UNIVERSITY OF CALIFORNIA
SCHOOL OF LAW

Law 250A, Sec. 1 Corporations
Instructor in Charge: Professor Richard M. Buxbaum

FINAL EXAMINATION
FALL 2008

Time allowed: 4 hours[1]
Closed Book

LAPTOP USERS: Create a header in a new Word document that includes your exam number, course name, instructor name, and semester. Title the document with the course name, instructor name, and your exam number (e.g.: Corporations, Buxbaum, 12345) and save it to your hard drive. Be sure to format your document with page numbers and double-spacing.

WRITERS: Place your exam label or clearly print your exam number on the cover of all bluebooks. Write the course name and instructor's name on each bluebook. Number your bluebooks to indicate their order, and state the total number of bluebooks that you are submitting (1 of 4, 2 of 4, etc.) Students should write only on one side of the page.

SPECIAL INSTRUCTIONS:

1. This is a closed book examination. You may use one sheet of notes that you have prepared for the exam. L.L.M. students (only) also may use a dictionary. Students are not allowed to use electronic notes, internet access, or any casebook, handouts, outlines, or written materials other than the sheet of notes.

2. There are two questions in this examination, with the grade component for each noted in the text.

3. Read carefully, enjoy the exam and your well-earned vacation.

* * * * *

You will be given a 10-minute and a 1-minute warning. When time is called, please stop typing/writing promptly and turn in your copy of this exam and your answers. Please do NOT leave your exam or bluebook (or typed answers) on the desk. All copies of this exam and bluebooks must be turned in to the person in charge, or if you finish early, taken to Exam Headquarters (Room 124).

---

[1] **A faculty policy prohibits me from continuing the traditional practice of giving non-US trained LLM students an additional hour to take the examination. Therefore I have reluctantly made this a four-hour time period for everyone. But JD students please note: This is not by any stretch of the imagination a set of question deserving four hours of time. Please be judicious in avoiding the temptation to write more to fill in the time.**

Question I (60% of the grade)

Ash-Birch, Inc., a Boalt corporation, operates a mineral-water bottling plant. Its 80% majority shareholder, Cherry-Dahlia, Inc. (Boalt), a glass manufacturer, of course controls the director-nomination and election process. Of the seven board members of A-B, four always are senior executives of C-D and three typically are persons with a professional but not an employment relationship with C-D (investment banker; attorney; local dignitary) and who lend some gravitas to the A-B board. The outside shares, held by perhaps 50 local residents or their descendants, are not actively traded because of the thinness of the public float. Only a couple of local broker-dealers even bother to make a market for these shares, and the price at which the shares occasionally trade generally is no higher than the conservatively calculated book value of the subsidiary.

Elm, CEO of C-D and a member of the A-B board, learns during a vacation that a property near the A-B mineral springs and plant is for sale. His source does not know of Elm's involvement with A-B and mentions it only because of the property's potential as a vacation development; she does, however, point out that it has a beautiful natural spring that enhances its value. Elm reports this information to the C-D board of directors, and as its CEO recommends, and its directors approve, (successful) negotiations for the purchase of this property. Before the C-D board acted, Elm did report the same information to the A-B board, but states that he could not "approve" taking up this opportunity by A-B because "our financial situation couldn't carry it and we still have unexploited capacity in the water sources that we do control." Forest, one of A-B's outside directors, objects and says that these opportunities, especially for a contiguous parcel of such property, come along only rarely, and all C-D had to do was to guarantee A-B's purchase obligation for the benefit of the seller; it would be easy to work out a credit arrangement permitting C-D a security interest in the property to protect it in the event of A-B's default on the purchase obligation. Elm rejects the notion, stating that he owes it to C-D's shareholders not to take this risk. Forest's alternative suggestion, to issue further stock to generate the purchase funds, is put to a vote but also is rejected by A-B's board though all three outside directors vote in favor of that plan.

C-D obtains the property, leaving it unexploited for the time being. Already two years later, AB's springs are depleted and its directors resolve to open negotiations with C-D either to purchase the adjacent property or to obtain a long-term supply contract from it. At this point Grape-Holly, a competitor, also bids for the property or for a similar supply contract, and C-D's board of directors declares that it has the obligation to take the best offer in light of its fiduciary duty to its shareholders. G-H's higher bid is accepted, and AB has no choice but to liquidate its business as well as it can.

A-B's outside directors ask your firm for legal advice; specifically, whether A-B has a viable claim against C-D and if so, on what legal theories.

1. Provide a response to that request, and be specific in applying any doctrines you come up with to these facts.

2. Separately, speculate on the possible impact of the following two policy statements by the Delaware Supreme Court on your fact situation:

a. "One cannot read into the situation presented [in the particular case before it at that time] any special relief for the minority stockholders in this closely-held corporation. It would be inappropriate judicial legislation for this Court to fashion a special judicially-created rule for minority investors when there are no negotiated special provisions in the certificate of incorporation, by-laws, or stockholder agreements. Standard rules requiring contracting parties to deal with each other in good faith provide sufficient protection." [**Ed.**: **Recall the different doctrinal approach fashioned by the Massachusetts courts in the case of close corporations: First, "it must be asked whether the controlling group can meet the burden of demonstrating a legitimate business purpose for its action." Second, if so, minority shareholders have the burden of proof that the same legitimate objective could have been achieved through a less harmful alternative course of action.**]

b. "Although good faith may be described as part of a triad of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty. It may only indirectly be relevant to a finding of a violation of one of the two main duties. Second, the fiduciary duty of loyalty is not limited to cases involving a financial conflict of interest. It also encompasses cases in which the fiduciary fails to act in good faith."

You are permitted to ask whether Ash-Birch indeed is the kind of corporation to which direct shareholder-to-shareholder fiduciary standards should be applied at least as the default position, or whether the "unmodified corporate form" is the better default position. But again, be specific on how your facts lead to your conclusion on this point.

Potentially relevant statutes:

Boalt § 100:

No contract or other transaction between a corporation and any corporation of which one or more of its directors are directors is either void or voidable if

(1) The material facts as to the transaction and as to such director's other directorship are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the common director or directors or the contract or transaction is approved by the **[non-interested]** shareholders in good faith, or

(2) As to contracts or transactions not approved as provided in paragraph (1) of this subdivision, the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified.

Boalt § 101:

(1) A corporate opportunity means any opportunity to engage in a business activity of which a director or senior executive becomes aware (a) either in connection with the performance of functions as a director or senior executive, or (b) under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation engages or expects to engage.

(2) A director’s taking advantage of a business opportunity shall not be challenged on the ground that it should first have been offered to the corporation, if, before becoming legally obligated respecting the opportunity, the director brings it to the attention of the corporation and action by qualified directors disclaiming the corporation’s interest in the opportunity is taken under the same conditions as if the decision concerns a director’s conflict-of-interest transaction with the corporation under §100.

Question II

1. (20% of the grade)

Most close-corporation statutes contain only a few threshold provisions, since their only purpose is to remove obsolete impediments to agreements among shareholders that allocate decision-making authority in ways varying from the standard statutory arrangement. A limit on the number of shareholders, participation by all shareholders in the shareholder agreement, identification in the articles of incorporation as a "close corporation," and in Delaware some form of reasonable transfer restriction are the only affirmative conditions. In addition, the California statute lists a small number of statutory provisions that may not be changed or eliminated by a close-corporation agreement; for present purposes, these are inspection rights and the right to petition for dissolution on the ground of persistent fraud or oppression or in order to protect the reasonable interests of the petitioning shareholder/s.

That non-waiver list does not, however, include the statutory provision allowing the majority shareholders the right to purchase the complainant's shares in lieu of dissolution (provided that the neutrally determined value thereof is paid in cash), nor the basic "safe harbor" statute allowing conflict-of-interests transactions only if a (sufficient number of) independent directors approves and the transaction is just and reasonable or non-interested shareholders approve it or the transaction's proponents meet the burden of proving the transaction just and reasonable.

Assuming, as is indeed the case, that the state's modern and both pre- and post-statutory (i.e., still evolving) jurisprudence accepts the continuing validity of "common-law" close-corporation shareholder agreements, discuss whether, and which if any of these statutory provisions might/should be accepted, ignored, or rejected by that jurisprudence. Separately consider whether a unanimous shareholders' agreement stating that any shareholder may engage in transaction with the corporation "on the same basis as any unaffiliated third party" would be acceptable.

2. (10%)

Here is a specific variant on #2. The common law (e.g., the *Ringling* case) accepted the validity and at least in principle some mechanisms to enforce an expected outcome of a shareholder agreement concerning the election of directors – it just didn't accept the self-enforcement of an arbitrator's resolution of a dispute under the circumstances of that case. Later statutes resolve that specific problem and also validate even stronger "self-enforcement" mechanisms, in particular the voting trust. Your question is based on the following statutory text, adapted from existing state statutes:

Boalt § 123:

(a) A proxy which states that it is irrevocable is irrevocable for the period specified therein when it is held by a person designated by an agreement under §124.

b) Notwithstanding the period of irrevocability specified, the proxy becomes revocable when the agreement under §123 has terminated.

c) A proxy may be revoked, notwithstanding a provision making it irrevocable, by a transferee of shares without knowledge of the existence of the provision unless the existence of the proxy and its irrevocability appears on the certificate representing such shares.

§124:

(a) A written agreement between two or more shareholders of a corporation may provide that in exercising any voting rights the shares held by them shall be voted as provided by the agreement, or as determined in accordance with a procedure agreed upon by them, and the parties may but need not transfer the shares covered by such an agreement to a third party or parties with authority to vote them in accordance with the terms of the agreement. Such an agreement shall not be denied specific performance by a court on the ground that the remedy at law is adequate or on other grounds relating to the jurisdiction of a court of equity.

(b) Shares in any corporation may be transferred by written agreement to trustees in order to confer upon them the right to vote and otherwise represent the shares for such period of time, not exceeding 10 years, as may be specified in the agreement. The validity of a voting trust agreement, otherwise lawful, shall not be affected during a period of 10 years from the date when it was created or last extended as hereinafter provided by the fact that under its terms it will or may last beyond such 10-year period.

(d) This section shall not invalidate any voting or other agreement among shareholders or any irrevocable proxy complying with §123, which agreement or proxy is not otherwise illegal.

If an agreement made among the 100 shareholders of a company transfers the involved parties' shares to a trustee for a 20-year period, would the doctrines and principles discussed in the course permit a court to avoid it at the instance of a complaining shareholder or is the second sentence of §124(b) dispositive of that litigation? Would it make a difference if the parties thereto hold 60% of the voting power but some of the shareholders holding 40% are complaining because they had not been invited to participate in it and did not even know of its initial adoption? What detriment could they specify to justify their possible legal attach on the arrangement?

3. (10%)

Boalt Corporation uses cumulative voting. A 55% majority of the shareholders then approve the introduction of a staggered board system, which given the number of directors results in only two directors being up for election each year. Obviously the two policies are in some tension with each other, but are they in absolute conflict? Turn this around: A bare majority of the shareholders eliminates the cumulative voting system (whether the board is staggered or not is irrelevant). Would you require a higher vote? If so, is there any higher vote that is "safe" in the sense of guaranteeing some minority representation? Does the staggered-board context suggest a mandatory minimum vote requirement for the purpose of this second action?