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NOTES AND COMMENTS ON BUSINESS ASSOCIATIONS EXAM FOR FALL 2007

GENERAL COMMENTS:

• This exam is structured so that not all of the legal issues raised by the facts are required to be discussed (e.g. the Bill corporate opportunity issue). Nor is there any general invitation to discuss other issues. Therefore, if you discuss such issues in answers to the specific questions asked, the reader is bound to wonder whether you are able to distinguish between what is and is not relevant to the questions.

• There is a general issue as to the nature of BI which runs through the exam. There is some ambiguity about whether BI was effectively established as a LLBE in Arcadia because the question does not state that it was, and because there is no LLBE agreement as required by the statute. The exam does not make clear what the result would be. Because the questions also ask whether it would make a difference if the business were a partnership/corporation and because the question does also refer to BI as being established I don't think it is a mistake to treat BI as a valid LLBE. But I also accept arguments that it might not be. If BI is not an LLBE it has to be a general partnership and cannot be anything else as there is no indication of a filing under any other statute which would establish another type of entity. So answers that assumed that if BI were not an LLBE it could somehow magically become a corporation, or which assumed that introducing new owners could somehow magically transform a general partnership into a limited partnership, were very mistaken. I think the best course, if you thought there were an ambiguity, would be to say what the positing might be under the ALLBEA and what the position would be if BI were to be treated as a general partnership.

COMMENTS ON SPECIFIC QUESTIONS AND ANSWERS

Question 1. (30 points) On what theory or theories might Bill and Ted be liable to the different creditors of BI? Do you think they should be liable to the creditors in these circumstances? Would it make a difference to your answer if BI were an Arcadian partnership (and Bill and Ted were partners) or an Arcadian

corporation?

This question asks about **liabilities to creditors** (not to the firm or its owners). It asks about liabilities of Bill and Ted who are owners of the business and also designated as "supervising managers" (i.e. they have potential liabilities in 2 capacities). This question does not ask about Joe's liability (that comes later).

The first question involves thinking a bit about the form of the business. The question specifies that B&T incurred some liabilities (to the owner of the premises and to staff) before BI was established. The question does state at one point "[a]fter Bill and Ted had established BI" and the abbreviation BI is defined in the question as referring to "Billted Imports LLBE". It seems to me that there is an implication that they did file to create the LLBE, although it would not be wrong to raise the question. The question does not include all provisions of the ALLBEA so we do not know what the statute states about limits on liability of owners, or about what the consequences of non-compliance with formalities are (i.e. not having 2 managing agents), or about whether the requirement for an LLBE agreement relates to an agreement in writing or whether an oral agreement might suffice, or about whether managers might have duties to creditors. What the statute said about these matters should make a difference to the answer (n.b. the exam specifically asks what further facts you would need). I don't think it is appropriate to assume that the LLBE is in fact an LLC, LLP, LP, or corporation. It is explicitly designated with different language so you should not make such assumptions. So we have questions about:

1. Liability of owners to creditors with respect to debts incurred before a business entity with a particular legal form was actually created although while its creation was in contemplation (ie. The owner of the premises, the employees); here the contracting parties could provide for liability only once BI came into existence or for other treatment - we have no information about what the contracts did provide (cf. Pre-incorporation transactions; cases we looked at which are similar are: Camcraft, Atlantic Salmon);
2. Liability of owners to creditors where debts were created through what purported to be an LLBE but which never actually existed (Bigbank, others);
3. Liability of owners to creditors with respect to debts incurred through a LLBE (Bigbank, others):

(a) The question does not specify the terms of the limited liability, so we don't know. On

what basis may owners of a limited liability entity be liable ? Are there any relevant provisions in the statute (mention RUPA provision as an example)?
(b) Liability for own torts (the question does not mention tort creditors)
(c) Veil piercing ? Courts have allowed vp with respect to llcs (LLC case). Whether this approach should be applied to a LLBE? Non-compliance with formalities - no written LLBE agreement, only 1 managing agent.
(d) Unlawful distributions? (question refers to generous remuneration packages for Bill and Ted though they don't do much work).
4. Liability of supervising managers to creditors. We don't know what the statute says about liability, plus it doesn't appear to refer to supervising managers anyway. With respect to the duties of managers of businesses to consider the interests of creditors we read *Francis* v *United Jersey Bank.* But *cf*. *NACEPF* v *Gheewalla* where the Delaware Supreme Court held that "creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."[1]
Where a corporation is insolvent and directors of the corporation have breached duties to the corporation and caused loss to the corporation as a result or have benefitted personally from a breach of duty it is possible for those in charge of the management of the corporation's business, or shareholders in a derivative suit, to sue for breach of those duties. However, the question asks about B&T's liability to creditors and not liability to BI.[2]
5. Many people assumed that the participation shareholders were creditors. If they had successfully brought claims under the securities laws for rescission for failure to register securities (see question 2) they would be judgment creditors. But otherwise the situation is less clear.
6. Normative question - should they be liable?
7. Liability if BI were a partnership and B&T were partners (partners have unlimited

[1] http://blenderlaw.umlaw.net/business-associations/corporations-archive/

[2] It is possible that some sort of claim could be brought here on behalf of BI but there are difficulties. Joe would seem to be liable (but this question does not ask about Joe). If B& T were liable it would have to be on the basis that their inattention allowed Joe to embezzle the money (cf Francis). Their failure to act to make sure the toys were safe is much more problematic - Caremark etc involve much larger businesses than BI.

liability for debts of the partnership but under RUPA partnership assets have to be exhausted first).
8. Liability if BI were a corporation (limited liability subject to veil piercing).

Question 2. (15 points) What issues are raised by the sale of "participation shares" by BI? Would it make a difference to your answer if BI were an Arcadian partnership or corporation?

The question says: "friends and relations agreed to buy the participation shares which gave them the right to a share in the profits of BI and limited rights to participate in decision-making with respect to BI's business." The question later states that the holders of the participation shares want their money back.

Some people seemed confused as to whether the federal securities laws would apply in Arcadia. The question states in the first sentence that "Arcadia and Urbania are states in the US". Thus US federal laws apply in Arcadia.

There are a number of issues here. However, given that the question states the participation shareholders want their money back, the first issue to consider is probably how they may do this:

1. Are the participation shares securities (investment contracts/stock; cf llcs: *Robinson* v *Glynn*)? If they are securities, then they should be registered unless an offering exemption applies (e.g. private offering exemption: *Doran*). If securities and no exemption applies and they were not registered, the investors should be able to claim rescission of their contracts to buy the participation shares and walk away. Here they do run into the issue of BI's solvency raised in question 1. If BI were a partnership the interests are probably less likely to be securities (although if the investors have no effective control this would make a difference), if a corporation, more likely.
2. If the investors can't claim this remedy what else can they do to improve their financial position (probably there aren't many people around who would want to buy them out at this point)? They might want to consider suing the managers of the business for breach of fiduciary duties - however, based on the facts given, there don't seem to be any direct claims the shareholders could bring. In addition, the contract states that disputes are subject to arbitration and we know that, as a general matter, in Arcadia business law disputes are sometimes resolved through arbitration, suggesting

there is some policy favouring arbitration. We read a Delaware case upholding arbitration in the context of llcs (*Elf Atochem*). However, the statute provides that an LLBE agreement "may not unreasonably restrict the right of a member to maintain a direct or derivative action..." In addition, any appointment of Karen as the arbitrator raises issues of conflicting interests: was she an appropriate person to act as an arbitrator given her background and skills, was she to be remunerated as she would be in an arm's length transaction? We don't know what the ALLBEA rules are on such transactions but we could analogise from the corporate rules we have looked at.
3. If BI were not effectively established as an LLBE (and treated as a partnership) or were established as a partnership there is an issue as to whether it would be appropriate to treat the participation shareholders as partners or creditors of the firm. If they were partners they would be at risk of liability, but they would also be able to dissociate from or even dissolve the partnership, and get out that way.

Question 3. (30 points) Explain whether Joe has any legal liability arising out of these facts, and, if so, to whom. Would it make a difference if BI were an Arcadian partnership (and Bill, Ted and Joe were partners)?

The question says: "On the basis of Joe's representations to them (not all of which were true), Bill and Ted were convinced that Joe's expertise was essential to the success of BI's business. Joe drove a hard bargain and insisted that his contract of employment included a provision that stated that Joe "is not subject to any fiduciary responsibilities whatsoever in respect of his functions as managing agent" of BI. Joe's contract also provides that if he feels that his ability to run BI's business effectively is prejudiced by any actions of Bill and/or Ted, he is entitled to a generous severance package." Joe does many things which raise issues of breach of fiduciary duty: the long trips including tourism, claiming back from BI more in "expenses" than he spends, spending working time looking for new employment, questions about the problems with the Ruritanian toys. Does Joe's contract exclude liability in respect of these acts? The contract does seem to have been procured by Joe through fraud, which casts doubt on its validity. In addition, although § 110 (c) of the ALLBEA contains a general provision precluding elimination of fiduciary duties, 110(d) states:

(d) If not manifestly unreasonable, the operating agreement may:

(1) restrict or eliminate the duty:

(A) to account to the LLBE and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the LLBE's business, from a use by the member of the LLBE's property, or from the appropriation of a LLBE opportunity;
(B) to refrain from dealing with the LLBE in the conduct or winding up of the LLBE's business as or on behalf of a party having an interest adverse to the LLBE; and
(C) to refrain from competing with the LLBE in the conduct of the LLBE's business before the dissolution of the LLBE;

(2) identify specific types or categories of activities that do not violate the duty of loyalty

This provision seems to imply provisions addressing specific acts and situations rather than the sort of general exclusion of duty that Joe's contract seems to contain. The statute refers to restrictions and eliminations of the duty in the operating agreement rather than in a contract of employment - it is not clear if this should make a difference. And there is also the manifestly unreasonable language.

Question 4. (25 points) Do you think that Bill and Ted <u>should</u> have any liability to BI as "supervising managers" in respect of their behavior as described? Would it make a difference to your answer if BI were an Arcadian corporation and they were directors of the corporation?

This was generally answered better than the other questions. However, there is an overlap with the first question which asks about Bill and Ted's liability to creditors. The question also asks whether they should be liable - so it isn't just asking for a description of the legal rules but also some analysis of what the principles of liability for business owners and managers should be. In terms of the actual liability rules we don't have details. We know that the statute has specific provision and requirements for managing agents, but Bill and Ted are not given this designation. Should they be treated as managing agents in substance despite this title (cases we looked at on form and substance might be relevant here). Does it matter that they did very little managing? If they were directors of a corporation there would be Caremark/Francis v United Jersey Bank issues here because of Joe's actions. Would it be appropriate to think of their liability in those terms here?

Arcadia and Urbania are states in the US. Arcadia has a partnership statute based on RUPA, but which includes no provisions for limited liability partnerships, and a corporations statute which borrows in all significant respects from the Delaware General Corporations Law. In Arcadia disputes involving issues of business law are resolved either through arbitration or in litigation in the Arcadian Chancery Court (which is modeled on the Delaware Chancery Court). The Urbanian corporations statute is based on the RMBCA.

Three years ago, the Arcadian legislature enacted the Arcadian Limited Liability Business Enterprise Act (ALLBEA) (selected provisions of this statute are set out in the APPENDIX to this exam (see pp. 5-6)). An Arcadian limited liability business enterprise (LLBE) is required to have an LLBE agreement. Unless the LLBE agreement provides that the LLBE is to be managed by its owners, LLBEs formed under the ALLBEA must have at least two "managing agents" who are responsible under the statute for managing the business of the LLBE. The managing agents are required to hold management meetings at least 12 times per year. Owner-managed LLBEs are free to choose their own arrangements for meetings, but the statute requires any alternative arrangements for meetings to be set out in the LLBE agreement.

Bill and Ted, who live in Urbania, decided to establish an Arcadian LLBE, Billted Imports LLBE (BI) to carry on the business of importing toys from Ruritania (which is a developing country with low wage rates). Bill developed contacts with toy manufacturers in Ruritania through his job as Vice President for toy manufacturing for a large corporation incorporated in and based in Urbania, and he has put these contacts to use on BI's behalf. Ted has a background in retail distribution.

Bill and Ted rented office premises and hired staff for BI in Arcadia before they actually filed to establish BI. Bill and Ted took for themselves the title of "supervising managers", a term which does not appear in the ALLBEA. BI has never had a written LLBE agreement.

Initially Bill and Ted shared ownership of BI equally, and agreed that they would take major decisions jointly. Soon, however, they realized that they would need more capital to develop the business. They borrowed money from Bigbank and approached friends and relations and encouraged them to buy "participation shares" in BI. Some of

the friends and relations agreed to buy the participation shares which gave them the right to a share in the profits of BI and limited rights to participate in decision-making with respect to BI's business. The contract with the purchasers of the participation shares specifies that all disputes between the purchasers and seller (BI) are to be resolved by means of arbitration by an arbitrator appointed by BI. Ted promised his sister, Karen, that she would be the arbitrator BI would designate if any such disputes arose.

After Bill and Ted had established BI they approached Joe and invited him to become BI's managing agent. On the basis of Joe's representations to them (not all of which were true), Bill and Ted were convinced that Joe's expertise was essential to the success of BI's business. Joe drove a hard bargain and insisted that his contract of employment included a provision that stated that Joe "is not subject to any fiduciary responsibilities whatsoever in respect of his functions as managing agent" of BI. Joe's contract also provides that if he feels that his ability to run BI's business effectively is prejudiced by any actions of Bill and/or Ted, he is entitled to a generous severance package.

Initially, BI's business was very successful. Bill and Ted have very generous remuneration packages in their role as supervising managers, although they have never really paid much attention to BI's business and have let Joe do pretty much what he wants with the business.

Joe has made regular trips to Ruritania to visit the factories there since he was hired by BI. However, Joe has stayed in increasingly expensive hotels for these trips, and, over time, his visits to Ruritania have been extended to allow for time for tourism. He always claims back from BI more in "expenses" than he spends. When Joe is in Arcadia he spends more time trying to find new employment than he does on BI's business.

In the last few months it has become clear that many toys manufactured in Ruritania are unsafe. When BI was unable to establish that the toys it was importing from Ruritania were safe, stores cancelled orders they had placed with BI. Joe, who has now lined up a very attractive new position with a computer games company, says he wants to invoke the provision of his contract relating to the severance package.

Bill and Ted have begun to look into BI's accounts and have realized that Joe

had taken money from BI to which he was not entitled. BI does not have enough money to pay all of its creditors, including the owner of the leased office premises and the employees. The holders of the participation shares want their money back.

Answer the following questions, explaining what further facts you would need to know and giving reasons for your answers:

1. (30 points) On what theory or theories might Bill and Ted be liable to the different creditors of BI? Do you think they should be liable to the creditors in these circumstances? Would it make a difference to your answer if BI were an Arcadian partnership (and Bill and Ted were partners) or an Arcadian corporation?

2. (15 points) What issues are raised by the sale of "participation shares" by BI? Would it make a difference to your answer if BI were an Arcadian partnership or corporation?

3. (30 points) Explain whether Joe has any legal liability arising out of these facts, and, if so, to whom. Would it make a difference if BI were an Arcadian partnership (and Bill, Ted and Joe were partners)?

4. (25 points) Do you think that Bill and Ted should have any liability to BI as "supervising managers" in respect of their behavior as described? Would it make a difference to your answer if BI were an Arcadian corporation and they were directors of the corporation?

APPENDIX: SELECTED PROVISIONS OF ALLBEA:

SECTION 110. LLBE AGREEMENT

(a) Except as otherwise provided in subsections (b) and (c), the LLBE agreement governs:

(1) relations among the owners and between the owners and the LLBE;

(2) the rights and duties of the managing agents;

(3) the activities of the LLBE and the conduct of those activities; and

(4) the means and conditions for amending the LLBE agreement.

(b) To the extent the LLBE agreement does not otherwise provide for a matter described in subsection (a), this act governs the matter.

(c) An LLBE agreement may not:...

(4) subject to subsections (d) through (g), eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;

(5) subject to subsections (d) through (g), eliminate the contractual obligation of good faith and fair dealing...

(9) unreasonably restrict the right of a member to maintain a direct or derivative action...

(11) except as otherwise provided restrict the rights under this act of a person other than an owner or managing agent.

(d) If not manifestly unreasonable, the operating agreement may:

(1) restrict or eliminate the duty:

(A) to account to the LLBE and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the LLBE's business, from a use by the member of the LLBE's property, or from the appropriation of a LLBE opportunity;

(B) to refrain from dealing with the LLBE in the conduct or winding up of the LLBE's business as or on behalf of a party having an interest adverse to the LLBE; and

(C) to refrain from competing with the LLBE in the conduct of the LLBE's business before the dissolution of the LLBE;

(2) identify specific types or categories of activities that do not violate the duty of loyalty;

(3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;

(4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and

(5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.

(e) The LLBE agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts...

(g) The LLBE agreement may alter or eliminate the indemnification for an owner or managing agent and may eliminate or limit a member or manager's liability to the LLBE and owners for money damages, except for:

(1) breach of the duty of loyalty;

(2) a financial benefit received by the member or manager to which the member or manager is not entitled;

(3) a breach of the duty not to make improper distributions;

(4) intentional infliction of harm on the company or a member; or

(5) an intentional violation of criminal law.

(h) The court shall decide any claim under subsection (d) that a term of an LLBE agreement is manifestly unreasonable. The court:

(1) shall make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes and activities of the LLBE, it is readily apparent that:

(A) the objective of the term is unreasonable; or

(B) the term is an unreasonable means to achieve the provision's objective.