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Fall Semester 2007
Secretary: Rosalia Lliraldi.
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BUSINESS ASSOCIATIONS: Tuesday, Thursday, Friday, 8.00 am, Room F109.

COURSE BOOKS: William A Klein, J Mark Ramseyer & Stephen M Bainbridge, BUSINESS ASSOCIATIONS, 6th. Edition (2006); **AND** Eisenberg, CORPORATIONS AND BUSINESS ASSOCIATIONS. STATUTES, RULES, MATERIALS, AND FORMS, Foundation Press. There are pages relating to this class at http://blenderlaw.umlaw.net/?page_id=7 (this is the business associations page on my weblog). I will post details of assignments for class on this weblog to supplement this syllabus. I will also post questions for discussion and links to useful resources. You should check the weblog at least once each week during the semester.

ASSESSMENT AND ATTENDANCE: Your performance in this course will be assessed by means of a three-hour, in-class, **closed book** examination.

I will take attendance. You are entitled to three **unexplained** absences from class during the semester. This is not a policy which requires the Dean of Students' office to certify that your absence was "justified" in order for the absence to count as explained. In order to explain your absence you may visit the Dean of Students' office and fill out the form or you may send me an email. I reserve the right to lower the grade of anyone who misses more than three classes without informing me of the reason for their absence. If you miss a class please do ask me if you have any questions about the material you missed.

Consistent **and useful** participation in class may raise your grade. Class participation includes participation through the weblog.

GENERAL COMMENTS: This is an introductory business associations class that will provide a basis for advanced classes in the future. There are no prerequisites. However, if you are unfamiliar with business terminology you may find it useful to look at a book such as Klein & Coffee, BUSINESS ORGANIZATION AND FINANCE. **Ask me if you have questions.** You can see me by appointment (I prefer to set appointments by email), catch me before or after class, email me with your questions or submit them through the class weblog. Reading the newspaper (New York Times, Wall Street Journal) will help to develop comfort with some of the terminology. I will refer to

business news stories on the class weblog.

BA is a statutory course. The casebook includes many interesting cases, but please remember that the statutes are extremely important. The Casebook and/or an outline are not a substitute for reading the statutes. You will notice that some of the statutes we will look at are more detailed than others. I would like you to familiarize yourself with UPA, RUPA, the RMBCA, the Delaware General Corporation Law, some provisions of the Securities Exchange Act of 1934, and some provisions of the ALI's Principles of Corporate Governance during the semester. I will provide a list of what specific provisions you will be responsible for in the exam.

While we will often study rules in model or uniform statutes, obviously the states have their own statutes which may include modifications to the model/uniform act.

While it may seem important now to learn what the rules are **now**, bear in mind that there is a lot of scope for variations in rules between jurisdictions, and that whatever the rules may be in a particular jurisdiction today, the rules may be quite different tomorrow or next year. As an example, Congress enacted the Sarbanes-Oxley Act in 2002 in response to corporate scandals such as the collapses of Enron and Worldcom. Since the statute was enacted lawyers have had to advise their clients on the implications of the changes in the rules for public companies, and have lobbied for changes in the regulations proposed to implement the statute.

In the course we will be focusing in particular on some of the legal issues that arise out of particular legal relationships: agency, partnership and corporations. We will in addition focus more briefly on limited liability partnerships (LLPs), limited partnerships (LPs), limited liability limited partnerships (LLLLPs), and limited liability companies (LLCs). The terminology can be quite confusing. This is unavoidable, but it is worth spending the time to distinguish between the different legal forms.

In reading the cases, try to think about litigation issues and planning issues: what are the better arguments in a particular case, and how could the parties have avoided the litigation by advance planning.

Many of the cases we will be looking at involve distinctions between **form** and **substance**. Such distinctions are understandable, but problematic. You are probably familiar with his distinction as applied in other contexts. Think about whether it is

particularly significant in the context of business organization law.

In many of the cases, particularly at the beginning of the semester, it will be important to distinguish between (1) disputes among participants in a business organization and (2) disputes between a third party (an outsider) and the business organization or any participant(s) in the organization.

SEMESTER PLAN: Note: The following is an outline plan of how we will cover the material. In some semesters I tend to cover the material more quickly than in others, so we may adjust this plan accordingly. Please read the questions in the book (although we will not discuss all of the questions in class). I will use the weblog to raise additional questions about the material.

Week 1: CB pp 1-28. When thinking about the materials on authority bear in mind that officers of corporations (CEOs, CFOs etc) are agents of their corporations. The principles that apply to determine whether they have authority to bind their corporations are general agency principles.

Week 2 CB pp 28-62.

Week 3 CB pp 62-90.

Week 4 CB pp 91-131. Look at the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA). RUPA was designed to remedy defects in UPA. More than 30 states, DC, Puerto Rico and the US Virgin Islands have enacted RUPA based statutes.¹ At some point you will want to read the partnership agreement in the statutes book.

Week 5 CB pp 132-196. Think about what scope a non-dissociating partner would have under RUPA to invoke Page v Page.

Week 6 Limited Liability. Over the last few years state legislatures have begun to increase the number of ways in which people may limit their liability through adopting particular business forms. Where a statute limits liability of participants in a business there is some risk that the limits on liability will not in fact work.

¹ http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-upa9497.asp

Limited Liability Partnership (LLP): RUPA refers to llps (definitions of llp and foreign llp in § 101, Article 10). The limited liability in the LLP statute is really an addition to the basic general partnership provisions. This is a general partnership with a limited liability gloss. LLP statutes allow partners in a general partnership to obtain limits on their liability subject to certain constraints. What do the partners have to do to limit their liability? What are the risks that they will not in fact benefit from limited liability?

Limited Partnership (LP). The LP must have at least one general partner who manages the business and can have a number of limited partners who are investors. read CB pp 197-9, also look at Uniform Limited Partnership Act 2001 (this is a new version subsequent to the RULPA referred to in the CB at p 198-9, particularly § 303. This new section 303 changes the position of the limited partners so they do not have to worry about participation in management and control. Read the Comment on this provision. Do you agree with the comment? So far the 2001 version of ULPA has only been adopted in some states (including Florida).² This means that as a practical matter limited partners still have to worry about the control rule.

NCCUSL says about the 2001 uniform act (which combines rules from RUPA and rules from the Uniform Limited Liability Company Act: "... the new ULPA targets two types of enterprises that are largely beyond the scope of LLPs and LLCs. First, the ULPA 2001 includes provisions to meet the needs of sophisticated, manager-entrenched commercial deals whose participants commit for the long term. Second, the ULPA 2001 addresses the modern needs of estate planning arrangements, so-called "family limited partnerships." In addressing these concerns, this Act assumes that people utilizing it will want both strong centralized, entrenched management, and passive investors or limited partners with little capacity to exit the entity. As a result, the Act's rules, and particularly its default rules, have been designed to reflect those assumptions.

A fundamental change from RULPA involves the liability of limited partners and general partners for the partnership debts. Under RULPA, a limited partner could be held liable for the entity's debts if he participated in the control of the business and the third party transacted business with the partnership with the reasonable belief that the limited partner was a general partner. Under the new Act, a limited partner cannot be held liable for the partnership debts even if he participates in the management and control of the limited partnership. Concerning general partners, under RULPA, liability was complete, automatic and formally inescapable. Under this Act, limited liability limited partnership (LLLLP) status is expressly available to provide a full liability shield to all general partners...."³

In this week we will also begin thinking about corporations which offer limited liability to

² http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ulpa.asp

³ http://www.nccusl.org/nccusl/uniformact_summaries/uniformacts-s-ulpa.asp

their owners. Read CB pp 197-231. We will be using the DGCL and RMBCA.

Week 7 CB pp 232-281. Also read RMBCA §§ 7.40-7.47.

Week 8 Role and Purposes of Corporation. CB pp 282-298. Increasingly corporations are adopting codes of corporate social responsibility. In 2004 McDonald's said:

Responsibility at McDonald's means striving to do what is right, being a good neighbor in the community and integrating social and environmental priorities into our restaurants and our relationships with suppliers and business partners. We work toward responsible actions by understanding the perspectives and needs of our customers and other important stakeholders, by collaborating with experts to understand issues and opportunities and by inspiring the people in our System – company employees, Owner/Operators and suppliers – to share and act on our core values.⁴

Why did McDonald's say this? What does/should corporate social responsibility involve?

Then read pp 299-327 on Limited Liability Companies (LLCs). The ULLCA is in the statutes book. You will not be required to know this complete statute for the exam (although it is possible that the list of statutes for the exam might contain some of its provisions).

Week 9 CB pp 328-373; also RMBCA §§ 8.30 - 8.31

Week 10 CB pp 374- 412; DGCL § 144 and RMBCA Subchapter F, §§ 8.60 - 8.63

Week 11 CB pp 413- 449.

Week 12 CB pp 449- 477.

Week 13 CB pp 478- 510.

Week 14 Thematic review.

⁴ McDonald's USA Corporate Responsibility Report 2004, 3.

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

Utopias Inc. (UI) is incorporated in Arcadia. UI is in the (profitable) business of developing and marketing video games. Its most successful game is a massively multiplayer online role-playing game called Infinitequest. Large numbers of players pay a monthly fee to fight dragons and other weird creatures online and to search for treasure. In Infinitequest the players can spend time to develop skills in making weapons which give the players who own them advantages in battle. Players who are successful in battle generally collect more treasure than players who are unsuccessful in battle (and winning battles with dragons is particularly profitable as dragons hoard lots of treasure). Sometimes players make agreements with other players to collaborate in developing and using weapons to maximize the amount of treasure they can collect. There is an active market in weapons outside the game. Some players are willing to pay significant amounts in US dollars for the best weapons.

Although Infinitequest has been very successful, UI's Chief Development Officer (CDO), Fred, has been worrying for some time about UI's main competitors, AdamOnline Inc. (AOI) and Terraforma Inc. (TI), which are both also incorporated in Arcadia. Fred believes that UI needs to diversify into new types of online activity, consistent with UI's business plan which includes plans to acquire and develop new game ideas. Fred set members of his team working on developing new kinds of online activity. Game developers at UI and elsewhere work differently from other types of employee. They hang out in toy stores, toy museums, arcades and bookstores, work odd hours and drink lots of sugary drinks and eat lots of unhealthy snacks. Fred has always ensured that UI has large supplies of sugary drinks and unhealthy snacks available for its game developers. Because UI's game developers are often out in the field researching new games they are encouraged to carry promotional materials with them about UI's games and to apply UI stickers to their cars.

George, an officer at Maxbank, which is a large Arcadian bank, approached Fred to see if UI would be interested on working on developing an online game for the bank which would educate players about financial matters and make the players feel well disposed to the bank. George explained that it was very important for financial institutions to build connections with young people who would be their future customers and that, as young people were spending increasing amounts of time playing online games he thought an online financial game could be very useful to Maxbank. Fred decided that it would be a really good idea for UI to get into a different type of game and agreed on the spot that UI would take on the project. However, at the next meeting of UI's Board of Directors, when Fred was presenting a description of his team's current

projects the Board did not like the idea of the Maxbank game. Fred presented to the Board the results of the research he had carried out which showed that:

1. the financial game sector was new but growing rapidly;
2. there were very many financial institutions based in Arcadia which had not yet developed such games; and
3. such games would be very profitable for UI (based on George's comments about what Maxbank would be willing to pay UI for its work on a new game).

Some of the Board members thought that a financial game of the sort Fred described was too different from the sort of games that UI made. Some Board members thought that diversifying the sorts of games UI made could be useful in case consumers' tastes changed and that UI should be flexible, whereas others thought that the old games were the best and change was unnecessary. Some Board members thought that it would be undesirable for UI to identify itself too closely with the interests of financial institutions. The Board did not discuss the financial implications of the decision in any detail and after a very brief discussion instructed Fred to tell George that UI would not work on the new game.

At the same Board meeting one of the directors raised a question about whether UI should provide healthy snacks for the workers. The other members of the Board laughed at this idea.

Shortly afterwards, Fred learned that AOI had agreed to work on the financial game for Maxbank and that AOI was very excited about this new opportunity. AOI developed the game, and Maxbank has been very happy about the number of people who have been playing the game, and about their positive reactions to the game.

Because Maxbank was the first financial institution in the area to develop such a game, Maxbank and AOI have received much favorable publicity. Maxbank has, as a result, found many new customers since the game was launched. A large number of other financial institutions have approached AOI with requests to develop other financial games. When Fred was interviewed on the Arcadian Television Network after these developments about his work in the games industry he made some very negative comments about UI's Board's lack of vision. A number of UI's shareholders who saw this interview later sold their shares in disgust. But, after some of UI's Board members commented publicly about the strong performance of Infinitequest, UI's share price increased again.

In a book store, on a Tuesday morning, one of Fred's team members, Bob, ran across Marge, an old friend from college. Marge told Bob that she was developing a program which would allow people to plan and visualize events such as weddings and other large parties online. Marge pointed out that often people who were planning a large event together might live far apart and it would be useful for them to be able to see possible locations for an event from a distance and collaborate on arrangements at a distance. Bob's fiancé lives on the other side of the country and he immediately understood that the program could be very successful. Marge said that she thought that in order to develop the program properly she would need access to resources she did not have, and that she was thinking of trying to link up with a large company to develop the idea. Bob told Marge that her program wasn't really the sort of thing that UI was interested in, but that he had contacts at TI and could help her sell her idea to TI. Bob was so distracted by thinking about all of the possibilities associated with Marge's program that when he was backing out of his space in the book store's parking lot he bumped into and injured a child. The child's parents saw the UI sticker on Bob's car and the UI literature strewn all over the inside of Bob's car and they have threatened to sue UI for damages in respect of the accident.

UI was not very happy about Bob's accident so Bob went to TI and negotiated new (very remunerative) jobs there for himself and for Marge. Bob and Marge will receive a proportion of the profits of Marge's program in addition to their generous salaries. TI is excited about Marge's program and is planning a new range of similar virtual reality programs. Bob likes working at TI: the atmosphere is very comfortable: TI's management is interested in new ideas; and TI provides healthy snacks for its game developers and has a well equipped exercise room with a professional trainer on site. Bob recently met with Fred and told him about his new job. Bob said he was sure that TI would have room for Fred and for his best and most innovative workers. Fred has been discussing the idea of moving to TI with TI and with some members of his team at UI. Fred has an idea for a new game based on politics that he is excited about, but which he thinks that the UI Board would be unlikely to want to develop.

UI's last profit figures were much less healthy than UI's Board had expected. Infinitequest now seems to be an aging game and UI desperately needs new ideas. Unfortunately, UI's game developers are generally disgruntled and, if Fred leaves with the best people on his team it will take a long time for UI to build up an effective team.

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.(15 points) If the UI Board decides to offer Fred as much money (and other inducements) as it would take to persuade him not to leave UI, would there be any risks of liability for the individual Board members (in relation to Fred's compensation), and, if so, what should the Board do to minimize these risks?

2. (15 points) If the UI Board loses Fred and his team members to TI, and UI's financial position declines as a result, can the UI Board take any legal action against Fred, his team members and/or TI ?

3. (15 points) Can the UI Board take any legal action against Bob, and/or Marge, and/or TI (in respect of Bob's and/or Marge's actions)?

4. (15 points) Does UI have any liability in respect of Bob's accident?

5. (25 points) If UI's financial position declines, can unhappy UI shareholders sue UI's Board ? Describe what sort of claims the shareholders may want to bring against the Board and what problems the shareholders will encounter in trying to pursue these claims. In your answer, consider whether it would make a difference whether the Arcadian corporations statute was modelled on the Delaware General Corporations Law or the RMBCA.

6. (15 points) In *Re Walt Disney Derivative Litigation*, Chancellor Chandler made the following statement:

“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. Corporate decisions are made, risks are taken, the results become apparent, capital flows accordingly, and shareholder value is increased.”

Discuss this statement. In your answer you should evaluate this statement as a general matter, and discuss its application to the facts of the Walt Disney case and to the facts described in the hypothetical.

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Arcadia and Urbana are states in the US. The Arcadian partnership statute is based on RUPA (1997 version) and its corporations statute is based on the Revised Model Business Corporation Act (RMBCA). The Urbanian partnership statute is based on UPA and its corporations statute is the same as the Delaware General Corporation Law.

Medmark Inc. is a pharmaceutical company incorporated in Arcadia, and its shares are traded on the Arcadian Stock Exchange (ASE). Albert, Betty and Cody founded Medmark twenty years ago. They became friends while they were graduate students at the University of Arcadia (UA) and founded Medmark after they became dissatisfied with the research positions they had taken after leaving UA. Albert, Betty and Cody are directors and officers of Medmark. Betty is Medmark's Chief Executive Officer (CEO), Albert is the Chief Financial Officer and Cody is the Chief Communications Officer (CCO). All three are actively involved in the UA alumni association. As Medmark has expanded over the years they have been increasing the size of their personal donations to UA. Two years ago the UA advancement office contacted Albert and asked whether Medmark would be interested in funding some research fellowships at UA. Albert knows that Betty and Cody like to support UA and he did not feel that he needed to consult them before agreeing that Medmark would fund a number of fellowships in his, Betty's and Cody's names. The UA Vice President for Advancement asked Albert if he would be interested in serving on the University's Board of Trustees and helping with the University's new capital campaign. Albert said he would be happy to serve on the Board and he is now discovering that the capital campaign is taking up increasing amounts of his time.

David, Eric and Fiona are Medmark's non-management directors. David is married to Cody's sister, Georgie. David and Georgie run an agribusiness, D.G. Farm Supplies, LLP, (DG LLP). Eric is a Professor of Botany at the University of Arcadia who taught Albert and Betty when they were students. Fiona is the President of the Arcadian Medical Technologies Association (AMTA) which is a trade association for health care businesses. Medmark is one of AMTA's largest members.

A part of Medmark's research agenda focuses on investigating traditional herbal remedies to try to develop commercially viable drugs. A year and a half ago Medmark funded an expedition which Eric led to Ruritania, a country in Latin America which was reputed to have a number of plants not known in other places and which could be used to treat different conditions. Eric and his team discovered a number of potentially useful plants and brought samples of the plants and seeds back to the US with him. Under Arcadian law it is illegal to import plants and seeds into Arcadia without phytosanitary certificates issued by the country of export which specify that the plants and seeds are free from pests and disease. It is very expensive to obtain such certificates in Ruritania so Eric decided not to do so. The savings allowed him to take a larger number of researchers with him than he would otherwise have been able to take. As CFO of Medmark, Albert approved Eric's budget for the trip without reading it because he was preoccupied with the UA capital campaign at the time. When Eric returned to Arcadia he handed over almost all of the plants and seeds he discovered on his expedition together with some notes on what he and his team had discovered. Cody immediately issued a press release which described the "dramatic" discoveries a Medmark research expedition had made in Ruritania. Medmark's share price increased significantly after the press release was issued.

Eric omitted to tell anyone at Medmark about a particular plant which people he spoke to in Ruritania described as a miracle plant. Eric suspected that the plant might have very useful antibiotic properties, and he thought that it could be very valuable given the recent increase in the number of drug resistant bacteria. Eric persuaded Helen, a colleague of his at UA, to help him with the work and to agree that the work could be done at her lab at UA. The initial tests were very promising and Eric negotiated an agreement to sell the rights in the plant to Worldwide Pharmaceuticals, Inc., which is incorporated in Urbana. Under the agreement Worldwide agreed to fund Eric's next two research expeditions and to provide some funds for the support of Helen's lab. The agreement contained a clause committing Eric and Helen to keep the discovery confidential. Worldwide has begun to test a drug developed from the plant on mice. So far there appear to be no adverse side effects of the new drug. Immediately after

signing the agreement with Worldwide Eric invested in Worldwide shares. He thinks that Worldwide's share price will increase dramatically when Worldwide announces the new drug. Helen told her mother about the way in which she had obtained new funding for her lab, and Helen's mother also decided to buy some Worldwide shares.

In order to investigate properly the new plants Eric handed over to Medmark, Betty and Cody decided that it would be useful to grow more plants. Betty and Cody spoke to David and agreed that if DG LLP would commit to producing as many of the new plants as Medmark needed for its research Medmark would pay to DG LLP half of the costs of growing the plants and 25% of any profits made from any drugs eventually developed from the plants.

The plants DG LLP is growing for Medmark are infected with various pests and plant viruses. The plants are not growing well and the pests and viruses are spreading to crops grown by farmers near to DG's land and causing much damage. DG had borrowed from BigBank to be able to afford new equipment to grow these plants and has very little money. In fact, DG may have difficulty repaying the loan. BigBank is trying to decide whether to (1) cut its losses on this loan, (2) enter into a new longer term agreement with DG under which BigBank would have enhanced rights to information about DG's business and would have the right to advise DG about how to run its business, or (3) sue David and Georgie personally for the amount DG owes to BigBank. Bigbank did not ask David and Georgie for personal guarantees of the loan at the time DG borrowed the money. David and Georgie both have significant personal assets. Local farmers want someone to pay for the financial losses they are incurring as their crops fail. They want to know whether they can obtain a remedy for their losses from DG LLP, David, Georgie, BigBank and/or Medmark.

The Arcadian Plant Protection Authority (APPA) is concerned about the viruses and pests spreading from DG's land and is investigating how the viruses and pests came into Arcadia. APPA is considering prosecuting Medmark for its failure to obtain phytosanitary certificates on the import of the plants. When APPA announces this proposed prosecution Medmark's share price falls. Medmark's shareholders are very

unhappy about this and want to know what they can do. Some of these shareholders bought their shares after Medmark announced the dramatic Ruritanian discoveries.

Iris, an investigative journalist with the Arcadian Examiner, who has been researching commercial exploitation of traditional herbal remedies just published an article describing the dramatic differences between Medmark's situation and Worldwide's position. In the article she describes how Medmark and Worldwide obtained their plant specimens from Eric. The Arcadian Teachers' Pension Fund (ATPF or "Fund"), which owns shares in Medmark, decides that it wants to sue all of the directors of Medmark for breach of their fiduciary duties.

Discuss the legal issues raised by these facts. In your answer, consider the options available to BigBank, the farmers and ATPF. Consider also the risks of liability of Medmark, Albert, Betty, Cody, David, Eric, Georgie, Helen, and Iris. What actions can they take or what arguments can they make to limit these risks?