1. Parent, Inc., is a coal mining corporation. It has several subsidiaries. The subsidiaries are SubKY (which focuses on Kentucky mining operations), SubWV (which focuses on West Virginia mining operations), and SubUSA (which does business in the remaining 48 states). SubKY and SubUSA are wholly-owned subsidiaries, but Parent only owns approximately 70% of SubWV. The remaining 30% of the shares are held by various minority shareholders not affiliated with Parent or its directors or officers. By virtue of its controlling position in all three subs, Parent appoints all of the directors of the subsidiaries, many of whom are also officers or directors of Parent.

As its CEO has acknowledged publicly, Parent’s corporate strategy has shifted, and it wishes to let its West Virginian businesses slowly close down over the next several years. In accordance with this stated plan, SubWV’s board has been paying out large (but legal) dividends, selling off assets, and not investing in any new mining operations in West Virginia. The minority shareholders of SubWV have objected to this strategy. They claim both Parent and SubWV’s board have violated their fiduciary duties by causing SubWV to take up this strategy just because Parent wants it.

What is the most likely outcome?

a. The court is likely to find a violation of the fiduciary duty of loyalty only.
b. The court is likely to find a violation of the fiduciary duty of care only.
c. The court is likely to find a violation of the fiduciary duties of care and loyalty.
d. The court is likely to find no violation of fiduciary duties.

A1. The best answer is (d). This is a Sinclair Oil question. The majority shareholder has picked a corporate strategy that involves winding the company down, but there isn’t anything wrong with that. There’s no disproportionate benefit flowing to the Parent. 75% of the class got this correct.

2. (Add to the facts of the previous question.) Some independent mining engineers did geological surveys and spotted some geographical features consistent with large coal deposits in an area of Kentucky. They bring this information to the attention of one of the directors of Parent. Parent tells SubKY’s officers and board about the findings. SubKY immediately pays these engineers for their information and begins mining operations in those locations. SubWV’s minority shareholders claim that Parent should have permitted SubWV to pursue the opportunity and that its failure to do so was a breach of fiduciary duties.

What is the most likely outcome?

a. The court is likely to find a violation of the fiduciary duty of loyalty only.
b. The court is likely to find a violation of the fiduciary duty of care only.
c. The court is likely to find a violation of the fiduciary duties of care and loyalty.
d. The court is likely to find no violation of fiduciary duties.
A2. The best answer is (d). This is also from *Sinclair Oil*. This corporate opportunity came to Parent, and it is Parent’s to dispose of. 70.59% correct.

3. *(Add to the facts of the previous questions.)* Because SubKY is booming while SubWV is winding down its operations, SubWV recently sold some of its equipment to SubKY. Both sides agree that the price was about 10% below market value for the equipment. The minority shareholders bring suit, claiming that both Parent and SubWV’s board have violated their fiduciary duties by causing SubWV to make the equipment sale on these terms.

What is the most likely outcome?

a. The court is likely to look to the business judgment rule and find that no violation of duties.
b. The court is likely to look to the standard of intrinsic fairness and find a violation of duties.
c. The court is likely to find that the standard of “waste” was met.
d. The court is likely to find no violation of fiduciary duties.

A3. The best answer is (b). This is also from *Sinclair Oil*. The Parent has caused its wholly owned subsidiary to get a good deal at the expense of the minority shareholders of the non-wholly owned subsidiary. That is a version of self-dealing, and a breach of the duty of loyalty. It also has the effect of puncturing the presumption of the business judgment rule and requiring application of the intrinsic fairness standard, which this transaction will fail.

Waste is a very high standard, and merely selling somewhat below the market value is unlikely to meet that standard, nor would it reach the standard of duty of care violations. 55.88% correct.

4. *(Add to the facts of the previous questions.)* Joe is a taxi driver in Kentucky. He notices that a lot of the people he is driving around have “SubKY, a wholly owned subsidiary of Parent” logos on their notebooks, and that they seem to want him to drive them around one particular area of Kentucky, where they seem to be buying up a lot of land. He puts two and two together and realizes there are likely good things in the offing for SubKY and its owner, Parent. He spends his savings on Parent stock. A few months later, a big coal find is announced, and Parent’s stock rises steeply. Joe profits handsomely. But federal authorities investigate and charge Joe with insider trading.

What issue is the case likely to turn on?

a. Whether a tender offer was involved
b. Whether there was material, non-public information involved
c. Whether Joe had an “improper purpose”
d. Whether Joe had a relationship of trust with Parent or SubKY
e. Whether Joe was an insider or constructive or quasi-insider
A4. The best answer is (d). This is clearly not a tender offer. Clearly the information is material and non-public. This isn’t a tipper-tippee case, so “improper purpose” is a red herring. Joe is clearly not an insider or constructive or quasi-insider under the Dirks standard (that’s for actual employees of the company, and employee-like fiduciaries such as lawyers). The key question will be, under the misappropriation standard, does he otherwise have a relationship of trust such that this amounts to a misappropriation of the information from the holder of the information? It seems very unlikely in these circumstances. 44.12% correct.

5. (Add to the facts of the previous questions.) Richard is a lawyer, one of whose clients is Parent. Although he does no legal work related to coal mining (he is a tax lawyer), he happens to overhear a conversation about the big new coal deposits before they are announced while in an elevator at Parent.

Richard’s nephew is working two jobs, trying to pay for college, and Richard decides to give the tip to his nephew. The nephew trades, and make $50,000. Federal authorities detect the irregular trading activity, investigate, and charge Richard and the nephew with criminal insider trading.

Richard and the nephew’s lawyers argue in their favor that Richard did no trading on this information for himself (and didn’t get any “cut” of his nephew’s profits), that no tender offer was involved, that nephew had no relationship of trust with Parent or SubKY, that nephew is an orphan and is a very close family member of Richard for whom Richard has often done nice deeds over the years, and that nephew has maintained a perfect 4.0 g.p.a. in college and aspires to go to law school. Federal authorities are unpersuaded and prosecute both Richard and his nephew.

What is the most likely outcome?

a. Nephew and Richard will be exonerated
b. Richard is guilty but nephew is exonerated
c. Nephew is guilty but Richard is exonerated
d. Nephew and Richard are both guilty

A5. The best answer is (d). This is a classic tipper-tippee case, a la Salman. None of the facts that Richard and his nephew bring to the fore have any exonerating effect. If anything they bring this closer to the heartland of this type of liability. 70.59% correct.

6. Please consider the balance sheet below.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10</td>
<td>$8</td>
</tr>
</tbody>
</table>

Equity  
$__
What is the missing number?

a. -2
b. 2
c. Need more information
d. 1
e. 0

A6. The best answer is (b). Balance sheets involve balancing Assets (10) with Liabilities (8) plus Equity (x). Here’s the algebra: A=L+E. 10=8+x. 2=x. 100% correct!!

7. Please consider the balance sheet below.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in deposit accounts</td>
<td>Long-term debt</td>
</tr>
<tr>
<td>$3.3 million</td>
<td>$2.25 million</td>
</tr>
<tr>
<td>Property plant &amp; equipment</td>
<td>Short-term debt</td>
</tr>
<tr>
<td>$1.70 million</td>
<td>$1.75 million</td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
</tr>
<tr>
<td>$0.15 million</td>
<td></td>
</tr>
</tbody>
</table>

TOTAL ASSETS                  TOTAL LIABILITIES $4 million

<table>
<thead>
<tr>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock at par value</td>
</tr>
<tr>
<td>(1,000 at .01/share)</td>
</tr>
<tr>
<td>Additional Paid-In Capital</td>
</tr>
<tr>
<td>Retained Earnings</td>
</tr>
</tbody>
</table>

TOTAL EQUITY $1,150,000

Under the MBCA, how much could the company pay out in dividends?

a. Zero
b. $949,990
c. $200,000
d. $1,149,990
e. $1.15 million

A7. The best answer is (e). Balance Sheet/Bankruptcy Test: Under the MBCA balance sheet test, all equity (i.e., excess of assets over liabilities) can be paid out ($1.15m). Equity Test: The company can clearly meet its short-term debt obligations because it has cash in deposit accounts far in excess of its short-term debt. 58.82% correct.

8. (Add to the facts of the previous question.) Since the balance sheet was produced, the company took out a $5 million long-term loan. Half of the proceeds were put in the
corporation’s bank account and the other half were used to purchase inventory. A new balance sheet was produced.

What would the TOTAL ASSETS number of the new balance sheet look like?

a. $5.15 million  
b. $0.15 million  
c. $8.3 million  
d. $10.15 million

A8. The best answer is (d). All $5 m of the new money are “assets” and will be added to that side of the balance sheet. 92.65% correct.

9. (Add to the facts of the previous questions.) What would the TOTAL LIABILITIES number of the new balance sheet look like?

a. $4 million  
b. $9 million  
c. -$1 million  
d. $6.25 million

A9. The best answer is (b). You have added $5 m of debt. That is a liability and will go on this side of the balance sheet. Incidentally, these two questions are very similar to Practice Simulation Exercise 6, question 2. 94.12% correct.

10. Matt and Chris are the two partners in a knitting-goods partnership. They have agreed that the partnership is at-will. Over time, their company has been profitable, but business has declined a bit recently, and Chris has begun to get greedy and is imagining going into business by himself.

One week, he makes his moves to that end. On Sunday, he firmly decides to start his own knitting business. On Monday, he thinks of a name for his entity and files the paperwork to form an LLC with that name. On Tuesday, he rents out office space and begins purchasing knitting supplies and otherwise preparing the facility (he is careful to use his personal money for all of these purchases). On Wednesday, while Matt is out of the office, Chris approaches several staff members and signs them on for his new venture; he also calls several of their best customers and solicits them for his new business. On Thursday, he tells Matt that he no longer wants to be in the partnership, and they begin the partnership winding-up process.

Based on these facts, when did Chris most likely first breach his fiduciary duties to Matt?

a. Monday  
b. Tuesday  
c. Wednesday  
d. Thursday
A10. The best answer is (c). This is similar to our cases Community Counselling Servs. and Hamburger, as well as Meehan v. Shaughnessy. He should not have taken any steps that actually harm his existing partnership prior to dissolving it. His Sunday, Monday, and Tuesday activities were normal logistical business activities that didn’t violate any duties because there’s no direct conflict with the existing business. On Wednesday, however, he crossed that line. Poaching employees and clients is clearly not in the best interests of the existing business. 80.88% correct.

11. Hunter has a partnership with Ashley. They decide to part ways. They are going to dissolve the partnership and divvy up the assets pursuant to governing law. At the time of dissolution, the partnership’s financial situation is as follows. Ashley’s capital contribution was $60,000, and Hunter’s was $40,000. Ashley also loaned the company some money when it was starting up, and this loan is still outstanding. The balance on the loan, with interest included, is now $10,000. Other creditors are owed $30,000. The partnership’s assets are $300,000. The partners agreed to split profits evenly.

How much does Ashley get in total from the partnership’s assets?

a. $150,000  
b. $120,000  
c. $140,000  
d. $70,000

A11. The best answer is (a). The principle here is that creditors get paid first, then partnership contributions, and then profits paid out. Partnership assets are 300k. Creditors are owed 40k (of which 10k goes to Ashley). That leaves 260k. Now the capital contributions are repaid in the sum of $100k (of which $60k goes to Ashley). That leaves $160k of profits to divvy up (of which 80k goes to Ashley). So, how much does Ashley get in the end? 10k + 60k + 80k = $150k. 57.35% correct.

12. Bill and Ted are going to form a corporation called Excellent Tours Inc. Their lawyers are still working on the corporate paperwork and they are still getting the money together to start the business. But they enter into a contract with a supplier to purchase a shipment of canoes. The canoe supplier has presented them with a contract with the following language:

   It is understood by the parties hereto that it is the intention of the Purchasers Bill and Ted to incorporate. Upon condition that such incorporation be completed by closing of the canoe sale transaction, all agreements contained herein shall be construed to have been made between Seller and the resultant corporation and all documents shall reflect same.

They have asked your advice. Which is the best advice to give them?
a. Sign it. Even if you don’t incorporate, you will not be on the hook for this debt!
b. Sign it. As soon as you incorporate, you will be off the hook for this debt!
c. Be careful. You not only have to incorporate, the resulting corporation has to either adopt the agreement or close the transaction.
d. Be careful. You’ll be liable unless the canoe seller agrees to let you off the hook later—
even if your new corporation adopts the agreement and closes the transaction.

A12. The best answer is (c). This contractual language is basically drawn from the RKO-Stanley Warner Theatres case. There the court held that notwithstanding the apparent meaning of the clause (that upon incorporation, the promoters are released), in fact the clause required adoption/ratification, either implied or express, by the resultant corporation. Answer (d) is incorrect because once the corporation adopts the deal or the deal closes, the canoe seller has no grounds on which to hold you liable, as explained in the case. 45.59% correct.

13. Together with her friend Everett, Josephine owned a dog grooming business, JosEv Grooming. The business was formed as an LLC. The Operating Agreement made clear that Everett was to play a passive-investor role and that Josephine had total daily control of the organization, although it also made clear that Josephine would actually manage it through her own entity, JosManager LLC. (Technically, the members of JosEv are Everett and JosManager, and Josephine herself is in turn the sole manager/member of JosManager.) By the time she came to your office, relations between Everett and Josephine had soured and he was accusing her of all sorts of horrible acts and deeds toward him and toward their business.

One of the types of claims he has threatened to bring are fiduciary duty claims. Josephine was a UK law grad and thinks that because of the “extra insulation” provided by JosManager LLC, she has nothing to worry about.

As her lawyer, what do you think?

a. She should be worried about all fiduciary duty claims.
b. She should be worried about duty of care claims only.
c. She should be worried about duty of loyalty claims only.
d. She should not be worried!

A13. The best answer is (c). This is essentially the Feeley case, where the court (discussing and following USACafes) says that there’s no duty of care that will go up the chain through an artificial entity appointed as manager (which is why the Feeley court dismisses Count IV in that case), but that you can’t evade the duty of loyalty. Incidentally, as for (c), the Delaware courts have said there’s no independent duty of good faith, it’s part of the duty of loyalty, see Stone v. Ritter, and we have no indication that wouldn’t hold for the LLC context as well, so that’s not as good an answer. 30.88% correct.
14. *(Add to the facts of the previous question.)* Another type of claim that Everett has threatened is a breach of contract claim. He claims that Josephine didn’t perform certain functions she was contractually obligated to under the Operating Agreement. For instance, in her role as manager, she didn’t select good sites for their grooming studios, she sent Everett his annual report a few weeks late, and she sometimes used Apple products instead of Dell products, which she was contractually obligated to do (Everett is a big fan of Dell).

Again, Josephine feels confident that these are all, at most, breach of contract claims against JosManager LLC, which actually signed the contract, and not her in her personal capacity.

As her lawyers, what do you think?

a. She should be worried. He might be able to pierce the corporate veil, because it’s easy to pierce when you have a small LLC like JosManager LLC.
b. She should be worried. Even if the veil isn’t pierced, she will be liable for the contract (the Operating Agreement) that JosManager signed, because you’re always responsible for contracts—even if you sign on behalf of a corporate entity such as an LLC.
c. She should be not worried. The corporate veil will likely protect her against the actions described here.
d. She should not be worried because even though the operating agreement specified that Everett would have a passive-investor role, courts do not care very much about LLC operating agreements. The court will likely find that Everett assumed the risk of Josephine’s bad conduct and should have protected himself better.

A14. The best answer is (c). Nothing here seems likely to rise to the level of what is required for veil-piercing. And unlike the tort context (see the next question), you aren’t liable for contracts that you sign on behalf of an existing entity. As for (d), of course it is quite false to say that courts do not honor operating agreements. To the contrary courts go out of their way to honor the contractual agreements of the parties in LLCs. 51.47% correct.

15. *(Add to the facts of the previous questions.)* Another type of claim that Everett has threatened is a tort claim—for fraud. He claims that Josephine misled him about numerous aspects of the LLC, that he reasonably relied on her representations, and that he was harmed as a result. For instance, she induced him to invest more money and expand the business by leading him to believe that they were turning profits on each grooming studio, when in reality they were losing money and the expansion was simply a last-ditch shot she wanted to take at the business.

Again, Josephine feels confident that these are all, at most, tort claims against JosManager LLC, and not her in her personal capacity. As her lawyers, are you worried?

a. She should be worried. He might be able to pierce the corporate veil, because it’s easy when you have a small LLC like JosManager LLC.
b. She should be worried. Even if the veil isn’t pierced, she will be liable, because you’re always responsible for torts that you commit.

c. She should be not worried, because the corporate veil will likely protect her against the actions described here.

d. She should not be worried because even though the operating agreement specified that he would have a passive-investor role, courts do not care very much about LLC operating agreements. The court will likely find that Everett assumed the risk of Josephine’s bad conduct and should have protected himself better.

A15. The best answer is (b). You’re always responsible for your own torts. 86.76% correct.

16. Big Industry, Inc., is a public corporation that has been struggling of late. Its share price has recently dropped significantly as business moves overseas. Its CEO reassured investors with a public statement. The CEO stated, “We are planning to grow our business overseas by entering into strategic partnerships. Many, many potential partners have already approached us. We are very excited and hopeful about this course of action, which could be hugely beneficial to our shareholders. In my opinion, our stock may soon be more valuable than ever!” Six months pass and the CEO makes no further statements.

You are Big Industry’s federal securities law expert. You discover several facts. Which one of these facts gives you the most concern?

a. When the CEO made the statement above, several of the “partners” he referenced were in fact quite small companies, and entering into partnerships with them would have a modest at best influence on Big Industry’s value.

b. When the CEO made the statement above, his team was actively considering an equity offering to raise capital.

c. When the CEO made the statement above, “many, many” was more like 8-10 at most.

d. Now (six months later), talks with most of the potential partners have fizzled and seem unlikely to bring any big deals.

A16. The best answer is (b). This is very similar to the Time Warner case. He didn’t make any actionable misrepresentations; his statements were essentially puffery and/or statements of opinion. Also, because his predictions of success weren’t definite and specific, he doesn’t have a duty to correct them over time. However, it is a problem that he didn’t disclose that there was another type of plan that was actively being considered, and that was certainly material in that it would likely drive the stock prices down. 67.65% correct.

17. Big Industry has continued to struggle. The CEO has been making increasingly desperate efforts to salvage the company and its stock price. Most recently, he lied about some environmental exposure the firm faced: When newspaper reports of the problems started to surface, he posted on his official social media accounts, “Fake news! All lies! We don’t have any enviro problems!”
About two weeks later, federal authorities announced their findings that Big Industry had engaged in extensive polluting activity at several sites and would be fined several hundred million dollars. Securities lawsuits of course followed.

In those securities lawsuits, which of the following would be relevant to the court’s consideration of reliance/transaction causation for a given plaintiff?

a. The plaintiff didn’t follow the CEO on social media and thus likely didn’t specifically rely upon his statements.
b. While the plaintiff owned stock at the relevant time, and its value has gone down, the plaintiff hasn’t yet sold their stock, so they haven’t actually suffered any losses.
c. Other competitors of Big Industry have been suffering lately, from an industry-wide downturn, so some of the dip in stock price might not be because of the specific environmental concerns that the CEO lied about.
d. Because the major players on the stock market have learned to ignore the CEO’s blustering proclamations on social media, and because the initial rumors of degradation were credible, his statement didn’t affect stock price one way or the other.
e. When the CEO made his statement, he thought that the findings weren’t definitively, scientifically proven yet to a proper standard of statistical significance (although he was aware of some data suggesting potential problems at the sites).

A17. The best answer is (d). If market makers ignored his statement, and if the credible reports were already incorporated into the stock price, then that would threaten the Basic/Halliburton II presumption of transaction causation. The reason (a) is irrelevant is that this is exactly the sort of specific causation that the Basic presumption says you don’t have to show, thanks to the efficient capital markets hypothesis. The reason (b) is irrelevant is that it is at best relevant to loss causation (and of course even if you haven’t sold the stock, if it’s declined in value, you’ve lost something), which relates to what harm you have suffered, and not to transaction causation, which deals with why and at what price you purchased the security. As for (c), that too is relevant to loss causation and not reliance or transaction causation. It really doesn’t speak to whether these lies caused the stock to be artificially inflated. Also note that only “some of the dip” can be explained this way. Finally, (e) is similar to the unsuccessful argument advanced in the Matrixx case, where the court distinguished between material facts from facts that hadn’t been scientifically proven. This was a hard question. 19.12% correct.

18. You are good friends with two WNBA stars, who happened to be sisters, named Emerson and Lillian.

Emerson comes to you excitedly one day and tells you that she has a great new endorsement deal. Upon inquiring further, you learn that she has a signed endorsement contract with the shoe company Madidas, Inc., a Delaware corporation. The contract was negotiated and signed by “Molly Hill, Member, Board of Directors, Madidas.”
The next day, Lillian brings you more good news. Unbeknownst to her sister, she has also negotiated an endorsement deal with Madidas. Her contract was negotiated and signed by “Luke William, manager, Madidas Store, Fayette Mall” (Fayette Mall is a shopping center in the Lexington, KY area).

You check both Molly and Luke out on Madidas’ web page, and you discover that they are exactly who they say they are. You also note that both agreements are on official Madidas stationery.

Emerson and Lillian want to know if their agreements are likely valid. Based on the information given above, do you think the agreements are likely valid and enforceable?

a. Both are likely valid and enforceable.
b. Both are likely invalid and unenforceable.
c. Emerson’s is likely valid but not Lillian’s.
d. Lillian’s is likely valid but not Emerson’s.

A18. The best answer is (b). While it is of course possible that the agreements are valid, you have no real basis to think they are. The mere fact that you’re a director gives you no power to do anything in a company, on your own. (The slide on this topic says, “Individual directors are not agents of corporation—only the board itself can act as a ‘super-agent’ and bind the corporation.”) And a branch manager of a single mall-based store surely doesn’t have the authority on their own to enter into an endorsement contract on behalf of a shoe company. This question was hard. Most people who missed the question didn’t understand the first point, that a director on their own can’t bind the corporation. 13.24% correct.

19. (Add to the facts of the previous problem.) You hold several thousand dollars’ worth of shares of Madidas, and you are also a fervent environmentalist. You discover that one of the materials Madidas includes in one of its shoes, the Zoolander, requires use of a solvent that is extremely toxic to the duck-billed platypus, a creature of considerable grace and beauty, the U.S. population of which has sharply declined in recent years. While you are committed to doing what you can, you don’t have a lot of money. The Zoolanders that require this solvent make up an extremely small part of Madidas’ total business; sales of the shoe are less than .01% of Madidas’ total revenues, and the shoe line was unprofitable by a small margin.

What’s your best course of action?

a. Make a shareholder proposal with a resolution recommending that Madidas study ways to produce the Zoolander shoes without the solvent.
b. Make a shareholder proposal with a resolution demanding that Madidas immediately stop using the solvent in all shoes.
c. Wage a proxy fight and try to elect new directors who agree with your views.
d. File a lawsuit alleging that the directors of Madidas are violating their fiduciary duties by continuing to use this solvent to make a product that damages the environment.
e. Abide by the “Wall Street Rule”—Sell your shares. Then you can donate the profits to an environmental charity. The other courses of action are, legally speaking, hopeless.

A19. The best answer is (a). Lawsuits are unlikely to be successful, and are expensive if not successful; proxy fights are also expensive and unlikely to succeed. The shareholder proposal demanding the company stop using the solvent will be invalid because it intrudes into the management of the company. A precatory proposal like (a) has a likelihood of success; and despite the small impact on the company’s bottom line, the court in Lovenheim said that doesn’t bar it from working. 61.76% correct.

20. *(Add to the facts of the previous problems.*) Before you actually do anything, your research reveals that one reason for the production of the Zoolander shoe is that its designer, Derek Zoolander, is the nephew of Madidas’ President, CEO, Chairman of the Board, and majority shareholder, Bob Zoolander. Research also reveals that Derek and Bob have actively worked to prevented research on the solvent’s environmental effects from reaching the public eye. You aren’t sure of the composition of the remainder of Madidas’ board of directors, but since Bob is the majority shareholder, it seems highly likely to you that he hand-selected most if not all of the directors.

What’s your best course of action now?

a. Wage a proxy fight and try to elect new directors who agree with your views
b. Engage in discovery concerning the board and its decisionmaking with respect to the shoe.
c. Make a demand on the corporation to sue Bob for his breach of fiduciary duties.
d. Because demand will likely be excused, forget about it—bring a derivative lawsuit alleging breach of fiduciary duties.
e. Make a shareholder proposal with a resolution demanding that Madidas immediately stop using the solvent in all shoes.

A20. The best answer is (b). You need more information—discovery—in order to try to get around the presumption requiring demand on the board. The mere fact that Bob may have had a hand in appointing them isn’t enough. 51.47% correct.

21. *(Add to the facts of the previous problems.*) The facts you uncovered in the previous question “go viral,” and all of the sudden, plaintiffs lawyers are contacting shareholders and bringing all sorts of claims against Madidas and its board of directors. The pending cases relevant to this dispute have been consolidated in one Delaware court.

Following the typical corporate playbook these days, Madidas’ board designates a “Special Litigation Committee” made up of independent members of its board. The SLC commissions an outside law firm and an outside accounting firm to research the issue. After the reports come back, the SLC composes and approves a written report determining that litigation is not worth
pursuing with respect to these alleged breaches at this time. Naturally, all of the plaintiffs press their claims in court.

What is the Delaware court likely to do?

a. The SLC may be independent, but the court will not honor its decision unless the board that appointed it is also independent. That’s what the court will first determine. Only if both are independent will the SLC’s decision be entitled to business judgment rule deference.

b. The court is likely to look into the SLC’s independence and good faith, and the bases of its recommendations, and then also use its own business judgment to determine whether the case should be dismissed.

c. The SLC is composed of independent directors. Courts don’t like second-guessing the business decisions of independent directors. The court will likely accept the SLC’s determination because it will be entitled to business judgment rule deference.

d. The court is likely to look to the reality that the board is dominated by its majority shareholder and thus hold that demand is excused.

A21. The best answer is (b). The crucial point here is that we are in Delaware, so the so-called Zapata two-step will govern. That law is best described by answer (b). 80.88% correct.

22. Your client is Kentucky Jewelers, LLC. It is a modest venture, although it has numerous small branch stores throughout the bluegrass state. One of its three managing members calls you, thrilled, because he has just received a call from Sally McDonald, the managing partner of Lexington’s largest law firm, LexLawyers LLP. Sally explained that as a bonus to all of the lawyers at the firm, the firm wants to buy 80 beautiful rings, each worth $50,000. (The firm owns the building in which its offices are located, and the land alone is worth $5 million, so you know they have the money to do the deal.) This is one of the biggest deals in the Kentucky Jewelers’ history and would essentially amount to a sale of its entire stock of rings. Sally requested that all the rings be delivered to the law firm’s office the next Saturday.

What is the best advice for your client?

a. You should check the firm’s website and also call up a couple of other partners to confirm that Sally is still the managing partner of the firm. As long as you are confident in Sally’s position as managing partner, you should do the deal. The firm will be bound by its managing partner.

b. Insist upon having a certified resolution, adopted by the firm’s partners at a partnership meeting, approving the purchase.

c. To allay any concerns about payment, make sure Sally will personally meet you at the offices at the time of delivery with a check, under the firm’s name and bearing her signature.

d. The options above won’t work. Insist on being paid in cash for the transaction, otherwise the firm may “walk the deal” no matter what you do.
A22. The best answer is (b). While managing partners might have a lot of authority, buying large amounts of jewelry is not within that usual scope. The only way to protect yourself is to get confirmation of the action by the partnership itself. Once you have that, you should be protected, so demanding cash, as in (d), is unnecessary (and probably unwise—do you really want to deal with that much cash?). 57.35% correct.

23.  

*Change the facts of the previous problem slightly:* Your client is Sally McDonald, the managing partner of Lexington’s largest law firm, LexLawyers LLP.

Sally is outraged. She explains that last week, she struck a deal for the purchase of some rings that were to be distributed as a bonus to the lawyers are her firm. The rings were to be sold by Kentucky Jewelers, LLC, a modest venture with numerous small branch stores throughout the bluegrass state. The price was to be $50,000 per ring for 80 rings. The agreement was signed for the bank by “Dwight Shrute, Assistant Branch Manager.” Mr. Shrute was very excited about the deal and mentioned that this was to be one of the biggest deals in the Kentucky Jewelers’ history and would essentially amount to a sale of its entire stock of rings.

Now Kentucky Jewelers is trying to back out of the deal because they say the price should have been $60,000 (not $50,000) for those particular rings. Sally wants the jeweler to honor the deal that it entered into.

Which fact would *most* favor Sally’s case?

a. Mr. Shrute really *was* Assistant Branch Manager. The LLC gave him stationery and a badge that said so, and listed him as such on its website.

b. Mr. Shrute was only “Assistant *to the* Branch Manager,” a less prestigious position, but he had done jewelry deals on the LLC’s behalf before, including some small deals with Sally for her personal jewelry collection.

c. Mr. Shrute actually got written approval from the LLC’s three managing members to do the deal at the stated price—*but* he has never done this type of deal before, and he actually told Sally that.

d. Mr. Shrute got approval by phone of the transaction from one of the LLC’s members at the time he entered into it.

e. Sally carries around a small personal recording device, and she has Mr. Shrute on tape explicitly assuring her that he has the authority to enter into this transaction.

A23. The best answer is (c). It doesn’t matter who Dwight is or what he’s done before because if (c) is true, then he had actual authority to enter into the transaction. Note that the LLC is stated to have many “small” branches and that this is to be one of the biggest deals in the company’s history. Thus, the other options are not as good. It is unlikely that the purchase could be approved by an Assistant Branch Manager, or an Assistant to the Branch Manager, or even one member of the LLC acting alone. Mr. Shrute’s own statement of his authority is obviously inadequate. See, e.g., the *General Overseas* case on all of this. 61.76% correct.
24. Molly and Luke Tanner enter into partnership. Luke will supply their initial start up costs of $30,000. Molly will obtain clients, do the jobs, hire and supervise employees, and so on. They will split profits 50-50.

Their venture fails, their partnership loses all its money, and they agree to go their separate ways. Luke requests that Molly give him $15,000 to “make up her half of the loss.”

What is the most likely outcome?

a. Molly will have to pay this Luke what he is requesting, because unless otherwise agreed, partners share both profits and losses. The loss here is $30,000, and her half of it is $15,000.
b. She will not have to pay him because her capital contribution was in the form of “sweat equity.”
c. The court should estimate the value of Molly’s labor at some reasonable hourly rate, and give her “credit” for that amount. If the value of what she has “contributed” is less than $15,000 then she owes the difference to Luke. If her labor is worth more than $15,000, then actually Luke may owe her some payments.
d. The court should estimate the value of Molly’s labor at some reasonable hourly rate, and give her “credit” for that amount. If the value of what she has “contributed” is less than $15,000 then she owes the difference to Luke. But if her labor is worth more than $15,000, Luke doesn’t owe her anything.

A24. The best answer is (b) on the example of Kovacik v. Reed. Both lost their “contributions,” one in the form of wasted money, the other in the form of wasted sweat. 77.94% correct.

25. Having settled the dispute from their previous partnership, Luke and Molly enter into another partnership, in which they make equal monetary capital contributions, work equally for the partnership, and agree to split the profits 50-50.

When this one winds down, the partnership has two remaining assets, each a residential home worth about the same amount of money. Luke wants the court to award one house to each of them, so as to avoid taxes and transaction costs and to let each partner choose the right time to sell each of the houses. Molly wants the court to hold an auction to sell both houses and then distribute the money 50-50.

The relevant statute states as follows concerning the winding up of partnerships: “Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, the profits and losses that result from the liquidation of the partnership assets must be credited and charged to the partners’ accounts. The partnership shall make a distribution to a partner in an amount equal to the partner’s positive account balance.”

What is a court likely to do?
a. Do it Molly’s way because it will be too hard to figure out which house to give to which partner.
b. Do it Luke’s way because his way will be more economically efficient.
c. Inquire further into the conduct of the parties in the partnership and do it according to the preferences of the partner who behaved best in the partnership under principles of equity.
d. Do it Molly’s way because of the strict statutory language.
e. Do it Luke’s way because of the strict statutory language.

A25. The best answer is (d). This is essentially based on McCormick v. Brevig, where the court interprets liquidation to mean reduction to cash, not divvying up by principles of equity. 89.71% correct.

26. LexLawyers LLP is one of the finest firms in Lexington and it has an aristocratic, conservative reputation to uphold. The stodgy partners of the firm were scandalized, then, when sordid allegations against a famous basketball coach in a nearby city surfaced, and one of their law partners, Louis, made several statements to the effect that he thought the coach was innocent and was simply being smeared by those jealous of his coaching talent.

The partners at LexLawyers warned Louis not to continue to make such pronouncements, which didn’t comport with their “firm culture.” In retort, he reminded them of “this little thing called the First Amendment.” He also noted that he had brought in a lot of great business that year and was performing very well as a lawyer (and they had to admit he was right about that).

The LexLawyers partnership agreement gives broad authority to expel partners with or without cause upon the vote of the majority of the partners. Despite being warned, Louis kept making the statements, and the partners voted to fire him.

Louis sues for wrongful expulsion. What result?

   a. Louis wins because you can’t fire someone for such a trivial, non-business-oriented reason.
   b. Louis wins because you can’t fire someone for constitutionally protected speech; it’s void as against public policy.
   c. Louis wins because the other partners have violated their duty of loyalty toward him.
   d. Louis wins because even basketball coaches are entitled to due process of law.
   e. The partnership wins.

A26. The best answer is (e). Partnerships are consensual enterprises, as the court reminded us in Bohatch v. Butler & Binion. Partners can expel partners for reasons that wouldn’t represent “cause” in any meaningful sense—or, as in Bohatch, for reasons that are actually required by ethical duties. 94.12% correct.
27. *(Add to the facts of the previous problem.)* LexLawyers has other problems aside from Louis. One of their lawyers, Sam, has made mistakes on a couple of his cases lately. A junior partner, Laura, decides she has had enough. She realizes he hasn’t acted recklessly or been grossly negligent, but she has high standards! She sues Sam, alleging that Sam has been negligent, and thus has violated his duty of care to the other partners.

What is the likely result of this action?

a. The court won’t intervene because partners are responsible for monitoring each others’ negligence—that’s not the court’s job.

b. The court won’t intervene because all claims against lawyers should go to state disciplinary authorities and not courts of law.

c. The court won’t intervene unless Laura gets a majority vote of the partnership to bring the duty of care claim.

d. The court won’t intervene unless Laura shows that demand is futile.

e. The court won’t intervene unless Laura provides expert testimony showing that Sam’s performance was below the standard of care.

A27. The best answer is (a). The question here is whether the court will intervene, not whether Laura is right that Sam isn’t doing his job. Whereas courts have held that general or managing partners may owe limited or passive partners some judicially enforceable duties of care, and some courts have enforced breaches of duty of care for gross negligence, there is no cause of action for negligence (as alleged here), particularly in a partnership such as this one, where all partners have duties to monitor each other (and can avail themselves of the right to dissociate as needed). Her showing that he’s performing negligently won’t matter. *See Ferguson v. Williams.* 61.76% correct.

28. *(Add to the facts of the previous problems.)* LexLawyers has run into yet more problems, this time concerning partnership compensation. The back story is this: LexLawyers initially enticed Laura to join the partnership by promising her that her compensation would be “fair, and reflect the work you do and not just the clients you bring in.” That said, when Laura actually saw the partnership agreement, she noticed (before signing) that it gave the management committee “complete, utter, unchallengeable” discretion over compensation. She complained about this clause in writing and was told by the partners that if she didn’t like it, she could turn their offer down. She took the offer anyway.

Ever since her action against Sam, and despite her billing many hours, Laura’s compensation has gotten lower and lower. While the management committee always seems to find a reason—“we looked at client origination more this year,” “we awarded more for community service this year”—it seems as if they are simply selecting criteria that maximize compensation to them and their cronies, and minimize the compensation that goes to Laura.

Laura has now sued for breach of the duty of loyalty and the duty of good faith and fair dealing. What is the likely result of this action?
a. The court won’t intervene because she can always leave the partnership if she doesn’t like it.
b. The court won’t intervene because she knowingly and willingly signed the agreement that gave discretion to the management committee.
c. The court won’t intervene because the business judgment rule protects the actions of the management committee under these facts.
d. The court won’t intervene because (a), (b), and (c) are all true.
e. The court will intervene.

A28. The best answer is (e). This is basically the situation in *Starr v. Fordham*. This sort of contractual grant of discretion can’t allow the management committee to get around their duty not to self-deal to their partner’s detriment. (Although it bears noting that it is possible that in Delaware, in an LLC, you could contract out of the duty of loyalty component of this; the duty of good faith and fair dealing might still prevent the course of action as described, but that is beyond the scope of this course.) 47.06% correct.

29. You represent Mike. Mike is one of three members of Kentucky Jewelers, LLC. He is also a long-time director (although only a very small shareholder) of Diamond Mining, Inc. Kentucky Jewelers has made an offer to purchase some mining rights in a particular area from Diamond Mining. The board of Diamond Mining, which includes 3 other directors, is going to consider the offer at its next meeting. Mike notes that his fellow board members are aware that he is one of the members of Kentucky Jewelers.

He tells you, confidentially, the following: He is confident that Diamond Mining and any experts it might hire will find that the deal is fair. They are likely to find it is a better-than-current-market-price for the rights being sold. In fact, Mike has had numerous discussions with Diamond Mining’s CEO assuring him about that (Mike knows more about mining rights in this region than anyone else on the Diamond Mining board).

**But,** Mike adds that he has engaged in some geological surveying in his spare time, and he thinks that Diamond Mining’s holdings are worth more than it thinks, and that the deal will therefore end up quite beneficial to Kentucky Jewelers in the long run. You’re the only person aside from Mike who knows about these surveys.

Mike is aware that he should be careful of allegations of conflict of interest. That said, he wants—he needs—the deal to go forward, under the current terms and **without** either resigning from either position or disclosing his big secret. He isn’t going to take “no” for answer: “Either you’re going to help me or I’m going to find another lawyer.”

Of the following options, what is the best advice you can give Mike concerning the upcoming Diamond Mining board meeting?
a. Remain silent at the board meeting. Then no one can accuse you of having violated your duties.

b. Remain silent, and don’t vote, at the board meeting. Then no one can accuse you of having violated your duties.

c. You’re only one member of the board. If the other board members vote in favor of the transaction, that will have the effect of ratifying or “cleansing” the transaction, no matter what you do.

d. You can rely on the fact that the CEO, who is after all a well-compensated expert, has (albeit with your help) reached the conclusion that this transaction is beneficial for Diamond Mining.

e. None of the above options are likely to succeed. Find another lawyer if you must.

A29. The best answer is (e). On the example of *Globe Woolen Co. v. Utica Gas & Electric Co.*, remaining silent and abstaining from the vote will not help. Nor will the fact that there are other directors who approve of this transaction, and/or that the CEO thinks it’s a good idea. To the contrary, the problem remains that Mike isn’t disclosing all the material facts that he is aware of to the board on which he sits. That’s part of his duty, according to *Globe*.

Even if he were to resign his position on the board, I don’t think that would work, if for no other reason than that he has influenced the process already. And even if he hadn’t, I think that once he obtains his valuable knowledge (even if on his own spare time), he likely has a duty to disclose his knowledge concerning the actual value of Diamond Mining’s land and not to benefit from it himself. But this is a closer call and I didn’t test it here. 70.59% correct.

30. Which one of the following is a leveraged buy-out?

a. A small group of investors purchase all the equity in a firm by buying out existing shareholders with a combination of the investors’ money and the proceeds of an issuance of junk bonds.

b. A company makes an initial public offering of its stock. Five million shares are sold on the New York Stock Exchange for $60/share. The founders of the company receive a huge payday.

c. A wealthy private investor buys a public firm. The investor makes a tender offer and buys out all existing shareholders.

d. A venture capitalist converts large amounts of its convertible debt into stocks in the company, thus obtaining substantial control of the company.

e. A company decides to issue a lot of bonds, and use the money to repurchase large amounts of its own stock (thus leaving it highly “leveraged”).

A30. The best answer is (a). The other forms of acquisition are simply not LBOs although some of them involve leverage. 39.71% correct.

31. The Efficient Capital Markets Hypothesis relies upon the notion that in active marketplaces, the frequent buying and selling of securities will lead to accurate pricing of those securities by the natural effect of market dynamics.
Which of following concepts is a crucial part of how market activities make prices converge on one single, accurate value for a given thing?

a. Diversification  
b. Arbitrage  
c. Leverage  
d. Black-Scholes Valuation Model  
e. Freedom of Contract

A31. The best answer is (b). Arbitrage is how people make money on mispriced items, thus putting pressure on values to converge at an accurate location. 45.59% correct.

32. Consider this quotation:

“[T]he essence of business is risk — the application of informed belief to contingencies whose outcomes can sometimes be predicted, but never known. The decisionmakers entrusted by shareholders must act out of loyalty to those shareholders. They must in good faith act to make informed decisions on behalf of the shareholders, untainted by self-interest. ... Even where decision-makers act as faithful servants, however, their ability and the wisdom of their judgments will vary. The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decisionmakers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike. That is why, under our corporate law, corporate decision makers are held strictly to their fiduciary duties, but within the boundaries of those duties are free to act as their judgment and abilities dictate, free of post hoc penalties from a reviewing court using perfect hindsight.”

This quotation is best read as a defense of which doctrine?

a. Fiduciary Duties  
b. Intrinsic Fairness  
c. Business Judgment Rule  
d. Mandatory Indemnification  
e. Permissive Indemnification

A32. The best answer is (c). This is the explanation for the business judgment rule given by the court in the Disney litigation. 92.65% correct.
33. If one of a company’s shareholders files a lawsuit alleging that its CEO breached fiduciary duties (for instance because of a self-dealing transaction), what sort of lawsuit will that likely be?

a. Direct lawsuit  
b. Derivative lawsuit  
c. Federal securities lawsuit  
d. SEC compliance action  
e. Demand letter

A33. The best answer is (b). The director has directly harmed the corporation, and only indirectly harmed the shareholders, so the shareholder’s claim is derivative of the corporation’s. 89.71% correct.

34. The current value of Google stock is $1035.49. You have been offered a call option on Google stock with an exercise price of $1500. You may exercise your option any time from January 1, 2021, until December 31, 2021.

Which of the following is true about this option?

a. It has no value until January 1, 2021.  
b. Its value can’t be estimated now but you can be sure that by January 1, 2021, it will be worth at least $464.51—and maybe more.  
c. Its value is $464.51.  
d. Mathematically adept experts can give it a range of current values, but a court may not consider this valuation dispositive.  
e. Mathematically adept experts can give it a range of current values, and a court will consider this valuation dispositive.

A34. The best answer is (d). This was tested in the The Limited litigation, where the court rejected a claim of waste despite the Black-Scholes valuation model suggesting that the options that the board gave away for very little were worth hundreds of millions of dollars. 36.76% correct.

35. Jack, Jill, John, and Judy are four siblings with equal stakes in a family business (a close corporation). They are the only four shareholders in the corporation. For many years, by mutual consent, they shared management responsibilities and all received nice, regular salaries from the business. By long-established policy, the business didn’t make any distributions of profits to shareholders.

Jill is an accountant, and she was in charge of the company’s bookkeeping. But it turns out that she had her hand in the till—she stole money from the business over the course of several years. When the other siblings found out, they immediately fired her from her job, changed all the locks and online passwords, and have told her never to come on premises.
Jill feels bad about her misdeeds, but she needs money to live. She claims that she is being oppressed by her siblings and has requested that (1) that the siblings reinstate her in her old job (she promises she won’t do it again!); (2) that they give her access to the business’ corporate records; and (3) that they buy her out or start to pay distributions of the profits rather than only paying out salaries.

What is the most likely outcome of their dispute?

a. She has been punished enough. At this point, they need to take all of the steps she has requested.

b. They don’t have to allow her to participate in the business any more, but they do need to provide her access to corporate records and make some reasonable distributions or offer a buyout.

c. They don’t need to allow her to participate or to review any corporate records, but they need to make some reasonable distributions or offer a buyout.

d. Provided they can prove in court that she did indeed embezzle, they can lawfully deny her all of these things.

A35. The best answer is (b). This is based on the case of Gimpel v. Botstein. The court there held that the business had to give the embezzler access to corporate records, and either buy him out of make distributions (despite a history of not making distributions). But they could continue to exclude him from management. 54.41% correct.

36. Paul and Zack have a law partnership, “LexLandLaw LLP,” that provides development advice for residential developers. They each contributed $100,000 to the partnership. It has been successful. But Paul wants more. Paul secretly creates a new venture on the side, “Parcel Plans LLC,” to actually purchase and develop land. Parcel Plans then hires LexLandLaw to do legal work for it. Paul secretly “negotiates” regarding the hourly rates that LexLandLaw will charge Parcel Plans; he frequently sends bills for his LexLandLaw work to Parcel Plans, where he himself usually opens the mail and helps pay the bills.

Parcel Plans occasionally struggles to pay its bills (and that’s when Paul, in his capacity as a partner at LexLandLaw, has to send letters seeking payment from himself, in his capacity as one of the member-managers of Parcel Plans). But over time, the work is profitable to both. Thanks to LexLandLaw’s legal advice (which both Paul and Zack provide), Parcel Plans makes a lot of sophisticated development moves, and LexLandLaw collects its usual, profitable hourly fees. Everything is great, right?

Well, Zack doesn’t see it that way. When he finds out what has happened, he is furious. He immediately seeks a court order to (1) forfeit Paul’s capital contribution in their LexLandLaw partnership, (2) disgorge Paul’s “cut” of all work done at LexLandLaw from the time Parcel Plans was formed onward, (3) disgorge all of Parcel Plans’ profits in the deals in which LexLandLaw was involved, and (4) award punitive damages for this egregious outcome.
What is the most likely outcome of Zack’s lawsuit against Paul?

a. Zack will win as to (3), the disgorgement of Parcel Plans’ profits, but lose as to all others.

b. Zack will win as to (3), the disgorgement of Parcel Plans’ profits, and at the court’s discretion may also win as to (2), the disgorgement of Paul’s LexLandLaw compensation for the period of disloyalty, but will lose as to (1), the capital contribution, and (4), the punitive damages.

c. Zack will win as to (3), the disgorgement of Parcel Plans’ profits, and at the court’s discretion may also win as to (2), the disgorgement of Paul’s LexLandLaw compensation for the period of disloyalty, and (4), the punitive damages, but will lose as to (1), the capital contribution.

d. “Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior” as between partners. Zack will get everything he asks for, because this is a truly outrageous course of conduct and he, not Paul, deserves any benefit that resulted from it.

e. Zack will lose, because everyone profited. There is no harm here.

A36. The best answer is (c). This is based on Vigneau v. Storch Engineers. There, the court said that the capital contribution couldn’t be awarded as a form of liquidated damages. But it held that the secret profits had to be disgorged. It also exercised its discretion as to fees earned during the period of disloyalty, and also as to punitive damages. 44.12% correct.
B. Short-Answer and Essay Questions

37. Mark and Kevin are part of the cast of a television show called “Shark Tank.” In the show, entrepreneurs present their ideas to a panel of wealthy investors (including Mark and Kevin), to seek funding for startup businesses. Mark and Kevin have decided to invest in the business of one of the presenters, Felicia. Felicia’s business is called “Rocket Socks.” It involves a technology that is being developed to permit tiny jet engines to be woven into socks, permitting the wearers to fly.

Mark and Kevin are going to join with Felicia and start a new LLC, Rocket Socks LLC, in which their investment and Felicia’s existing business assets will be placed. Mark, Kevin, and Felicia will be the sole member-managers of this LLC. They have decided that each shall have veto power over all of the LLC’s decisions. They believe the business is going to be able to corner the burgeoning jet-socks market.

Mark and Kevin are seasoned business people with a large number of existing interests, ranging from clothing to jet packs to spatulas, and so on and on. Felicia also has some other entrepreneurial ideas. While they all recognize that Rocket Socks may have to pursue relevant business opportunities in order to corner its chosen market, they wish to make sure that they aren’t barred from pursuing their other business ventures, including (but not limited to) ventures involving other non-sock items of clothing.

After some tough negotiation, Mark, Kevin, and Felicia agree that if any of them learn of other clothing companies that manufacture socks become available for purchase, they must offer the opportunity to Rocket Socks and give the LLC one week to decide if it wants to take the opportunity. They also agree that if any of them learn of the availability of other opportunities, including a clothing company that does not make socks, they are entitled to take that opportunity for themselves without first offering it to Rocket Socks.

Mark, Kevin, and Felicia are sophisticated business people but have no legal training, so they look to you for help on this. They ask you to draft provisions of the Rocket Socks LLC Operating Agreement that reflect the agreement discussed in the preceding paragraph and will help them avoid future conflicts—they all have big egos and can get occasionally aggressive when their business interests are at stake. Please draft the relevant provisions (not whole operating agreement, just the provisions to implement as well as possible the agreements in the preceding paragraph). If you believe their agreement as stated above is incomplete in some important way, you may explain and then provide options for them to choose among. (30 minutes)

A37. The basic drafting needs to be in place. The basic points are for clearly drafting the requested provisions, with precision—and avoiding spending time drafting numerous other provisions that will often be in an LLC agreement but aren’t relevant to this question. This was in many ways a test of reading instructions carefully.
In addition to these basic points, there are some subtle points:

• Is it too vague to say that Rocket Socks must "decide" within a week? What qualifies as "deciding"? Best answer may say that Rocket Socks has to provide notice of a decision by 7 days, and specify what notice entails.

• "They have decided that each shall have veto power over all of the LLC’s decisions." Can the conflicted member thus bar any decision to accept an opportunity? Note that the problem characterizes our people as potentially aggressive. So, the best answers suggest a way around this conundrum. Many suggested explicitly leaving the decision up to the remaining two members only (i.e., the veto power doesn’t apply here).

• The best answer should make clear that the members are free to do what they want with ANY opportunity—including not just other clothing companies but whatever other business opportunities—aside from the particular scenario of clothing companies that manufacture socks, which is all that they are obligated to offer to the LLC.

• Several people introduced provisions concerning whether other manager-members could pursue the opportunity if it’s refused by RocketSocks. This was a very interesting wrinkle, which got points.

63% of the available points were awarded on this question.

38. MyPeople, Inc. is a popular social media application. It is also a public company, based in Delaware, with roughly 1,000,000 shares outstanding. As of January 1, 2018, each share was worth $100 (so the company was worth, altogether, approximately $100 million). The company’s main source of revenue is selling advertising space to merchants. Its model is effective because MyPeople is able to tailor ads very effectively, drawing from the immense amount of data about people that it has. MyPeople’s storage of huge amounts of data also represents an information security risk. If it is hacked, then users whose information is used maliciously might be able to sue MyPeople under governing law.

In part to insulate MyPeople from potential liability should it lose user information, MyPeople created a subsidiary, MyPeopleData, Inc., a wholly owned subsidiary also based in Delaware, to provide the service of storing all of its user data. The arrangement between MyPeople and MyPeopleData, formally speaking (and as embodied in the “service agreement” contract between the two companies), is that MyPeople pays all of the operating expenses of MyPeopleData and transmits all user data directly and in encrypted form to MyPeopleData. MyPeopleData stores the encrypted data and furnishes it upon request of MyPeople and its advertising clients, where the data can be unencrypted, used for a brief period, and then deleted again (so that it is stored permanently only on MyPeopleData’s servers). MyPeople retains sole ownership of the data; MyPeopleData is just a service provider. MyPeopleData’s assets include little more than servers and other related computer equipment; its bank account balances are maintained at a level just sufficient to sustain daily operations and no more. The user agreement that each user accepts upon creating a MyPeople account explains the arrangement above to each user, and solicits user consent prior to letting users obtain accounts. It also expressly disclaims liability by MyPeople for any mistakes or leaks that are the fault of MyPeopleData.
The board and officers of MyPeopleData are mostly also directors and officers of MyPeople, although of course they abide by all corporate formalities for each separate entity. The directors and officers keep close tabs on MyPeopleData’s expenses and policies, which are shaped according to MyPeople’s overarching strategies and corporate priorities. While initially MyPeopleData had cutting edge servers and computers and paid its staff industry-leading prices, it has resisted matching the increasingly lavish salaries and perks that MyPeopleData’s engineers have been offered by other technology companies, and it has replaced used equipment at a somewhat slower pace than other technology companies.

MyPeopleData’s servers were breached in mid-January by a malicious hacker who stole and sold vast amounts of highly personal user data to various underworld actors. This data may be used for identity theft, blackmail, political sabotage, and so on. For this reason, federal privacy law requires prompt notification to users and the public when personal information is stolen. The timing of the breach was very bad, because MyPeople was about to seek necessary shareholder approval of a large merger transaction with one of MyPeople’s competitors. Accordingly, MyPeople’s and MyPeopleData’s officers and directors issued a quick internal memo (which has been leaked) that no one was to investigate the breach or make any further move with respect to the breach until the merger vote was completed. MyPeople released the proxy materials for the merger without a mention of any potential breach.

A couple of weeks after shareholder approval was obtained, MyPeople’s board made an initial announcement about the breach, on April 1, 2018, noting that “we just discovered up to 10 million user accounts may have been violated.” The stock immediately fell $20 per share, to $80. The initial board statement turned out to be very optimistic. Several months after the initial statement, on July 1, 2018, the board issued a statement that “actually, up to 20 million user accounts may have been violated.” The stock fell another $20 per share, to $60. Finally, on September 1, 2018, the full extent of the breach was announced: “actually, all 120 million user accounts were breached.” The stock fell another $20, to $40.

You represent several class action plaintiffs—MyPeople users whose data was stolen and has been used maliciously to damage their financial and emotional well-being. The above is all that you know at this time (you haven’t, for instance, had any discovery regarding the mental state of any directors and officers at the time the various statements were made). What is the likely legal exposure of (a) MyPeople, Inc., and (b) its shareholders as a result of the facts described above? Please limit yourself to considering veil-piercing and securities law issues. (1 hour)

A38. This problem says to focus on veil piercing and securities law issues, and it asks specifically about MyPeople, Inc., and its shareholders. Answers dealing with other issues, or with MyPeopleData, don’t help get points.¹

¹ As some people noted, the plaintiffs were said to be users of MyPeople, and so it’s unclear if they were also shareholders—a point that is relevant to the securities law analysis. (Although of course many users will also be shareholders, as many of you noted.) I gave extra points to those
Securities Law

**Rule 14a-9:** The problem states that MyPeople was seeking “necessary” approval of a transaction, which sounds like Rule 14a-9 issue. The information seems clearly material and it was omitted from proxy materials. Per *Virginia Bankshares* and its progeny, reliance and causation are presumed when the vote is necessary to a transaction (as the problem states it to be). The scienter standard (which we said was negligence) seems easily met based on the facts we know (because we discussed scienter so little in the Rule 14a-9 context, I awarded most points for this).

**Rule 10b-5.**

MyPeople suppressed the truth and then made repeated false statements. Various shareholders who traded during this time period, during which there were repeated stock drops, will sue on Rule 10b-5 grounds. Note that there may be different groups of shareholders and the analysis differs to some degree for these different groups, depending on when they bought.

The materiality of the information seems clear at every stage (particularly in light of the lurching share prices). Note that (per *Matrixx*), the mere fact that the company wasn’t sure (because it intentionally failed to investigate) about the data breach’s scope doesn’t help the company; what they *did* know appears clearly to have been material.

Some shareholders will obviously have a good claim that there were actual misrepresentations. Other shareholders will have bought the shares prior to any disclosure about the hacking. As to these shareholders, there might be a question as to whether the omission was made in the face of a duty to disclose. After all, we have learned that frequently silence can be an inoculation against a 10b-5 claim. However, here, it is problematic to argue that there was no duty to disclose. First, there is a duty to disclose because of the federal privacy law mentioned. Second, the inaccurate proxy statements were promulgated by the company and amount to statements made by the company. These are all factors worth mentioning.

*Scienter* is clear as to the omission because of the memo. But as to the remaining misstatements, we probably don’t have enough information to conclude that the inference that they were intentional is “cogent and at least as compelling as any opposing inference.” That said, the facts are obviously bad; insofar as the company initially stopped any investigation efforts, their later ignorance looks much like the product of their own actions.

As far as reliance/transaction causation, there isn’t any apparent reason here that the *Basic* presumption wouldn’t apply, so this element is met.

In terms of loss causation, given the drop in share price, this element seems likely to be met.

Several people mentioned other stuff that got some points: For instance, that there might be securities law exposure for non-compliance with Sarbanes-Oxley requirements and the filings of 8Ks.

who noted this fact, and for those who accordingly minimized their securities law discussion, I shifted more points over to how good their analysis of veil piercing was.
Several people also just noted generally that shareholder discovery/document requests would be a good idea.

**Veil Piercing.** This is a concern for both MyPeople, Inc., and for its shareholders.

*MyPeople, Inc.*: The first question is whether the aggrieved creditors of MyPeopleData (i.e., the MyPeople users who have had their data hacked) can pierce up from that entity, which has very shallow pockets, and into MyPeople, which has more assets. This might remind you of Craig v. Lake Asbestos or *Bestfoods*.

The argument will be that the parent’s domination of the sub is so complete, and its behavior so inequitable, that the veil-piercing standards are met. There’s some support for this.

- The breach of data requirements and of securities laws (as we discovered above) is important as a sign that the domination was used to engage in inequitable behavior. Users were not provided with notice required under federal law, which presumably exacerbated their injuries. Many answers didn’t discuss this inequity adequately.

- Another factor is the overlap in the management and the imposition of MyPeople’s strategies and priorities, although again, on the example of *Lake Asbestos* and *Bestfoods*, this is unlikely to be enough in most cases (as in *Bestfoods*, presumptions are applied in favor of the officers acting on the behalf of the sub even when that strains credulity as a matter of reality).

- Another factor is the behavior as parent with respect to the sub’s operations, which seems negligent at best. Again, on the example of *Lake Asbestos* and *Bestfoods*, this is unlikely to be enough on its way, but the facts here may support it.

- What about an inadequate capitalization argument? But note that the initial capitalization seems to have been adequate. And we have seen that courts are reluctant to use subsequent failures of capitalization as dispositive evidence. On the other hand, the capitalization here may be analogous to the cases discussing when a company has not procured any insurance against relatively predictable harms.

- Fraud on the users. Note that the problem clearly states that everything was disclosed to the users prior to their creating accounts. You might still be able to argue that this disclosure was inadequate (did they disclose, for instance, that they weren’t paying their engineers or updating their equipment adequately?). But it’s a tough one.

Ultimately, I think that veil piercing is a very close call here.

*MyPeople, Inc.’s Shareholders*: The theory here would be that MyPeople itself was used to engage in a whole fraudulent scheme to harm the plaintiffs through this corporate “data service provider” charade.

As we discussed in class, there is no known case where never a public company was pierced.

There’s really no evidence not much evidence in favor of the veil piercing here. There’s no evidence that MyPeople itself was inadequately capitalized or was used by shareholders for fraudulent purposes. While its directors and officers certainly behaved badly (and may themselves be subject to all kinds of actions and investigations), these circumstances seem unlikely to be the first case in which veil piercing will happen in a public company. Some of the
factors already discussed, for instance the consent of users to at least some of the conditions under which MyPeople was structure, are relevant here. Ultimately, this claim, while worth exploring, is unlikely to be viable based on the facts we have. (Most people who remembered to discuss this got most of the analysis correct.)

57.94% of the available points were awarded on this question.