Question MEE 2 – July 2024 – Selected Answer 1

Question 1

The issue here is whether XYZ as controlling shareholder of Resort Co., breached a fiduciary duty of loyalty to Resort Co. or its minority shareholders.

Under the MBCA, controlling shareholders owe a duty to minority shareholders the utmost duty of good faith and fair dealing. This rule applies to parent companies who own all or most of the stock of its subsidiaries. Under this rule, a parent corporation may not favor itself or one of its subsidiaries to the detriment of another.

Here, XYZ corporation likely violated its duty of loyalty because it favored itself as well as another one of its subsidiaries to the detriment of another. The facts indicate that XYZ "demanded" that ResortCo. stop charging CrusiseCo. for ship docking fees. Even though RestortCo.'s directors unanimously voted to allow the demand, this does not change the analysis because "XYZ has the power to choose all members of the boards of directors for both companies." Thus, the board decision was very much a decision of XYZ itself. Further, this decision and demand by XYZ benefited itself while hurting minority shareholders in ResortCo., especially the ones who are not owned by XYZ. The facts state that this decision "would help CruisCo by reducing its operating costs and hurt ResortCo by lowering their revenues." This is very clearly a benefit to XYZ because XYZ owns all the stock of CruiseCo, which means that XYZ is really saving on operating costs in the long run. While on the other side of the equation, ResortCo has some shares owned by other outside of XYZ, who will now see their dividends drop because ResortCo. is making less money.

Thus, XYZ has breached a fiduciary duty of loyalty to ResortCo and its shareholder because it has benefited itself to ResortCo's detriment.

Question 2

The issue here is whether ResortCo's minority shareholders may challenge the board's decision not to declare a divided and whether they are likely to prevail.

Under the MBCA, the general rule is that a shareholder cannot compel the corporation to make a distribution. The decision to make a distribution is protected by the business judgment rule, which requires directors to make informed decisions that have rational business purposes. The court will not question a board's decision to declare a dividend unless there is (1) bad faith and (2) the corporation has sufficient funds to declare a dividend.

Her, the shareholders have no basis to challenge the decision to declare a dividend under the business judgment rule and will not prevail because the directors have acted in good faith. First, the board's decision will be protected byt the business judgment rule because there is a rational business purpose for their decision - "the rationale for this decision was to retain funds to construct new hotels and increase ResortCo's market share."

Further, the business judgment rule generally require the board to make informed decisions, but the board my rely on advisers when (1) the adviser is qualified and (2) reliance is reasonable.

Here, the board, even though relying on the CFO and independent accountant, were reasonable to do so and both were qualified. The CFO, independent accountant, and a law firm are all likely qualified advisers on the issue of whether to declare a dividend. Because they are qualified, their reliance on the experts is likely also reasonable. Further, the fact that the board reached this decision after considering the opinions for "several hours" shows they made a good faith effort to make a decision for the best interest of the corporation, which they are required to do under their fiduciary duties.

Lastly, there is no showing of bad faith on the part of the board and there are insufficient facts to suggest that ResortCo has the capital to declare a dividend. Thus, the court will not get involved.

Thus, the shareholder cannot challenge the board's decision and will not prevail.

Question 3

The issue here is whether ResortCo's decision to purchase Ava's land is protected the business judgment rule.

Under the MBCA, the business judgment rule protects the board of directors for informed business decisions that are made with care and good faith. If the decision has a rational business purpose, the court will not second guess the board's decision. It is then on the shareholder's to rebut this presumption.

Here, the board's decision to purchase Ava's land will likely not be protected by the business judgment rule because the decision was not an *informed* one. Although there is a rational business purpose for buying land for property development, the decision was extremely rushed and was not sufficiently informed. The board discussed the offer for "only 15" minutes before voting to buy the property. Nor did the directors "obtain any guidance about the transaction's fairness or potential impact on the company's financial condition." The facts even indicate that the property was above market value, which means the company's decision was not well informed.

The board may argue that the offer was only open for 48 hours and thus, they had to make a decision quickly. However, they still could have asked for advice from the CFO and the same independent accountant, considering they already did work for them on the dividend issue. This argument will fail because the judgment was ultimately uninformed. The board couldn't even declare a dividend, yet they immediately went to purchase property for $50 million and did not take time to reach this decision. This all shows bad faith and the board will likely not be protected by the business judgment rule.

In conclusion, the ResortCo board of directors will not protected by the business judgment rule because the decision to purchase the property was not an informed one.

Question MEE 2 – July 2024 – Selected Answer 2

The issue of whether XYZ has a duty of loyalty to ResortCo or its minority shareholders.

A corporation that owns the majority shares of another corporation such that the parent corporation completely controls the owned corporation has a fiduciary duty to the owned corporation. Additionally, such a parent corporation owes a fiduciary duty to the minority shareholders of the owned corporation. Here, since XYZ is the parent corporation of ResortCo and owns a majority of the stock such to completely control RestortCo, XYZ owes a fiduciary duty to ResortCo and to the minority shareholders. The fiduciary duty includes the duty of loyalty and the duty of care.

The issue of whether XYZ breached the duty of loyalty to ResortCo and the shareholders and by causing ResortCo to stop charging CruiseCo's docking fee

The duty of loyalty includes the duty not to self-deal and the duty not to usurp business opportunities. Self-dealing includes using the corporation for the benefit of another controlled corporation at the cost of the corporation. There three are safe-harbor provisions for the duty of loyalty. (1) the board of directors is informed of all the material elements of a deal and a majority of disinterested board members approve the deal, (2) the shareholders is informed of all the material elements of a deal and a majority of disinterested shareholders approve the deal, and (3) the deal is proceduralily and substantively fair.

Here, XYZ certainly did self-dealing by having ResortCo stop charging docking feeds to XYZ's other company, CruiseCo. XYZ is using its power by controlling the board and being the majority shareholder of ResortCo to benefit its other company at the determent to ResortCo. Furthermore, none of the safe harbor provisions apply. All of ResortCo's board members are also employees of XYZ, so they are interested the vote to remove the docking fee. So there can't be approval by disinterested board members. Additionally, the shareholders never voted to approve it. Lastly, the deal is unfair in substance and procedure. The procedure is deficient because the board did not fairly consider the impact to ResortCo with the interests of ResortCo in mind. And the substance is deficient because it loses ResortCo money with no benefit.

Thus, because XYZ did self dealing by voting to remove docking fees for CruiseCo, it breached its duty to ResortCo and the shareholders.

<u>The issue of whether the minority shareholders will prevail in a challenge to not declare a dividend</u>

As a general matter, the board of a corporation is not required to declare a dividend unless the bylaws or article of incorporation require one. The board can properly vote to reinvest profits back into the corporation. So long as the board does not violate their duty of care or some other duty, they can properly vote to not declare a dividend. The board may breach a duty if they vote not to declare a dividend with insufficient research, preparation, or consideration. In the case of a parent company situation, the board might breach a duty if they don't declare a dividend to benefit another company.

Additionally, the business judgment rule would likely apply to this decision. The business judgment rule is a presumption that a board member made a reasonable business decision when they acted in good faith, meaning they took care to make an informed decision.

Here, the Board of ResortCo voted unanimously to not declare a dividend. The board wanted to reinvest profits to build new hotels and increase their market share. The board spent three hours deliberating over the decision. They used internal reports and external reports. They also solicited an advisory opinion prepared by an outside law firm. There is no evidence of bad faith or negligence so the business judgment presumption would likely apply. The board acted as a reasonable board would in that situation. Since the board took great care to consider the decision, the shareholders will likely fail.

The issue of whether the business judgment rule applies to the ResortCo's board to purchase Ava's land.

The business judgment rule is a presumption that a member of a board took a reasonable decision when they acted in good faith and as a reasonable person would have under the situation. Board members are not protected when they make grossly unreasonable decisions that are in bad faith. Here, the board decided to purchase 1,000 acres of coast land from Ava for $50,000,000. There is considerable evidence the board rushed into the decision. They did not receive the offer until thirty minutes before their meeting. The board did no research on the purchase. They did not confirm they were getting the price at fair-market value. Nor did they get any guidance on the companies financial condition or get help from the CEO. They only discussed the offer for 15. On the other hand, the land was well suited to development in ResortCo's area. And they were under extreme time pressure. They only had 48 hours to accept.

Ultimately, the board was extremely unreasonable in the decision and they are likely not protected. While the offer was only for 48 hours they could have waited to meet later after they had done a little due diligence. They met only took 30 minutes ater getting the offer and only spent 15 minutes deliberating.

Question MEE 2 – July 2024 – Selected Answer 3

1. XYZ breached its duty of loyalty by entering into a self-dealing and conflict of interest transaction

The first issue is whether XYZ owed a fiduciary duty of loyalty to ResortCo.'s minority shareholders and, if so, whether it breached that duty.

In corporations, shareholders typically do not owe fiduciary duties to other shareholders or the corporation. However, this rule does not apply if the shareholders are controlling shareholders, if shareholders are acting as directors/officers, or in a close corporation. Controlling shareholders owe a fiduciary duty to minority shareholders to not oppress them and to conduct the business with loyalty and care. If shareholders do owe fiduciary duties, they owe the duties of loyalty and care. The duty of loyalty states that they must exercise their duties in the reasonably belief that it is in the best interest of the corporation. The duty of care states that they must exercise their duties with the care that people would reasonably believe appropriate under the circumstances. The duty of loyalty centers around fairness: people who owe the duty have a duty to act fairly to those they owe a duty to and not enter into any self-dealing or conflict of interests transactions. The duty of loyalty prohibits self-dealing transactions unless there has been approval from (1) disinterested directors, (2) disinterested shareholders, or (3) the contract was fair and reasonable to the

corporation. Some jurisdictions require fairness in addition to approval from disinterested shareholders/directors.
XYZ, as controlling shareholder of Resortco, breached a fiduciary duty of loyalty to ResortCo and ResortCo's minority shareholders by removing the docking fee for CruiseCo's ships. First, XYZ owes a fiduciary duty to ResortCo because its employees are on the board and is a controlling shareholder. It has, and exercised, the power to elect all of ResortCo's board, so it owes fiduciary duties. Further, XYZ owes fiduciary duties to ResortCo's minority shareholders because controlling shareholders owe fiduciuary duties to not oppress the minority shareholders. As fiduciaries, XZY has the duty to not enter into transactions which contain a conflict of interest. XYZ breached this duty when XYZ demanded that ResortCo stop charging CruiseCo's docking fees. There was no approval by disinterested directors here because XYZ has the power to choose all the board members, and it choose all XYZ employees, so all of the directors are interested. Further, there was no approval from disinterested shareholders because XYZ owned 90% of ResortCo's stock and there is no information about the 10% voting. Further, the contract was not fair at all to ResortCo because it hurt them by lowering its revenues. ResortCo was contractually obligated to the fees; however, it did not get the fees due to the self-dealing. XYZ demanded to not have CruiseCo pay ResortCo's docking fees solely so CruiseCo, which they own 100% of the stock in, would save some money and not continue operating in the red. XYZ would have the burden of proving this was not a breach of loyalty case and it is unlikely they would be able to prove it was not.
In conclusion, XYZ breached its fiduciary duty of loyalty to ResortCo and ResortCo's minority shareholders by demanding the self-dealing and conflict of interest transaction to stop charging CruiseCo.

2. Resortco's minority shareholders likely do not have a cause of action for failure to declare dividends because the board did not abuse its discretion in refusing to do so

The next issue is whether ResortCo's minority shareholders are able to challenge the board's decision not to declare a dividend.
The right to dividends is exclusively up to the board of directors. It is reviewable on an abuse of discretion standard. However, directors still owe duties of loyalty and care, so this discretion can be abused.
ResortCo's minority shareholders likely do not have a cause of action for failure to declare dividends. As mentioned above, the right is discretionary and up to the board. Here, the board did not declare yearly dividends because it wanted to retain funds to construct new hotels and increase ResortCo's market share. Further, the board considered this decision for several hours and analyzed a report on the financial implications of the potential dividend from the company's CFO and its independent accountant, as well as an advisory opinion prepared by an outside law firm. Therefore,

ResortCo's board was well within its discretion to not distribute dividends and it clearly did its homework in making the decision. Therefore, it's unlikely a court will find an abuse of discretion in this case. If ResortCo had refused to declare a dividend to help with their other business in CruiseCo, that likely would constitute an abuse of discretion. However, wanting to build more resorts and increase market share is likely a reasonable reason for not declaring distributions.

In conclusion, ResortCo's minority shareholders likely will not prevail as to the board's decision not to declare dividends because the board did not abuse its discretion.

3. ResortCo's board's decision to purchase Ava's land is not protected by the business judgment rule

The next issue is whether ResortCo's board's decision to purchase Ava's land was grossly negligent.

The business judgment rule is a presumption that the board of directors was educated, did its homework, and qualified in making decisions. It excuses negligence in breaches of the duty of care in that it assumes decisions were informed and not doing in haste. However, the business judgment rule only excuses against negligence and not gross negligence. Negligence is a deviation from the standard of care and gross negligence is a substantial deviation from the standard of care.

ResortCo's board's decision to purchase Ava's land is likely not entitled to the business judgment rule protection because it constitutes gross negligence. Ava offered 1,000 acres of land for $50 million, which is a lot of land and a lot of money. Therefore, Resortco's board needed to take its time in analyzing a decision for this much land and this much money. Ava's offer was semi time-sensitive with 48 hours allowed to decide. ResortCo was grossly negligent because it discussed Ava's offer for only 15 minutes, it did not obtain any guidance about the transaction's fairness or potential impact on the company's financial condition from experts or ResortCo's CFO, and did not even realize the property was priced at above fair market value. While the offer was time sensitive, a mere15 minute discussion over whether to purchase $20 million in land without even consulting anything about the company's financial condition and what this purchase would do to it is grossly negligent. Therefore, the business judgment rule would not excuse this negligence because this was gross negligence and a substantial deviation from the standard of care, rather than a slight deviation which is what the rule protects against.

In conclusion, ResortCo's board is not protected by the business judgment rule because its conduct constitutes gross negligence.