SPRING 1996 BUSINESS ORGANIZATIONS - MODEL ANSWER SUMMARY

1. No. Schiffman's authority as president and CEO may extend to the power to fire Barron as an employee, but the power to appoint and remove officers is vested in the board of directors. DGCL §142(b). The other significant argument that Barron's removal as an officer was ineffective is the claim that it constituted a breach of the agreement among Schiffman, Barron and Jessup. Such an agreement, however, at least as it relates to the appointment of officers, is probably unenforceable because it represents an intrusion, not provided for in the certificate of incorporation, upon the prerogatives and responsibilities of the directors (see McQuade v. Stoneham).

If the MBCA governed, §7.32 would probably validate the agreement among Schiffman, Barron and Jessup. That statute allows agreements among all the stockholders, as was the case here, even if such agreements establish, among other things, "who shall be the directors or officers of the corporation," §7.32(a)(3).

[This question does **not** call for discussion of cause for Barron's removal as an officer. That issue may be pertinent in regard to some employment contract issue, but it is not presented on the facts posed.]

- 2. No, for several reasons. First, the special meeting of stockholders was not validly called. Under DGCL §211(d), absent further provision in the bylaws (and none is recited here), only the board of directors may call a special meeting. Schiffman lacked the power to do so unilaterally. Second, even if the meeting was validly called, the vote was insufficient to remove Barron. The only way to have obtained the necessary majority of the shares outstanding (DGCL §141(k)) and present at the meeting (DGCL §216) is if the Jessup shares were counted as voting for removal. That result, however, is inconsistent with the proxy given by Jessup to Barron. That proxy, giving to Barron the right to vote the Jessup shares, was irrevocable under DGCL §212(e). It was "coupled with an interest," within the meaning of the statute, because (I) it stated that it was irrevocable, and (ii) it was given in connection with the option sold to Barron to acquire the Jessup shares. Hence, Barron's direction that the shares be voted against removal was effective, and the vote to remove him as a director therefore failed to achieve the necessary majority of the shares voting. A third reason that the attempted removal was ineffective is the stockholders' agreement that Barron should be a director. Although such an agreement may not be enforceable insofar as it restricts the authority of directors to select officers, it may be enforceable insofar as it binds the stockholders in their choice of directors.
- 3. Yes. Schiffman could have convened a special meeting of the board of directors to vote on removing Barron as an officer. A 2-1 vote of the board in favor of removal would have been effective (DGCL §141(b)).

[In response to this question and question 4, it is unhelpful to speculate about solutions that might have worked if the facts were completely different than they were when Schiffman decided to seek Barron's ouster. For example, there is no value in

discussing a hypothetical provision in the certificate of incorporation -- the exam instructions preclude reliance on assumed facts, and adopting an amendment to the charter in the midst of the controversy (requiring both board and stockholder approval) is cumbersome and not potentially more effective than what Schiffman actually attempted.]

4. Yes. Schiffman might have been able to take stockholder action by written consent to remove Barron as a director. Had he secured such a written consent from Jessup at the outset, before she was "bought off," and if only one other small stockholder had executed such a consent, Schiffman could have immediately delivered those consents and his own consent to Axxia at its principal office, and stockholder action effective to remove Barron would have been taken. DGCL §228. Although §1.10 of the bylaws purports to preclude such stockholder action by written consent, that bylaw is invalid because a provision limiting or eliminating the stockholder's right to act by written consent can only be effective if embodied in the certificate of incorporation. DGCL §228(a).

[Discussion of Barron's fiduciary duties is irrelevant here, as is discussion of a derivative suit. Under applicable Delaware law (unlike the Model Act), there is no statutory procedure for removing a director by judicial decree; even if there were some common law basis for a court to remove a director (a matter of serious doubt), pursuing a lawsuit cannot be considered more likely to be effective than prompt stockholder action by written consent. Moreover, discussing a derivative suit is irrelevant for the further reason that the board of directors, and probably Schiffman alone as CEO, is able and likely to prosecute a case against Barron, as evidenced by the facts as presented.]

5. The principal theory on which to attack the Bidsecure license agreement is breach of the fiduciary duty of loyalty. The agreement is a transaction between Axxia and a partnership of which Barron, a director, is partner. As reflected in DGCL §144(a), such a transaction can be saved from voidability by several means, but Axxia's complaint should argue that none of those means is available here. There was no approval by disinterested stockholders, as §144(a)(2) specifies; and there was no effective approval by the two disinterested directors, for at least two separate reasons. First, §144(a)(1) requires "the affirmative votes of a majority of the disinterested directors," and only 50% of the disinterested directors voted in favor of the agreement. Second, even the one disinterested director (Jessup) who voted in favor of the agreement did so without the benefit of disclosure, as required by §144(a)(1), of "the material facts as to [the interested director's] relationship or interest" in regard to the transaction -- specifically, Jessup was not informed prior to her vote that Barron was a partner and thus materially interested in the agreement. Thus, the transaction can be sustained only if Barron and Street can establish that it was "fair as to [Axxia] as of the time it [was] authorized" by the board. DGCL §144(a)(3). To make that showing, Barron and Street would bear the burden of proving both substantive fairness ("fair price"), and procedural fairness ("fair dealing"). Although the substantive fairness or

unfairness of the agreement is not evident from the facts provided, there is at least a serious question with regard to the "fair dealing" element of the entire fairness test, where the board's approval is obtained through the highly misleading means of not disclosing Barron's interest in the transaction. (Other comments might address the questionable sufficiency of the directors' investigation of the transaction and alternatives, and the lack of any negotiation over the terms of the agreement).

An alternative or supplemental theory of the complaint would be a violation by Barron of the corporate opportunity doctrine. Specifically, Axxia could assert that he was obligated to present to Axxia the opportunity to join Street in developing the Bidsecure software. The question does not provide much factual background to determine how Barron came to speak with Street about the subject, but one can surmise that it came about because of Barron's position with Axxia. Since the Bidsecure project relates to some extent to Axxia's municipal client services, it can be argued that Bidsecure was in Axxia's line of business. Moreover, Axxia was apparently financially able to take the Bidsecure opportunity, had it been presented to Axxia. Had the opportunity been presented to and accepted by Axxia, Axxia would have owned the Bidsecure package without having had to pay an up-front cash fee and an ongoing license fee to Barron/Street -- thus, the license agreement actually adopted could be viewed as a waste of corporate assets, and in no way "entirely fair." The only likely defense to the corporate opportunity claim would hinge on Schiffman's adamant opposition to Axxia's involvement with Bidsecure. It can only be speculated, however, what Schiffman's reaction would have been if Axxia had been able to develop Bidsecure as a partner with Street, instead of buying it from her and Barron; likewise, it seems possible that Jessup and Barron himself would have voted to accept and pursue the opportunity on behalf of Axxia, had Barron presented the idea to the board of directors of Axxia.

[Again, discussion of the mechanics of a derivative suit is irrelevant here. The question calls for discussion of the legal theories underlying Axxia's claims to relief, not the procedure in which such theories are invoked. Besides, the facts state that Axxia has brought suit; in that circumstance, a derivative suit is completely inappropriate, since the corporation has already determined to prosecute the claim in question.]

6. No. Ordinarily, advancement of defense costs is discretionary, even with submission of a repayment undertaking, and not mandatory unless some charter, bylaw or contract provision creates a right to advancement. DGCL §145(e). Section 6.1 of Axxia's bylaws makes *indemnification* mandatory, but advancement of expenses is a distinct matter, addressed by statute separately from indemnification, and Section 6.1 therefore cannot be read to impose upon Axxia an obligation to advance defense costs. This result could be quite different, however, under the Model Act, which specifies that an obligation in the bylaws to "provide indemnification to the fullest extent permitted by law" is "deemed to obligate the corporation to advance funds to pay for or reimburse expenses ... to the fullest extent permitted by law." MBCA §8.58(a). However, §8.53 of the MBCA, governing advancement of expenses, requires, in addition to an undertaking

to repay if indemnification is not permitted, a certification of a good faith belief that indemnification is appropriate. The facts here do not recite that any such undertaking was given, so there should be no right to advancement of expenses under the MBCA either.

[Extended discussion of whether Barron would ultimately satisfy the standard of conduct for indemnification is irrelevant under Delaware law, and largely irrelevant under the Model Act. The critical question presented only addresses Axxia's obligation to **advance** Barron's defense costs. How any such advances would be handled at the conclusion of the litigation in relation to the indemnification decision is a question that was not asked.]

7. Yes. Barron and Street are partners in a partnership, since they agreed to carry on a business as co-owners for profit. UPA §6(1). In particular, their agreement to share profits on the Bidsecure software equally is *prima facie* evidence of their partnership. UPA §7(4). Insofar as Street incurs expenses defending the enforceability of the Bidsecure license agreement with Axxia, she is doing so "for the preservation of [the partnership's] business or property," and the partnership must therefore indemnify her in respect of those expenses. UPA §18(b). To the extent that payment of such expenses by the partnership results in losses to the partnership, Barron would be obligated to share equally in such losses and, if necessary, make contribution to the partnership towards such losses. UPA §18(a).

[Discussion of the statutes governing partner liability to third parties for wrongful acts of a partner is not in point. The question addresses Barron's obligation, vis a vis Street, to share in an expense reasonably incurred -- not wrongfully incurred -- on behalf of the partnership.]

8. No, although the question is a close one. The enforceability against Barron of the British license agreement and the promissory note turns on the extent of Street's authority to bind the partnership in which she and Barron were associated. Under UPA §9(1), Street's execution of the British agreement/promissory note binds the partnership (and in turn binds Barron under UPA §15(b)) to the extent that such act was "apparently carrying on in the usual way the business of the partnership" Although there was an express limitation on Street's power to enter into such arrangements transferring rights in the Bidsecure package, there is no indication that such limitation was known to the British investors. As to the British investors, then, §§9(1) and 9(4) make clear that the limitation on Street's authority was ineffective as to them, since they lacked knowledge of it. Nonetheless, a third party seeking to enforce what is allegedly a partnership obligation under §9(1) must present some evidence that for this partnership, or firms like it, agreements of the sort at issue are within the usual course of partnership business and the usual scope of a single partner's authority. In the absence of such evidence, the partnership (and its nonconsenting partners) cannot be

GRADING SHEET (Spring 1996 Business Organizations Examination)

Q#		Max.
	Answer Component	
1.		2
	Identify DGCL §142(b)	3 5 2
	Lack of president's authority/analysis of bylaw	5
	Effect of stockholder agreement	2
	Identify MBCA §7.32(a)(3)	3
	Validation of s/h agreement to elect officers	_
2.	1.1	2
	Identify DGCL §211(d)	. 3
	Note invalid call of special meeting	2
	Identify DGCL §§141(k)/216	3 2 3 2 3
	Note insufficient vote	2
	Identify DGCL §212(e)	
	Irrevocability option as interest "coupled"	4
3.	Analysis of stockholder agreement issue	0
	Idantify DCCI C444/h)	2 3
	Identify DGCL §141(b)	3
4.	Meeting of directors to remove officer	2
	Identify DCCL 5229	2 3
	Identify DGCL §228	3
	Use of stockholder majority written consent	3
5 .	Analyze efficacy of bylaw §1.10	2
	Identify DGCL §144(a)(1)	2 3
	Identify DGCL § 144(a)(1) Identify majority disint. director vote required	4
	Identify majority district director vote required	3
	Articulate entire fairness test	3 3
	Elaboration/application of entire fairness test	3
	Corporate opportunity identify issue and oppty.	7
6.	Analysis (business line/fin.abil./possib. rejection)	,
٥.	Analysis (business intermitability possibly rejection)	2
	Identify DGCL §145(e)	2
	Apply bylaw §6.1	3
	Fricke rule	2
	Identify MBCA §8.58(a)	2
7	Good faith certification under MBCA §8.53	
7.	Good failth continuation and of the continuation	2
	Identify UPA §§6(1), 7(4), 9	3
	Note partnership existence	2
	Identify UPA §18(b)	3
	Note expense to preserve p'ship property	3 2
	Identify UPA §18(a)	3
_	Obligation to contribute to p'ship losses	
8.	Oprigation to commission to harmle reserve	2
	Identify UPA §§9(1)/15(b)	3
	Effect of express limit on authority	3
	"Usual way" issue identification	4
	Analysis burden of proof, evaluation of evid.	