

BUSINESS ASSOCIATIONS
 Professor John Orcutt
 Spring Semester 2008
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:

Question 1 = 70 points	Question 4 = 35 points	Question 7 = 25 points
Question 2 = 60 points	Question 5 = 45 points	Question 8 = 15 points
Question 3 = 25 points	Question 6 = 25 points	

I have written this examination to be a 2½ hour (150 minutes) 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:

Question 1 = 35 minutes	Question 4 = 17.5 minutes	Question 7 = 12.5 minutes
Question 2 = 30 minutes	Question 5 = 22.5 minutes	Question 8 = 7.5 minutes
Question 3 = 12.5 minutes	Question 6 = 12.5 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. 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.
- For those of you who are taking this exam on a laptop computer, the above rules are modified to permit usage of a laptop and are supplemented by the laptop exam rules that have are provided to you by the Registrar.

Good luck on the examination!

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

Question No. 1 (70 points possible: 35 minutes suggested)

Acme Corporation, a Delaware corporation (“Acme”), manufactures brake pads for the automotive aftermarket. From 2003 – 2007, Acme consistently lost money. Prior to that time frame, Acme had generally been a profitable company for the preceding 25 years. One explanation for the recent losses was Acme’s insistence on manufacturing its brake pads solely in the United States. In the late 1990s, the costs for manufacturing brake pads in China began decreasing substantially, while the quality of Chinese-manufactured brake pads increased. Industry analysts point out that by 2003, the quality of Chinese-manufactured brake pads rivaled those manufactured in the United States, but could generally be manufactured 35% cheaper than U.S. manufactured brake pads. Faced with this situation, the majority of U.S. brake pad manufacturers began outsourcing most, if not all, of their brake pad manufacturing to China somewhere between 2003 and 2006. Acme, however, has resisted the trend to outsource manufacturing to China and continues to manufacture 100% of its brake pads in the United States.

Beverly, a minority shareholder for Acme, has filed a derivative action against each of Acme’s directors for negligence and mismanagement. Specifically, the suit (a) seeks damages for lost profits that resulted from the directors’ refusal to outsource manufacturing to China and (b) an order that defendants be caused to outsource manufacturing to China. Beverly’s complaint alleges the following against Acme’s directors:

- Tommy, the CEO of Acme and also a director, refuses to even consider outsourcing to China. Tommy has given numerous speeches and interviews where he has stated his belief that U.S. companies should (i) support U.S. manufacturing and U.S. workers and (ii) resist the temptation to outsource to China irrespective of the economics of outsourcing. Tommy typically states in these interviews/speeches that maintaining U.S. manufacturing is a “moral imperative” and that U.S. companies that outsource are “morally reprehensible” for turning their backs on U.S. workers.
- In 2003, Acme’s board passed a resolution that it would maintain its manufacturing facilities in the United States. The resolution reads as follows:

RESOLVED, that Acme’s board of directors is committed to U.S. manufacturing and will not consider outsourcing its manufacturing capacity to foreign countries.

- It was Tommy that suggested the resolution, and the resolution was passed after roughly 20 minutes of deliberation that consisted of Tommy giving an 18 minutes speech on the need for U.S. manufacturing and 2 minutes of directors congratulating

Tommy on the speech. Acme's directors did not conduct any formal study (e.g., cost-benefit analysis) of the economic impact on Acme (e.g., potential cost savings versus impact on quality) of conducting its manufacturing in the United States versus outsourcing it to China, nor did the directors explore any specific outsourcing proposals.

- Acme's board of directors has refused to reconsider the issue of outsourcing to China since the resolution was passed in 2003.

In filing the derivative lawsuit, Beverly did not make a demand on Acme's board of directors alleging that demand would have been futile. For purposes of this question, please assume that the court has already ruled that Beverly was not required to make a demand on Acme's board of directors, and that the court is ready to consider the merits of Beverly's complaint. Please provide an analysis of what Beverly must prove in order to prevail in her breach of duty of care lawsuit against the Acme directors (including a discussion of how the directors will likely defend themselves) and evaluate her chance of success.

Question No. 2 (60 points possible: 30 minutes suggested)

Paula is a shareholder of Zenith Corporation, a Delaware corporation. Paula brought a derivative suit in the Delaware Court of Chancery on behalf of Zenith against several of its officers and directors based on a series of transactions that Paula claimed violated the officers' and directors' duty of care to Zenith. Paula did not make a demand on Zenith's board of directors, alleging that demand would have been futile. The court agreed with Paula's futility assertion and excused demand. Zenith's board responded by establishing a special litigation committee composed entirely of those directors who were not named as defendants in the derivative suit and who had joined the board after the challenged transactions. The special litigation committee investigated Paula's complaint and decided that the suit should not be maintained. The special litigation committee sought to have Paula's suit dismissed.

- (a) Under Delaware law, what is the effect of the special litigation committee's decision to seek dismissal of the suit? Please analyze. **(accounts for 32 of the possible points)**
- (b) Would your answer change if Zenith were a New York corporation and New York law was applied (i.e., the Auerbach case)? **(accounts for 24 of the possible points)**
- (c) Was Paula correct in asserting that Zenith's officers owed a duty of care to Zenith? **(accounts for 4 of the possible points)**

Question No. 3 (25 points possible: 12.5 minutes suggested)

Giselle is a loan officer at TownBank, Inc. Townbank's internal procedures provide that loan officers can enter into loan agreements of up to \$200,000. For loan agreements above \$200,000, TownBank loan officers must get approval from the Credit Department before signing the contract.

Brady walked into the TownBank branch and asked to speak with someone about getting a loan. Brady was walked to Giselle's desk, where her nameplate identified her as a loan officer. Brady sought a loan for \$300,000 and Giselle approved Brady's request. Giselle pulled out a loan agreement from her desk, filled in the \$300,000 principal amount and the interest rate and signed the agreement. Brady also signed the agreement. Giselle did not get approval from the Credit Department. Townbank found out about the loan two days later and refused to honor the agreement. If Brady sues Townbank, should the court find Townbank to be bound to the loan agreement? Please analyze.

Question No. 4 (35 points possible: 17.5 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 the coming 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, written partnership agreement.

ABC Partners' research for a vaccine/cure for the bird flu progressed nicely. Word got out of the advances being made by ABC Partners, which resulted in the World Health Organization pledging to assist in a field test of ABC Partners' primary product. Pfizer, a major drug company, has become highly interested in ABC Partners' progress and has offered to license the vaccine from ABC Partners for \$3 million. Abe and Barry are ecstatic about the Pfizer deal, but Carla hates the idea of doing business with a major, multinational corporation. Carla would like to use her position as a partner to try to prevent the transaction with Pfizer. Please analyze whether Abe and Barry can cause ABC Partners to enter into the license agreement with Pfizer over Carla's objection.

Question No. 5 (45 points possible: 22.5 minutes suggested)

Corinne is an entrepreneur who recently decided to start a French bakery business. Specifically, Corinne wanted to start two separate businesses. First, she wanted to open a retail French bakery that sold bread, pastries and coffee to residents of the community. Second, she wanted to start a wholesale bakery business that sold bread and pastries to restaurants and grocery stores within the state. Corinne has successfully started a few businesses in the past and has become quite rich in the process. Corinne was willing to risk \$100,000 in her newest venture, but did not want to otherwise risk her personal wealth. As a result, Corinne decided to form two separate corporations to undertake this venture. Retail, Inc. was capitalized with \$50,000 and focuses on the retail business. Wholesale, Inc. was also capitalized with \$50,000 and focuses on the wholesale business. Corinne is the sole shareholder of each of the two corporations and has complied with all necessary corporate formalities in operating the two companies.

Corinne found a suitable location (the “Rental Space”) for the retail bakery and negotiated a lease arrangement between the lessor (“Lessor”) and Retail, Inc. (Corinne herself was not personally a party to the lease). The lease was for five years and called for Retail, Inc. to pay \$10,000 per month. Wholesale, Inc. subleased a portion of the Rental Space from Retail, Inc. to conduct the wholesale business. In addition, Retail, Inc. and Wholesale, Inc. shared usage of the bakery ovens and certain common supplies (e.g., flour, butter, eggs, milk).

Unfortunately, the people of Corinne’s city turned out to be truly unsophisticated in their eating habits and Corinne’s retail bakery performed very poorly. Within one year, the retail bakery had lost \$50,000, and Corinne decided to shut down Retail, Inc. Wholesale, Inc., however, turned out to be a very profitable venture and Corinne continued that business. She moved Wholesale, Inc. to a cheaper location and it continues to be very successful and has generated a substantial residual. The result is that Retail, Inc. defaulted on the final 4 years of the lease. Lessor was able to mitigate much of the loss by finding a new tenant for the Rental Space, but not before suffering approximately \$100,000 in damages. Retail, Inc. has no assets.

Please analyze Lessor’s options for recovering the \$100,000. In addition, do you have any advice for Lessor to help Lessor avoid this type of problem in the future?

Question No. 6 (25 points possible: 12.5 minutes suggested)

Sam is the Chief Operating Officer for Xanadu Corp. (“Xanadu”), a Delaware corporation. Xanadu develops and distributes educational software for young children. Recently, Cool Games Inc. (“CGI”) approached Sam and asked him if he would be interested in acquiring a 30% stake in their company. CGI develops and distributes “mature” and “adults-only” video games. As

COO, Sam is well aware of Xanadu's business plans for the future and he is fairly confident that Xanadu would not be interested in the CGI opportunity. First, Xanadu is struggling financially and does not want to take on any new ventures. Second, Xanadu's products are very family friendly while CGI's are not. Xanadu has always had an internal policy that it will not consider any new ventures unless they are family friendly.

Sam is seeking advice on whether he must present the CGI opportunity to Xanadu's board. Please analyze whether Sam is required to present the CGI opportunity to Xanadu's board under Delaware law.

Question No. 7 (25 points possible: 12.5 minutes suggested)

Frank was a senior vice president for Pierce Securities, Inc., a major investment bank and a Delaware corporation. A few years ago, Frank decided to partake in a practice called "spinning", whereby he would grant shares in particularly hot initial public offerings (e.g., IPOs that were expected to rise in price by 50%, or more, in the days immediately following the IPO) to select senior executives of client companies in exchange for future investment banking business from these clients. Spinning can be viewed as a form of corporate bribery. Frank's spinning activities were discovered by the Securities and Exchange Commission (the "SEC"), and the SEC charged Frank with violating various securities regulations. Frank eventually settled with the SEC by paying a \$1 million fine and agreeing to a suspension from working in the securities industry for 2 years. Frank incurred \$250,000 in attorneys' fees defending the action.

Frank had an indemnification agreement with Pierce Securities that provided:

Pierce Securities shall indemnify Frank for all expenses (including attorneys' fees) or liability he incurred in any suit arising by reason of his services as an officer of Pierce Securities.

Pursuant to the indemnification agreement, Frank sued Pierce Securities for indemnification of the \$1 million fine and the \$250,000 in attorneys' fees that he spent. As part of the suit, Frank stipulated that he did not establish that he acted in good faith regarding the spinning activities.

Under Delaware law, is Pierce Securities required (or permitted) to indemnify Frank for the \$1 million fine and the \$250,000 in attorneys' fees?

Question No. 8 (15 points possible: 7.5 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

FOR THE 3Ls AND GRADUATING GRADUATE STUDENTS: Enjoy wonderful careers and please keep in touch.

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