

**BUSINESS ASSOCIATIONS**  
 Professor John Orcutt  
 Fall Semester 2014  
**FINAL EXAM – IN CLASS**  
**December 17, 2014**

**INSTRUCTIONS:**

1. 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.
2. This is a 3-hour examination and is worth 280 points (or 70% of your final grade). The examination consists of 8 essay questions:

Q1 = 44 points	Q2 = 22 points	Q3 = 30 points
Q4 = 26 points	Q5 = 44 points	Q6 = 44 points
Q7 = 44 points	Q8 = 26 points	

I have written this exam to be a 2 hour and 40 minute exam (160 minutes). ***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:

Q1 = 25 minutes	Q2 = 12.5 minutes	Q3 = 17.5 minutes
Q4 = 15 minutes	Q5 = 25 minutes	Q6 = 25 minutes
Q7 = 25 minutes	Q8 = 15 minutes	

To provide some cushion in your taking of the exam, I am giving you an extra 20 minutes. Therefore, you will actually have 3 hours for the exam.

3. 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.**
4. For those of you who are handwriting your exams, 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.
5. For those of you who are taking this exam on a laptop computer, you will be subject to the laptop exam rules that are provided to you by the Registrar.
6. 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 or on your laptop.
7. I have tried my best to write and proofread the exam so 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 point out the error in your 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 (44 points possible: 25 minutes suggested)**

*Slimmi Jimmi Co.* (“SJ”) is a Delaware corporation. Historically, SJ has made high-quality pork salami. Ann, who is SJ’s CEO, recently had a heart attack. Following the heart attack, Ann became more informed about the role of animal fat in coronary artery disease. Ann decided that salami is bad for one’s health; it substantially increases the risk of heart attacks.

Ann prepared a short report (the “Report”) for SJ’s board of directors recommending they change the company’s strategy. Rather than produce traditional high-fat, pork salami, Ann argued SJ should produce low-fat, turkey salami (the “Switch”). The Report provided a cursory outline of the business merits for the Switch. However, the Report did not include a comprehensive market study of consumer demand for turkey salami nor did it provide detailed financial models of the Switch. At a duly called meeting of the board, Ann presented her recommendations. To assist the board with its decision, Ann also brought Mary to the meeting. Mary is an economist who specializes in the economics of the food industry. Ann engaged Mary to read the report and give her opinion of its merits. Mary told the board she thought making the Switch could be economically beneficial for SJ. When various directors pressed her with detailed questions, Mary was forced to admit that she had not done an independent study of the matter. She simply read the report and was giving her general impressions. Based on Ann’s recommendation and Mary’s support of the Report, the directors voted unanimously to approve the Switch. Unfortunately, the change from high-fat to low-fat salami proved to be a financial disaster. SJ’s profits plummeted.

One of SJ’s shareholders (“Plaintiff”) wants to bring a derivative suit against SJ’s directors. The suit would allege the directors breached their duty of care by approving the Switch. Plaintiff is a very small shareholder of SJ, holding less than 1 percent of SJ’s outstanding stock.

### **Your Assignment:**

- (a) Please explain why Plaintiff’s lawsuit against SJ’s directors would be derivative rather than direct. (8 points possible)
- (b) Why do shareholder-plaintiffs frequently avoid making demand when bringing a derivative lawsuit? Please explain. (8 points possible)
- (c) Plaintiff does not want to make demand on SJ’s directors prior to filing her derivative suit. Based on the limited facts in the hypothetical, please analyze whether a Delaware court is likely to excuse demand because it would be futile. (20 points possible)
- (d) Some states (e.g., New York) have adopted restrictions for “small shareholders” who bring derivative lawsuits. What is a “small shareholder” statute? What is their rationale? Please explain. If the case was moved to a federal court in New York, would New York’s “small shareholder” statute apply to Plaintiff? Please explain. (8 points possible)

**QUESTION NO. 2 (22 points possible: 12.5 minutes suggested)**

The Documentary Channel, Inc. (“DC”), a Delaware corporation, is a cable television station that broadcasts documentaries. DC is always looking for additional shows to air. Janet is DC’s Head of Programming. She recently became aware of a documentary on big wave surfing that she wanted DC to acquire. The rights to the Documentary (the “Rights”) were held by Acme, Inc. (“Acme”). Acme is 100 percent owned by three DC directors (the “Conflicted Directors”). Acme produced the documentary a few years ago before the Conflicted Directors were on DC’s board. Janet approached Acme about buying the Rights, and Acme was interested.

Before making an offer, Janet hired an independent expert to appraise the market value of the Rights. The expert issued a report stating the fair market value for the Rights was between \$8 million and \$12 million. After some negotiation, Acme agreed it would sell the Rights to DC for \$9 million. Before signing the contract, Janet informed DC’s board of the proposed purchase, including the role of the Conflicted Directors. DC’s board consisted of seven directors: the three Conflicted Directors plus four non-conflicted directors. Two of the non-conflicted directors were present at the meeting (the “Present Non-Conflicted Directors”), and two were not. After thoroughly reviewing the terms of the transaction and the expert’s report, the Present Non-Conflicted Directors plus the three Conflicted Directors discussed the merits of the transaction and decided to approve it. The vote was 5-to-0 in favor of the transaction.

Following the board’s approval of the Rights purchase, the transaction was submitted to DC’s shareholders for their approval. The shareholders, who were fully informed about the transaction and the conflict, voted to approve it. DC has 100 shares of outstanding stock and the shareholder vote generated the following results:

- 60 shares voted to approve the transaction (including 12 shares held by the Conflicted Directors).
- 5 shares voted against the transaction.
- 35 shares did not vote.

Following the board and shareholder approvals, Janet consummated the purchase of the Rights from Acme. After the transaction was completed, a shareholder (“Plaintiff”) brought a derivative lawsuit challenging DC’s purchase of the Rights. In the lawsuit, Plaintiff sought to void the purchase. DC’s directors responded to the charge by explaining the purchase of the Rights complied with Delaware General Corporation Law (“DGCL”) section 144(a).

**Your Assignment:**

Please evaluate whether DC’s directors are correct. Did DC’s purchase of the Rights comply with DGCL section 144(a)(1), (2), or (3)? Please explain.

To help you with this question, here is the text for DGCL section 144(a):

**Sec. 144. Interested directors; quorum**

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the

meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

### **QUESTION 3 (30 points possible: 17.5 minutes suggested)**

Wu-Tang Financial Inc. (“WT”), a Delaware corporation, is a global financial services company. As a financial services company, WT is subject to various federal anti-money-laundering (“AML”) regulations. Among other things, the AML regulations require WT to (a) monitor customer transactions for the purpose of identifying potential money-laundering activity and (b) report any suspicious activity to federal regulators. Federal banking regulators conducted an investigation of WT’s AML compliance procedures. The regulators found WT’s AML compliance procedures to be wholly inadequate. More specifically, the regulators found:

- WT wholly failed to implement many of the compliance procedures required by the AML regulations; and
- For those compliance procedures that were implemented, WT’s directors consciously failed to monitor the outcome of such procedures thus disabling themselves from being informed of risks and problems requiring their attention.

As a result, the regulators (a) imposed significant fines and penalties on WT; (b) ordered WT to fix a number of its most grievous problems immediately; and (c) ordered WT to engage an independent consultant to conduct a comprehensive review of its AML compliance procedures and make recommendations for improvements. WT paid the fines and instituted all of the corrective measures mandated by the regulators. The total cost to WT of handling and resolving the investigation was roughly \$50 million.

A group of shareholders (“Plaintiffs”) formed to bring a derivative suit against WT’s directors for allowing the AML compliance problems to occur. Plaintiffs did not make demand on WT’s board of directors before filing the derivative suit.

#### **Your Assignment:**

- (a) WT’s certificate of incorporation includes an exculpatory clause per Delaware General Corporation Law section 102(b)(7). Will the 102(b)(7) clause preclude Plaintiffs from bringing their planned derivative suit? Please explain. (8 points possible)
- (b) WT’s board of directors formed a special litigation committee (“SLC”) to investigate the derivative action and determine whether WT should press the claims raised by Plaintiffs, settle the case, or seek to terminate it. WT’s board granted the SLC full authority to decide these matters without the need for approval by the other members of the WT board. The SLC consists of two independent directors who joined the board after the AML problem was resolved. The SLC was provided with sufficient financial resources to hire counsel and other advisors and conduct a full investigation. The SLC thoroughly investigated the matter and concluded the derivative suit should not be maintained. Does the SLC have the power to dismiss the derivative suit? Please explain. Would your answer change if WT were a New York corporation and New York law applied? Please explain. (22 points possible)

**QUESTION 4 (26 points possible: 15 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 we 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 knows 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 would like to pursue the CGI opportunity, but also does not want to breach his fiduciary duties to Xanadu.

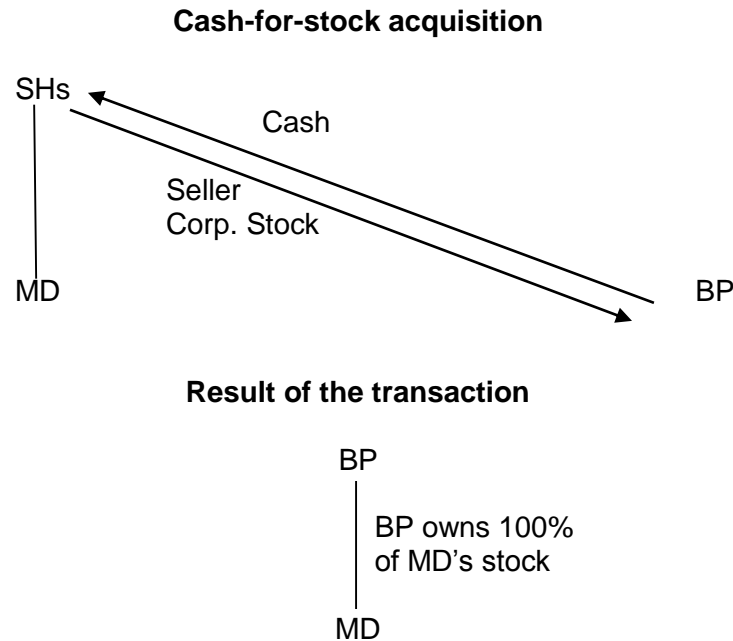
**Your Assignment:**

- (a) Sam is an officer of Xanadu, but not a director. Does Sam owe fiduciary duties to Xanadu? Please explain. (5 points possible)
  
- (b) Is Sam required to present the CGI opportunity to Xanadu's board before pursuing it? Please explain. (21 points possible)

**QUESTION 5 (44 points possible: 25 minutes suggested)**

Big Pharma Co., a Delaware corporation (“BP”), is a large pharmaceutical corporation. Miracle Drug Inc., also a Delaware corporation (“MD”), is a small start-up company that has developed a drug that some think may play a large role in curing cancer. BP bought all of the stock of MD in a cash-for-stock acquisition. Following the stock acquisition, BP owned 100 percent of MD (see Diagram A).

**Diagram A**



Following the acquisition, BP’s relationship with MD can be described as follows:

1. BP ignored some corporate formalities with MD. Specifically:
  - ✓ Two of MD’s three directors were BP officers. In addition, MD went for long periods without holding board meetings;
  - ✓ BP made the major (and even some of the minor) financial decisions regarding MD; and
  - ✓ BP set employment policies and wage scales for MD.
2. BP has been very involved in MD’s business. Specifically:
  - ✓ Other BP subsidiaries distributed MD’s miracle drug without charging MD a fee;
  - ✓ BP’s research department helped MD with tests regarding the safety of MD’s miracle drug;
  - ✓ BP’s in-house lawyers regularly did work for MD; and
  - ✓ BP bought a \$100 million insurance policy for MD.
3. MD never paid BP a dividend (i.e., BP did not take any of the residual out of MD).

Roughly two years after BP acquired MD, problems were discovered with MD’s miracle drug. MD’s miracle drug resulted in roughly 200 deaths and a number of other negative health implications for roughly 500 additional patients. A \$1 billion class action lawsuit was filed against MD under a products liability theory. MD, however, has only \$250

million of assets to pay off the lawsuit (the \$100 million insurance policy + an additional \$150 million of residual). The class action plaintiffs (the "Plaintiffs"), therefore, are seeking to pierce the corporate veil and sue BP.

**Your Assignment:**

- (a) Please evaluate the Plaintiffs' chance of successfully piercing the corporate veil and holding BP liable for MD's product liability problem under the alter ego doctrine. (30 points possible)
  
- (b) In addition to the traditional alter ego doctrine, what other theories could Plaintiffs pursue to hold BP liable for MD's product liability problem? Please explain. (14 points possible)

**QUESTION 6 (44 points possible: 25 minutes suggested)**

Harbucks Inc. is a leading franchisor of quick-service restaurants serving coffee, tea, and various baked goods (e.g., muffins, bagels, and pastries). Harbucks Inc. has more than 10,000 franchised restaurants operating throughout the United States.

Tweek, a customer at a Harbucks' franchise (the "Franchisee"), was severely injured when the restaurant was robbed. Please assume the Franchisee was liable in tort to Tweek due to negligence in establishing security procedures. However, the Franchisee is largely judgment proof. The Franchisee is very poorly capitalized and unable to pay the million dollar judgment that Tweek is seeking. Therefore, Tweek would like to sue Harbucks Inc. and hold it liable for his injuries.

**Your Assignment:**

Will a court hold Harbucks Inc. liable for Tweek's injuries? Please explain.

**QUESTION 7 (44 points possible: 25 minutes suggested)**

Bill and John formed a consulting firm (the "Firm") as a two-person partnership. The Firm provides patent valuation services and generates more than \$1 million per year in revenues. Economically, Bill is the more important partner. He receives 80 percent of the partnership's profits, while John receives 20 percent. Their partnership agreement is silent regarding their respective management rights in the partnership.

John approached Bill about hiring an administrative assistant for the Firm. The Firm's business involves a lot of paperwork. John explained to Bill that hiring an assistant would free the two of them up to do more revenue-generating work. Bill refused. John believed Bill's refusal was unreasonable, so he went ahead and hired an assistant without consulting Bill any further. John hired Xavier to be an administrative assistant for the Firm. In order to entice Xavier to leave his then-current employer and work for the Firm, John gave Xavier a written employment contract with a one-year guaranteed term. The contract called for the Firm to pay Xavier \$50,000 for the year.

John did not inform Bill that he hired Xavier. John figured Bill would like Xavier upon meeting him and relent to the hiring. Unfortunately, that did not prove to be the case. When Xavier showed up for his first day of work and introduced himself as the new assistant, Bill got very angry and threw Xavier out of the building. Bill screamed, "You do not work here and you never will!"

Xavier has sued the Firm for breach of contract and wants to be paid the \$50,000 he was promised in his employment contract.

**Your Assignment:**

Is the Firm liable to Xavier for the \$50,000? Please explain.

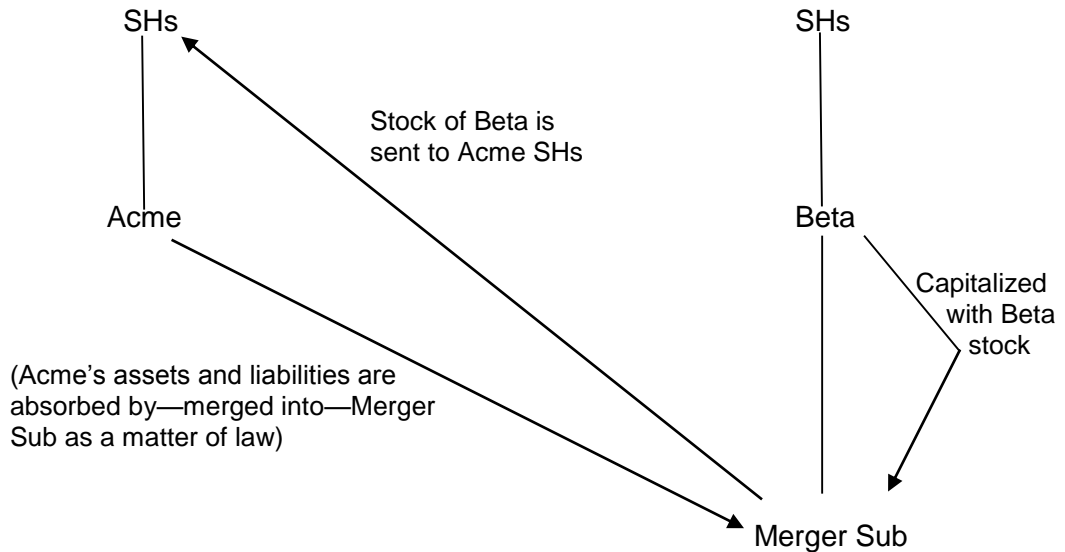
**QUESTION 8 (26 points possible: 15 minutes suggested)**

This question involves two Delaware corporations: (1) Acme Corp. ("Acme") and (2) Beta Inc. ("Beta"). Beta plans to acquire Acme by means of a forward triangular stock merger.

**STATUS OF THE COMPANIES PRE-MERGER**



**§ 251 FORWARD TRIANGULAR STOCK MERGER**



**Your Assignment:**

What board and shareholder approvals must Acme obtain to conduct the transaction? Please explain. What board and shareholder approvals must Beta obtain to conduct the transaction? Please explain.

**\* \* \* \* \* END OF EXAM \* \* \* \* \***