Caroline Bradley   FALL SEMESTER 2006

BUSINESS ASSOCIATIONS

THREE HOURS.
THIS IS A CLOSED-BOOK EXAM.

Try to show thought and critical analysis of the materials and issues dealt with in the course.

<u>DO</u> read the question carefully and think about your answers before beginning to write.

<u>DO</u> refer to statutory provisions, cases and other materials where appropriate. If you make general statements, try to back them up with specific references.

<u>DO NOT</u> use abbreviations unless you explain what you are using them to stand for.

<u>DO NOT</u> make assumptions in answering the hypothetical.

<u>DO</u> explain what further information you might need in order to answer the question properly.

<u>DO</u> write legibly and clearly.

You will get credit for following these instructions, and <u>may be penalized</u> for failing to do so.

David, Jack, Nick and William are all directors and officers of Codescape Inc, a corporation incorporated in Arcadia, which is a state in the US.

Codescape is in the (competitive) business of designing a wide range of software products, ranging from regulatory compliance systems to online multiplayer role-playing games (MMORGs). David is the CEO, Jack is the CFO (Chief Financial Officer), Nick is Vice President for Product Development and William is Vice President for Marketing. All four are members of the Board of Directors and there are four additional directors: Alan, Bob, Clark and Ed. Alan is the Dean of the Arcadian Business School, Bob is the President of the Arcadian Software Association, Clark is a well-known author who writes about MMORGs, and Ed is Nick's brother. David is a very forceful character: the idea of setting up Codescape was originally his idea and he has consistently pushed the business forward. He has a significant impact on board decision-making. Anna, who works as a journalist for the Arcadia Echo, the main newspaper in Arcadia, is currently writing a profile of David for the newspaper.

Two years ago, Arcadia introduced a new and very complicated system for regulating business brokers under a statute known as the BBRA. The Board determined that it would be important for Codescape to be first on the market with a new compliance system. Nick instructed his department to develop a BBRA compliance system, and the system, which built on existing Codescape products, was soon available for sale at a very high price. William and his marketing team actively marketed the product, and met a range of different reactions. In particular:

1. The CEO of Brokers, Inc (BI), a large firm incorporated in Arcadia, told William that there was no way he was going to spend large amounts of money on compliance with the BBRA. BI has subsequently discovered that breaching the BBRA is expensive as the regulatory agency imposes large fines for non-compliance. BI's shareholders are very unhappy as BI's profits have plummeted because of the fines and the impact of all the bad publicity;

2. Codescape agreed to sell the BBRA compliance system to ABC Brokers LLC, which is owned and managed by Tom and his brother, although the brother is not actively involved in the business because he has his own separate business services firm which is also set up as an LLC. ABC Brokers never paid for the compliance system, and does not currently have sufficient funds to do so.

Six months ago David became concerned that there were significant weaknesses in the BBRA compliance system after some customers raised questions about whether their systems were operating properly. David instructed Nick to investigate. However, as David thought about the complaints he began to wonder whether the customers had been informed about problems by someone at Codescape. David hired Industrial Espionage Inc. (IEI) to carry out a secret internal investigation. IEI placed voice activated recorders throughout Codescape's facilities. Recording people without their consent is a criminal offence in Arcadia. IEI reported back to David that Nick was actively negotiating to move to one of Codescape's competitors and was disclosing details about Codescape's products as part of this process.

David reported his decision to carry out the investigation and its results to the Board. He raised the question of what action Codescape should take against Nick (who was not present at the meeting). David urged that it would be better if the whole situation were kept quiet, and said that he would speak to Nick privately. Bob expressed some concerns about whether the investigation had been carried out appropriately and whether there was any risk that Codescape would suffer any harm as a result. After a very short discussion the Board decided to follow David's recommendations.

Before David went into the meeting he wrote up some notes about what he was going to say. He left these in his office and Anna read them and realized there were problems at Codescape. She immediately telephoned her husband, Pete, and told him what she had discovered. Pete owned shares in Codescape and told Anna he was going to sell them. She objected strongly because of the way in which she had acquired the information but Pete insisted and went ahead and sold the shares.

Answer the following questions (read all of the questions before answering any in order to avoid duplication in your answers), explaining what further facts you would need to know and giving reasons for your answers:

1. (20 points) Discuss the reasons for and against denying Business Judgment Rule protection to Boards of Directors with respect to illegal acts.

2. (20 points) Do BI's shareholders have any remedy against BI, the CEO and/or BI's Board of Directors? What problems might they face in pursuing a remedy?

3. (20 points) Will Codescape be able to obtain payment for the compliance system it sold to ABC from Tom, his brother, and/or his brother's firm? Should Codescape be able to obtain payment from any of these persons? Would it make a difference if ABC Brokers were structured as an LLP?

4. (20 points) Identify and analyze the issues of securities law raised by the facts described?

5. (20 points) Analyze the liability of the officers and directors of Codescape (you do not need to discuss derivative suits in this answer).