

**BUSINESS ASSOCIATIONS**  
 Professor John Orcutt  
 Spring Semester 2007  
**FINAL EXAMINATION – IN CLASS**

**INSTRUCTIONS:**

- This is a closed-book examination. You may not bring any materials to the examination with the exception of ESL students who are allowed to bring and use a Home Language/English dictionary.
- This examination is worth 300 points (or 75% of your final grade) and consists of 8 essay questions worth the following points:

• <b>Question 1</b> = 60 points	• <b>Question 5</b> = 40 points
• <b>Question 2</b> = 40 points	• <b>Question 6</b> = 20 points
• <b>Question 3</b> = 40 points	• <b>Question 7</b> = 30 points
• <b>Question 4</b> = 40 points	• <b>Question 8</b> = 30 points

I have written this examination to a 2½ hour (150 minute) examination. *It is your responsibility to apportion your time appropriately amongst the questions.* If you base your time on the possible points per question, the time apportionment should be:

• <b>Question 1</b> = 30 minutes	• <b>Question 5</b> = 20 minutes
• <b>Question 2</b> = 20 minutes	• <b>Question 6</b> = 10 minutes
• <b>Question 3</b> = 20 minutes	• <b>Question 7</b> = 15 minutes
• <b>Question 4</b> = 20 minutes	• <b>Question 8</b> = 15 minutes

To provide some cushion in your taking of the exam, however, I am giving you an extra 15 minutes, so you will in fact have 2 hours and 45 minutes (165 minutes) for the exam.

- The grading of examinations is anonymous. So, you must write your examination number on the examination and your blue book. **YOU MAY NOT WRITE YOUR NAME ON ANYTHING YOU MAY ONLY USE YOUR EXAM NUMBER.**
- Please write your answers in a blue book. Remember to write your examination number on your blue book. The only answers that will be graded are the answers written into a blue book. While you are free to use scratch paper, answers written on scratch paper, or anything else other than a blue book, will not be read and will not be counted for any credit. Please write only on the front side of the pages in the blue book. Please remember that organization, persuasiveness, neatness and legibility all count in determining your grade on the essay answers. To improve the organization of an answer, you may wish to quickly outline the answer on a separate sheet of paper prior to writing your full answer in the blue book.
- I have tried my best to write and proofread the exam so that there are no distracting typos or other errors – but, I may not have been totally successful. If you believe there is a typo or other error that makes it difficult to answer a particular question, please provide your best answer and explain any assumption you used to answer the question.

Good luck on the examination!

**DO NOT TURN TO PAGE 2 UNTIL THE PROCTOR TELLS YOU TO BEGIN**

**Question 1 (60 points possible – 30 minutes suggested):**

During this course, we read two of the leading Delaware cases regarding a corporate director's duty of care: Smith v. Van Gorkom and Brehm v. Eisner.

- Smith v. Van Gorkom: The board of directors from Tran Union approved a transaction (the sale of the company to Pritzker) that resulted in the shareholders receiving \$55 per share for stock that had been trading at roughly \$35 per share prior to the deal's announcement. Given that there were about 13.4 million Trans Union shares outstanding, the Trans Union directors earned their shareholders over \$200 million (an approximately 57% increase in value) by pursuing and recommending the deal with Pritzker.
- Brehm v. Eisner: The board of directors for Disney approved an "extraordinarily lucrative" employment contract with Michael Ovitz to be President of Disney. Ovitz as President turned out to be a disaster and Ovitz may have breached his employment contract with Disney. Rather than pursue a breach of contract claim against Ovitz or terminate Ovitz for "good cause", the Disney board decided to terminate Ovitz on a "non-fault" basis, which required that Disney pay Ovitz a \$140 million termination package. On its face, the Disney directors' decisions regarding Ovitz cost their shareholders roughly \$140 million.

The Trans Union directors were found to have breached their duty of care while the Disney directors were found not to have breached their duty of care. Please analyze and explain this disparity of outcomes.

**Questions 2 – 4 are based on the following fact scenario:**

- **Question 2 = 40 points possible – 20 minutes suggested**
- **Question 3 = 40 points possible – 20 minutes suggested**
- **Question 4 = 40 points possible – 20 minutes suggested**

The Documentary Channel, Inc., a Delaware corporation ("TDC"), is a cable television station that offers programming related to historical events and people. TDC is always looking for additional television shows to air.

In 2006, TDC acquired the exclusive rights to broadcast a series of documentaries on the history of big wave surfing (the "Documentaries") from Acme, Inc. ("Acme"). Acme is 100% owned by 5 TDC directors (the "Conflicted Directors"). The Conflicted Directors formed Acme to acquire the rights to the Documentaries in 1990, long before any of the Conflicted Directors were TDC directors (in fact TDC was not formed as a corporation until 2000). Acme paid \$5,000,000 for the rights to the Documentaries in 1990, and those rights now have a fair market value of approximately \$30,000,000 (you can simply assume this fact for purposes of this question). Acme sold the rights to the Documentaries to TDC for \$27,000,000 (the "Transaction"). At the time of the Transaction, TDC's board

of directors consisted of 9 directors (including the Conflicted Directors). In approving the Transaction, the 5 Conflicted Directors recused themselves from any discussions regarding the Transaction and left the decision to the 4 non-conflicted directors (who were fully aware of the conflict). After thoroughly reviewing the terms of the Transaction, the 4 non-conflicted directors unanimously approved it.

In 2007, a TDC shareholder brought a derivative suit in Delaware against the board of directors of TDC alleging that they wasted TDC's assets by acquiring the rights to the Documentaries for \$27,000,000. The plaintiff-shareholder did not make demand on TDC's board prior to filing this lawsuit. At the time the derivative lawsuit was filed, TDC's board of directors still consisted of 9 directors, but the composition of the board had changed somewhat.

<b>TDC Board Composition</b>	
<b><u>2006 (at time of Transaction)</u></b>	<b><u>2007 (at time of derivative suit and still current)</u></b>
<u>Conflicted Directors</u> Ann Barbara Carl David Edna	<u>Conflicted Directors</u> Ann Barbara Carl David Edna
<u>Non-Conflicted Directors</u> Frank Gina Hannah Ike	<u>Non-Conflicted Directors</u> Frank Gina John Karen

TDC responded to the derivative suit by establishing a special litigation committee that consists of TDC's new directors, John and Karen, who were brought onto the board after the Transaction was entered into. Neither John nor Karen had anything to do with the Transaction. The special litigation committee conducted a thorough investigation of the Transaction and the derivative suit and concluded:

- The Transaction was fair to TDC at the time it was made (and was actually a very favorable deal to TDC); and
- The derivative suit should be immediately dismissed as continuation of the suit was not in the best interests of TDC. Continuation of the suit would not benefit TDC but instead would require TDC to spend funds unnecessarily on litigation expenses and would be a distraction to TDC's senior management.

2. Prior to filing a derivative action, most states (including Delaware) require the plaintiff-shareholder to make a “demand” on the board of directors to take action against the alleged wrongdoer. Please answer the following two questions:
  - (a) Please analyze whether the plaintiff-shareholder was correct in assuming that demand was excused in this case.
  - (b) Please explain why the plaintiff-shareholder likely wanted to avoid making demand.
3. Under Delaware law, is TDC’s special litigation committee empowered to dismiss the derivative suit? Please explain the process for a special litigation committee to dismiss a derivative suit under Delaware law.
4. Why do you suppose that TDC’s Conflicted Directors recused themselves from approving the Transaction? What was the significance of TDC’s non-conflicted directors approving the Transaction?

**Question 5 (40 points possible – 20 minutes suggested):**

Acme Inc. (“Acme”) is a publisher of children’s books. Recently, Corinne (the President of Acme) told her secretary CT to go to the neighboring library to pick up a book that Corinne needed to examine – Corinne was concerned that a book she was considering for publication had plagiarized from this other book.

CT went to the library later that day to pick up the book, but the librarian told him that the book had already been checked out by someone else. CT explained to the librarian that he had just called one hour ago and was told that the book would be held until he got to the library. The librarian responded by telling CT, “So sue me.” CT was so mad that he climbed across the desk and slapped the librarian across the face.

The librarian is considering suing Acme. Please analyze Acme’s potential liability for CT’s action.

**Question 6 (20 points possible – 10 minutes suggested):**

Abe, Barry and Carla formed a partnership (“ABC Partners”) to research and develop an experimental herbal medication that has potential curative effects for a possible bird flu pandemic. Abe contributed \$700,000 and his business acumen. Barry contributed \$200,000 and his medical background. Carla contributed \$100,000 and her invaluable knowledge of herbal remedies and holistic healing. Trusting that their friendship and mutual respect for each other would see them through any and all matters, the three never entered into a formal partnership agreement, with one exception. They did agree that profits would be divided as follows: 50% to Abe; 25% to Barry; and 25% to Carla.

ABC Partners' work on developing a vaccine/cure for the bird flu went very poorly and ABC Partners incurred approximately \$1 million in losses. Abe, Barry and Carla never agreed on how losses were to be allocated. Please explain the responsibilities of Abe, Barry and Carla for the \$1 million in losses.

**Question 7 (30 points possible – 15 minutes suggested):**

Tiger Corporation ("Tiger") was party to a supply contract with Zebra Corporation ("Zebra"). Zebra has breached the contract and Tiger could potentially sue Zebra for damages related to the breach. Tiger's board of directors carefully examined the issue and decided not to take any action against Zebra.

Upon learning of the decision by Tiger's directors, Tiger's general counsel became very concerned. Tiger's general counsel explained that Tiger's directors will not be able to benefit from the business judgment rule because the business judgment rule only applies when directors take an action – and in this case they did not take any action.

Please analyze whether Tiger general counsel's concern is justified.

**Question 8 (30 points possible – 15 minutes suggested):**

Generally speaking, a corporation must be solvent in order to pay a dividend, and still be solvent after the dividend has been paid. A dividend violating this rule will be deemed to be illegal. This is not an entirely accurate summary of the law – there are a few approaches that states take to deal with this issue and a number of different tests for determining whether a corporation is in a proper financial position for paying dividends. It is, however, an accurate statement of the basic concept: no dividends unless the corporation is solvent.

What is the purpose for this rule that a corporation must be solvent in order pay a dividend (and still be solvent after the dividend has been paid)?

\* \* \* \* \*

**END OF EXAM**

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**FOR THE 2Ls AND RETURNING GRADUATE STUDENTS: I look forward to seeing you next year.**