

## **JULY 2019 MEE**

### **QUESTION 3—CORPORATIONS & LLCs**

Parent Inc., a company in the renewable energy business, has several subsidiaries. In all cases, Parent maintains control of its subsidiaries by selecting the members of each subsidiary's board of directors, most of whom also serve as officers and employees of Parent.

One of the subsidiaries, HomeSolar Inc. (incorporated in a jurisdiction that has adopted a version of the Model Business Corporation Act), was acquired three years ago by Parent. Parent owns 80% of HomeSolar's voting shares, with the remaining shares publicly traded on a national stock exchange. HomeSolar manufactures and sells products exclusively for the residential solar power market.

Another subsidiary, IndustrialSolar Inc., is wholly owned by Parent and manufactures products exclusively for the industrial solar power market.

A shareholder of HomeSolar, after making a proper demand on the board to which the board failed to timely respond, brought a derivative suit against Parent, as the controlling shareholder of HomeSolar, making the following allegations:

(1) HomeSolar has not paid dividends since being acquired by Parent three years ago. In SEC filings, HomeSolar has explained that its no-dividend policy provides funds for its research and development budget as it seeks to develop new products for the residential solar power market in which it operates. Nonetheless, HomeSolar has more than adequate earnings and was obligated to pay dividends to its shareholders.

(2) Since acquiring HomeSolar, Parent has caused HomeSolar to purchase the "rare earth" minerals necessary for the manufacture of its residential solar panels from SolarMaterials Corp., a wholly owned subsidiary of Parent. SolarMaterials was created for the purpose of acquiring such minerals and reselling them to the various renewable energy subsidiaries of the Parent group. The long-term contract under which HomeSolar purchases rare earth minerals from SolarMaterials, however, sets prices significantly higher than the current market prices under similar long-term contracts for such minerals.

(3) After Parent learned about a large government grant to develop industrial-scale solar projects, Parent caused IndustrialSolar to apply for and secure this grant, denying HomeSolar the opportunity to obtain this grant.

1. Did Parent breach any duties to HomeSolar with respect to HomeSolar's no-dividend policy? Explain.
2. Did Parent breach any duties to HomeSolar with respect to HomeSolar's contract with SolarMaterials for the purchase of rare earth minerals? Explain.
3. Did Parent breach any duties to HomeSolar by denying HomeSolar the opportunity to apply for the government grant? Explain.

## Question Presented

Parent Inc. controls HomeSolar Inc.: it owns 80% and selects the

entire board; the other 20% are public minority shareholders

(MBCA jurisdiction). HomeSolar makes residential solar products.

A shareholder brought a proper derivative suit against Parent.

Allegation 1: HomeSolar has paid no dividends for three years; the

policy funds R&D and applies to all shareholders (including

Parent).

Allegation 2: Parent made HomeSolar buy rare-earth minerals from

SolarMaterials (Parent's wholly owned subsidiary) at prices

significantly above market.

Because Parent selected every HomeSolar director and no minority

shareholders approved the contract, no disinterested approval

exists.

Allegation 3: Parent steered a government grant to IndustrialSolar

(wholly owned), where the grant was for industrial solar projects,

outside HomeSolar's residential business.

1. Did Parent breach any duty regarding the no-dividend policy?

2. Did Parent breach any duty regarding the SolarMaterials

contract?

3. Did Parent breach any duty by denying HomeSolar the grant?

← controlling shareholder →  
fiduciary duties to the sub and its  
minority

← affects everyone equally → not self-  
dealing → business judgment rule

← self-dealing / conflict of interest →  
duty of loyalty

← no disinterested approval → must  
prove the deal was fair

← corporate opportunity only if within  
HomeSolar's line of business

← → business judgment rule

← → duty of loyalty / self-dealing

← → corporate opportunity doctrine

### Question 1: The No-Dividend Policy

**Issue.** Whether Parent, as controlling shareholder, breached a fiduciary duty by causing HomeSolar to adopt a no-dividend policy.

**Rule.** A controlling shareholder owes fiduciary duties of loyalty and care to the controlled corporation and its minority shareholders. But where the challenged action is not self-dealing (it affects all shareholders alike and diverts nothing to the controller at the minority's expense), it is protected by the business judgment rule and will stand if supported by any rational business purpose.

**Analysis.** Here, the no-dividend policy applies equally to all HomeSolar shareholders, including Parent, so Parent gains nothing to the exclusion of the minority; it is not self-dealing. The business judgment rule therefore applies, and Parent has a rational purpose: funding HomeSolar's R&D for its residential products. Nothing shows a faulty process, so there is no breach of care either.

**Conclusion.** Therefore, Parent likely did not breach any duty with respect to the no-dividend policy.

*Which standard governs the dividend decision?*

*Controlling shareholder owes duties; but a non-self-dealing decision gets the business judgment rule (any rational purpose).*

*Applies to everyone → not self-dealing  
→ BJR; R&D funding is a rational purpose.*

*No breach (protected by the business judgment rule).*

### Question 2: The SolarMaterials Self-Dealing Contract

**Issue.** Whether Parent breached its duty of loyalty by causing HomeSolar to buy minerals from Parent's wholly owned subsidiary at above-market prices.

**Rule.** When a controlling shareholder causes the controlled corporation to enter a transaction that benefits the controller at the corporation's expense, the transaction is self-dealing that implicates the duty of loyalty, and the business judgment rule does not apply. A conflicted transaction is sustained only if approved by disinterested directors or shareholders, or shown to be fair to the corporation; the party defending it bears the burden of proving fairness.

**Analysis.** Here, Parent caused HomeSolar to buy minerals from SolarMaterials, another Parent subsidiary, funneling value into Parent's group, a classic conflicted, self-dealing transaction, so the business judgment rule does not protect it. There were no disinterested directors (Parent chose the whole board) and no minority approval, so it can be saved only if fair; but because the price was significantly above market, it fails the fairness test.

*Is this a self-dealing loyalty problem?*

*Self-dealing → duty of loyalty, no BJR.  
Saved only by disinterested approval  
OR proof of fairness.*

*Value funneled to an affiliate; no disinterested approval; above-market price fails fairness.*

**Conclusion.** Therefore, Parent breached its duty of loyalty to HomeSolar.

*Breach of loyalty (unfair self-dealing).*

### Question 3: The Government Grant and Corporate Opportunity

**Issue.** Whether Parent breached a fiduciary duty by directing the government grant to IndustrialSolar instead of HomeSolar.

*Was the grant HomeSolar's opportunity to take?*

**Rule.** Under the corporate opportunity doctrine, a fiduciary may not divert to itself a business opportunity in which the corporation has a legitimate interest, one closely related to a business the corporation engages in or expects to engage in. Within a corporate group, the controller has some leeway to allocate opportunities among affiliates, and an opportunity outside a subsidiary's line of business is not one the subsidiary was entitled to.

*Corporate opportunity only if closely related to the corporation's line of business; parent has some allocation leeway within the group.*

**Analysis.** Here, the grant was to develop industrial-scale solar projects, but HomeSolar's business is residential solar, so the grant was outside HomeSolar's line of business and not one it had a legitimate interest in; it is also unclear HomeSolar could have used or won it. Parent's allocation of the industrial opportunity to its industrial subsidiary is within a parent's permissible leeway.

*Industrial grant vs. residential business  
→ outside HomeSolar's line; parent may allocate within the group.*

**Conclusion.** Therefore, Parent likely did not breach any duty by denying HomeSolar the grant.

*No breach (not HomeSolar's corporate opportunity).*

### Step-by-Step: Controlling-Shareholder Fiduciary Duties

*Ask first whether the challenged act is self-dealing; that choice sets the standard of review.*

#### 1. Does a controlling shareholder owe duties here?

- A controlling shareholder owes fiduciary duties to the controlled corporation and its minority.  
**Parent controls HomeSolar**



#### 2. Is the challenged action self-dealing (controller benefits at the corporation's or minority's expense)?

- No, it affects all shareholders equally: **business judgment rule**, upheld on any rational purpose. **Q1: no-dividend → no breach**
- Yes: duty of loyalty; the BJR does not apply → step 3.



#### 3. Conflicted transaction: approved by disinterested directors/shareholders OR proven fair to the corporation?

→ No disinterested approval and not fair (above market): **BREACH of loyalty**. **Q2:**  
**SolarMaterials** → **breach**



**4. Diverting a business opportunity? Corporate opportunity doctrine: closely related to the corporation's line of business?**

→ Outside its business (parent has allocation leeway): **no breach**. **Q3: industrial grant vs residential** → **no breach**