

Final Exam, UWLA, 2020

University of West Los Angeles School of Law

FINAL EXAM ISSUE ANALYSIS

Business Associations
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December, 2020

QUESTION 1. (50%)

Anne is a successful attorney and author. Her law business is doing very well. She has a book agent who helps her sell her books. She is close to finishing a book called, "Getting Rich Using You Tube." Her agent has just advised her that he made a deal with Amazon for her to sell her new book once it's finished. Amazon will be the exclusive dealer and will pay her a royalty of 20% for every book sold. Anne is upset and immediately fires the agent. She tells Amazon that she will not honor the contract.

Anne recently agreed with her close friends Beth and Chuck to create a business teaching students how to pass the bar exam. They agree that Beth and Chuck will run the day-to-day operations and Anne will be the President. They properly form ABC, Inc. which properly issues 1,000 shares of common stock to each of them. The three of them are on the five person board of directors of ABC, Inc. The other two directors are two of their former law professors, John and Joan.

ABC is struggling so Anne advises the board of directors that she will buy more stock of ABC for \$100,000. The new shares will give her 60% of the total shares issued after the sale. The board including her discusses the proposal at length and agrees. The vote is four to one with Chuck voting no. Chuck is upset because he thinks Anne is a terrible President. Anne calls a special meeting of shareholders to throw Chuck out of the company. Chuck thereafter agrees to sell his shares to his uncle.

1. Is Anne bound by the contract entered into with Amazon? Discuss.
2. Has Anne breached any fiduciary duties owed to ABC? Discuss.
3. Can Chuck prevent his being thrown out of the company? Discuss.

4. Did Chuck violate any securities laws under these facts? Discuss.

Analysis

1. Is Anne bound by the contract entered into with Amazon? Discuss.

Yes, if the agent had authority to enter into the contract on her behalf. No, if he didn't. Express authority. There are no facts that show any express authority *to enter into this contract*. But there appears to be *some* express authority since the agent was hired presumably to do things for Anne re her books. There may be implied authority if the agent reasonably believes that he is authorized to do things based on the express authority he has. This could come from a course of prior dealings or if the conduct is typical in the industry or is necessary in order to do what the express authority mandates. There aren't many facts but signing a contract that gives exclusive rights to sell her books without even telling her about it seems pretty unlikely to be implied from "help me sell my books." I conclude there is no actual authority unless it is implied from what is typical in the industry.

Apparent authority arises when the principal does something that made Amazon believe that the agent had authority to sign a contract on her behalf. There are no facts suggesting Anne did something to make Amazon believe she didn't need to even see the contract and you would think Amazon would know that the contract is no good unless Anne approved it. So no apparent authority.

2. Has Anne breached any fiduciary duties owed to ABC? Discuss.

Anne as a director owes a fiduciary duty of care and loyalty to the corp. The purchase of the stock from the company brings up both. Care means good faith business judgment and reasonable care of a reasonably prudent person under similar circumstances. Here a careful person would make sure the corp is selling the shares for the amount the shares are worth. She owned a third of the total already so she is buying more for \$100,000. Normally directors are protected by the business judgment rule, i.e., if the director uses due diligence and there is no conflict, fraud, illegality or waste, care is presumed. Here there is a clear conflict so she is not protected by the BJR. What the BOD is voting on is totally about her. The burden is going to be on her to show that selling that stock for \$100,000 is what a reasonably prudent person would have done under similar circumstances. Loyalty is relevant too. She is doing a transaction with the corp. She is negotiating the price she will pay for the shares with the BOD which she is on. This is an interested director transaction. She should have advised the board of the price she would pay and then leave the room. If she did that, the price would be presumed to be fair to the corp. But here she did not do that and the transaction is presumed to be unfair. Either way, if the \$100k was fair to the corp, she breached no duties to the corp. If it's not worth \$100k, she will have to give the stock back, i.e., reverse the transaction.

As to calling the special shareholders meeting, that does not violate any fiduciary

duties to the corp. That is her prerogative.

3. Can Chuck prevent his being thrown "out of the company." Discuss.

Chuck can prevent being thrown off the BOD by the shareholders only if he has sufficient votes to elect himself to the BOD using cumulative voting. One seat on the BOD is 20% of the BOD so if he owns more than 20% he cannot be thrown off the BOD. Once the new shares are sold to Anne, his percentage goes down so if it goes to less than 20%, he cannot prevent his removal. The shareholders cannot fire him from his day to day job but the BOD can. There would have to be a BOD meeting. They cannot take away his stock.

If this is a "close corp," throwing him out of the company might violate the shareholders' duties to him as it would prevent him from receiving the benefits he agreed to in the first place. The shareholders would need a good reason to do it other than they simply changed their minds about doing business with him, especially if they are doing it for their own personal reasons.

4. Did Chuck violate any securities laws under these facts? Discuss.

Chuck sold securities so he violated securities laws unless the sale was exempt. Under federal law, it was exempt if not sold to the public. Uncle is a member of the public unless he had the information necessary to make a reasonable determination about the sale. As to California law, the sale is exempt if Chuck had a preexisting business or personal relationship with his uncle. It is also exempt under California law if his uncle is rich or has a good advisor. There are no facts to show how much info uncle had when he entered into the transaction with Chuck. Unless it was a lot, Chuck will lose.

Chuck also had a duty to disclose material nonpublic information under Rule 10b(5) if he was on the BOD at the time of the sale i.e., he owed fiduciary duties at the time of the sale. I don't see that he had any material non-public info. His view that Anne is a terrible President is not a fact, it's just his opinion. If Chuck said anything about the stock to uncle before selling it, he had a duty to disclose any additional facts which were necessary to make the facts stated not misleading. If he said something to his uncle about the percentage the shares were of the total, or about the company, its business, its financial situation, then the statements must be true and further disclosures are required to make the statements made not misleading.

Comments:

1. As to part 1, many students commented that there was no express authority but there might be implied authority. Implied authority can only come from express authority. If the "agent" literally had no authority at all, there is no agency relationship and there cannot be implied authority. The only possible express authority in the facts is "help me sell my books." Does the agent reasonably believe from that that he can sign a contract for her without even telling her about it? I doubt it. As to apparent authority, I was surprised how many students said that if she bothered to get someone to help her sell the books, she essentially told the world that the agent could sign contracts for her

without telling her about the contract in advance. I think it takes a lot more than that to get someone to believe that the agent has authority.

2. As to question 2, I was surprised how many students did not see the obvious conflict Anne had. Many students thought that since she was helping the company, it was okay. But the stock might be worth more than \$100k. She is negotiating both sides. Also, many students misstated the safe harbor rule. It is that if the director discloses the conflict (here it is obvious) and leaves the room (she did not so it wasn't worth much discussion), the price is presumed to be fair. Many students said that the person must disclose and leave OR the price must be fair. That is not the rule – it is not either/or. Either way it has to be fair to the corp.

3. As to Chuck. I was basically looking for the cumulative voting issue. I don't recall that any student mentioned that one seat on the BOD was 20% of the board. But most students did say that he could stay on the BOD if he had enough votes and could not if he didn't which was good.

4. Again as to Chuck, most students did reasonably well with the securities exemptions. The key to the public exemption is the need for information which most students said. Several students said since they were family, it's somehow automatically exempt which is wrong. I was also looking for the duty to disclose from Rule 10b(5) which many students missed completely.

QUESTION 2. (50%)

Frank is the head coach of the State College football team. He has recently been properly appointed at a shareholders meeting to the 11 person Board of Directors of Nike Athletic Shoes, Inc., a public company. The appointment was at the recommendation of his good friend, Billy, the President of Nike and owner of 65% of the outstanding common stock. Nike has made profits of more than \$10 billion in the last two years but has come up with no new products in the past six months. Frank is about to attend his first Nike Board Meeting. The following is on the agenda:

- a) Approval of a marketing program including paying \$10,000 each to 100 different coaches including Frank for their use of Nike shoes for the upcoming year.
- b) Approval of a \$10 million consulting contract with XYZ, Inc. XYZ will analyze and report on ways the company can create new products for the following year. Billy owns 10% of XYZ.
- c) Approval of the compensation of the board of directors of \$100,000 per meeting.
- d) Discussion of whether to fire a senior vice-president. The VP has said he will sue Nike and the board if he is fired.

Discuss what Frank should do at the board meeting with respect to each item on the agenda. Be sure to explain the benefits of your recommended action.

Discuss what Billy should do at the board meeting with respect to each item on the agenda. Be sure to explain the benefits of your recommended action.

Analysis: Question 2:

a) Approval of a marketing program including paying \$10,000 each to 100 different coaches including Frank for their use of Nike shoes for the upcoming year.

Frank owes fiduciary duties of care and loyalty to the corp. He should do his due diligence and he will be protected by the business judgment rule unless there is a conflict, fraud, illegality or waste. So as to the marketing program, he should attend the meeting, study the reports, ask questions and do what he thinks is best, what a reasonably prudent person would do under similar circumstances. Here he may have a conflict because he is getting \$10,000 from the corp if this is passed. But not every conflict will kill the BJR for the director. There must a significant chance that the conflict will materially impair the director's ability to do his job. Here the corp is going to pay \$1 million to coaches. I would think Frank's interest in getting the money himself is outweighed by the real issue of whether paying \$1 million is a good idea. If it is, the fact that he is getting some of it is not material. If paying that amount is reasonable, Frank has not breached his duty of care in any event. But Frank also has loyalty to worry about. He is not supposed to unreasonably profit at the expense of the company. To be careful he should disclose that he will get \$10,000 and leave the room. Then, as to him, the transaction will be presumed to be fair. He could still have to give the money back if it is not in fact fair to the corp, i.e., what he did is worth \$10,000.

Billy should use care of a reasonably prudent person under the circumstances. Show up, read the reports etc. Then the BJR will protect him. Again, it is possible that there is a conflict in that he and Frank are friends but how could that materially impair a decision to spend \$1 million and give one-hundredth of that to your friend? I don't see any conflict. Billy should show up and do his best.

b) Approval of a \$10 million consulting contract with ABC, Inc. ABC will analyze and report on ways the company can create new products for the following year. Billy owns 10% of ABC.

Again, Frank should use care of a reasonably prudent person under the circumstances. Show up, read the reports etc. Then the BJR will protect him. There is a small issue of his relationship with Billy - is that enough to prevent the protection of the BJR, i.e, does he have a conflict? Is the relationship such that there is a substantial likelihood that the relationship will materially impair his ability to focus on the corp? Knowing Billy, without more, doesn't seem like it is material. There is no loyalty issue as to Frank since he is receiving nothing from this transaction.

As to Billy, the BJR may not protect him if the conflict he has will substantially impair his ability to do his job. A 10% interest in a company that is doing business with Nike doesn't seem likely to impair his ability to do his job. If it is sufficient to kill the

BJR, he will have to establish that he still did what a reasonably prudent person would have done under the circumstances. As to loyalty, he may be an interested director if he is negotiating the transaction for both sides. But he is getting nothing directly at least from Nike based on this transaction. But if he is receiving something from Nike which is unfair to Nike, he has breached his duty of loyalty and must give it back. To be careful, he might want to disclose and leave the room. Then it would be presumed to be fair to the corp.

c) Approval of the compensation of the board of directors of \$100,000 per meeting.

As to both, they cannot leave the room, there would be no one there. So they should use care - see above. The BJR is not going to protect either of them and the amount paid is going to be presumed to be unfair to the corp since the safe harbor rule doesn't apply, it can't be done. Therefore they should get some outside, independent advice from an expert about how much compensation is fair to the corp. The issue was and is what level of compensation is fair to the corporation. How much does the corp have to pay to get top financial people to attend board meetings and help make decisions for the company?

d) Discussion of whether to fire a senior vice-president. The VP has said he will sue Nike and the board if he is fired.

Frank and Billy both should use care. There is no issue of loyalty since neither is getting anything from the corp based on this event. As to care, they should attend the meeting and do their due diligence. If they do they will be protected by the BJR and will win any suit against them. The threat to sue them and the corp is a factor to consider but that is just part of the due diligence. Consider everything and do what a reasonably prudent person would do under the circumstances.

Comments:

1. As to part 1, most students did reasonably well. The conflict was the key issue and most students saw that. Most students laid out the fiduciary duties and the rules and the BJR, and the safe harbor rule – fine.

2. As to part 2, again, the conflict was the issue. The big issue I had with many answers is that students cut and pasted their entire answer to part 1 into part 2 and then changed a few words here and there, maybe added a few sentences here and there. That makes the answer hard to read which doesn't help the student. In part 2, Billy was not getting anything from the corp. That is what made the question different from part 1. Some students took the position that Billy was not on the BOD because it didn't say he was. I have no problem with that as long as the answer is consistent with that assumption. Here Billy was an officer so the answer is exactly the same since both owe the same fiduciary duties to the corp.

3. As to part 3, again many students cut and pasted the answers to part 1 and part 2 verbatim into part 3 and changed a few words here or there. Part 3 is completely different from the first two. I was surprised how many students even said that there is no

conflict with the per meeting compensation and just repeated most of parts 1 and 2 again. Many students said that \$100,000 seemed reasonable so there was no issue. Many students said it is too much to pay them so they shouldn't do it. This is not helpful to show me you know the rules, and what issues come up when directors are figuring out their own pay.

4. Most students saw that there really wasn't much to say about firing the VP. Do your job, the BJR will protect you. I was fine with that response.