent or inequitable that was done through these two layers of LLC, Tusk actually did (in other words, if the court is going to pierce the first layer it will probably pierce the second too, since it’s Tusk pulling the strings of both LLCs). Many answers simply ignored this issue, but those who didn’t got a lot of credit even if they didn’t agree with me, because it’s a hard issue.
  - The principle is also explored in the Feeley case, which in turn discusses (as we discussed in class) the USACafes case, where some nefarious human controllers of an entity that was the general partner of an LP tried to say that only the
general partner entity could be held liable, not them, even though they were the puppeteers of that entity.

- In USACafes, as explained in Feeley, the court said, nope, you have duties too, if you’re the human controllers of an entity with fiduciary duties. It seems highly likely that a court would follow that principle here and say that Tusk isn’t protected just because he did all this bad stuff purportedly through his intervening investment entity.

- Thus, the piercing analysis could follow a similar line to the Feeley/USACafes line of reasoning; since Tusk himself seems to have completely dominated both layers of entities, if you can pierce the first layer, the second layer should be easy to pierce too. Again, this is less than clear from the cases, so I gave a lot of credit for attempts to give an answer here.

The average score on this question was 65%.