

**BUSINESS ASSOCIATIONS**

Professor John Orcutt  
Fall Semester 2016

**FINAL EXAM – IN CLASS**  
**December 21, 2016**

**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 2 hour and 40 minute examination and is worth 210 points (or 70% of your final grade). The examination consists of ten essay and short-answer questions:

Q1 = 7 points	Q2 = 23 points	Q3 = 23 points	Q4 = 23 points	Q5 = 7 points
Q6 = 23 points	Q7 = 30 points	Q8 = 30 points	Q9 = 37 points	Q10 = 7 points

I have written this exam to be a 2 hour and 20 minute exam (140 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 = 5 mins.	Q2 = 15 mins.	Q3 = 15 mins.	Q4 = 15 mins.	Q5 = 5 mins.
Q6 = 15 mins.	Q7 = 20 mins.	Q8 = 20 mins.	Q9 = 25 mins.	Q10 = 5 mins.

To provide some cushion in your taking of the exam, I am giving you an extra 20 minutes. Therefore, you will actually have 2 hours and 40 minutes 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. The above scratch paper rules also apply to laptop exams. I do not grade scratch paper.
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**

## BACKGROUND INFORMATION FOR QUESTIONS 1—5:

The board of directors for Stark Industries Inc., a Delaware corporation (“Stark”), recently voted to hire Pepper as its new CEO and award her a generous employment contract (the “Contract”). The most significant terms of the Contract were:

- **Term:** Stark agreed to employ Pepper as its CEO for a 6-year term;
- **Compensation:** Stark agreed to pay Pepper a compensation package of roughly \$20 million per year during the 6-year term; and
- **Termination clause:** If Stark fired Pepper for gross negligence or gross malfeasance (a “for-cause termination”), it would owe her no further compensation. If, however, Stark fired Pepper for any reason other than gross negligence or gross malfeasance (a “no-fault termination,” or “termination without cause”), Pepper would be entitled to a no-fault termination payment equal to 1.5 times (or 150% of) her remaining compensation. [Example: If Stark terminated Pepper without cause at the end of four years, it would owe her \$60 million for the remaining two years ( $2 * \$20 \text{ million} * 1.5$ ).]

The Contract was unilaterally negotiated by Tony, who is one of Stark’s directors and is chair of Stark’s compensation committee. To approve the Contract, Tony called for a special meeting of the board. Tony provided the board with only one day’s notice for the meeting. When Tony notified the directors of the special meeting, he told them the purpose of the meeting (“we will be deciding whether to hire Pepper as our new CEO and whether to approve an employment contract that I have prepared”), but he did not provide the directors with any particular information package.

At the special meeting, Tony gave a 45-minute presentation on Pepper’s qualifications as CEO and outlined the terms of the Contract. In giving that presentation, Tony did not discuss the termination clause.

Following Tony’s presentation, the board asked questions for roughly 20 minutes. One question was whether a study was done of executive compensation for CEOs of companies that are comparable to Stark. Tony stated that such a study had not been done and explained:

“Pepper demanded a 6-year contract at roughly \$20 million per year and was not going to accept anything less than that. Knowing that, what would be the point of a compensation study?”

Another director asked if a copy of the Contract was available to be reviewed. Elizabeth, Stark’s general counsel, responded to that question as follows:

“I don’t have a copy of the Contract with me right now. I can tell you that I have read the Contract and everything looks in order to me.”

All told, the special meeting lasted roughly 90 minutes and concluded after the board unanimously voted to approve the Contract and hire Pepper as Stark’s new CEO.

When Pepper took office, the initial reaction was optimistic, and Pepper did make some positive contributions. By the end of the first year, however, it had become clear that Pepper was a poor fit for Stark. The company’s performance was way down, and Pepper’s management style was the likely culprit. Stark’s board met to consider its options. The board examined whether it could terminate Pepper for cause, but there

were no facts to support a for-cause termination. At the end of the meeting, Stark's board voted to terminate Pepper without cause and pay her a \$150 million no-fault termination payment. Following Pepper's termination, one Stark director was quoted in a newspaper article saying, "I had no idea Pepper's termination package was so generous."

A number of Stark shareholders were outraged by the Pepper incident. These shareholders (the "Plaintiffs") brought derivative actions against Stark's directors who served at the time the Contract was formed (the "Defendants"). They alleged the Defendants breached their fiduciary duties to Stark when they blindly approved the Contract. To support their claim, the Plaintiffs did an analysis of executive compensation for CEO's of companies that are comparable to Stark. Their research found:

- The average contract term for CEOs in their study was 3 years;
- The average compensation for CEOs in their study was \$10 million per year; and
- The average no-fault termination clause entitled the CEO to a no-fault termination payment equal to 1.1 times (or 110% of) of her remaining compensation.

NOTE: Plaintiffs are only alleging Defendants breached their fiduciary duties when they approved the Contract. They are not alleging Defendants breached their fiduciary duties when they decided to terminate Pepper without fault.

Three more pieces of information for you to consider:

- The composition of Stark's board of directors has not changed at all since the Contract was approved.
- Stark's certificate of incorporation includes the following section 102(b)(7) clause:  
"A director of this Corporation shall not be liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except to the extent such exemption from liability or limitation thereof is not permitted under the Delaware General Corporation Law."
- Stark's bylaws include an *internal affairs forum selection clause* (the "Forum Selection Clause"), which designates New York as the exclusive forum for litigating lawsuits asserting internal corporate claims, including derivative actions.

### **Your assignment:**

Defendants filed three motions to dismiss Plaintiffs' suit. Question 1 deals with the first motion to dismiss, Question 2 the second, and Question 3 the third.

#### **Question No. 1 (7 points possible: 5 minutes suggested)**

Plaintiffs filed their derivative actions in Delaware state court. Defendants move to dismiss the complaint for lack of subject matter jurisdiction. Defendants claim a Delaware state court lacks jurisdiction over the dispute due to the Forum Selection Clause. Please analyze the validity of the Forum Selection Clause.

#### **Question No. 2 (23 points possible: 15 minutes suggested)**

Defendants contend Plaintiffs' complaint cannot be read to allege any fiduciary duty violation other than, at most, a breach of the directors' duty of due care. As such, they moved to dismiss the case at summary judgment arguing Plaintiffs' claims are barred by Stark's section 102(b)(7) clause. Please analyze the strength of Defendants' contention.

**Question No. 3 (23 points possible: 15 minutes suggested)**

Defendants also seek to dismiss Plaintiffs' suit because Plaintiffs failed to make demand on Stark's board before filing their derivative action. Please analyze the strength of Defendants' contention. In conducting your analysis, please explain whether you are using the *Grimes/Aronson* test or the *Rales* test, and why.

\* \* \* \* \*

Two more questions about the Stark/Pepper controversy.

**Question No. 4 (23 points possible: 15 minutes suggested)**

For purposes of Question 4 only, please assume Plaintiffs' complaint survives each of the motions to dismiss and goes to trial. Please provide an analysis of what Plaintiffs must prove in order to prevail in their breach of fiduciary duty lawsuit against Defendants. In conducting your analysis, please explain the role of the business judgment rule and the entire fairness test in Plaintiffs' ability to demonstrate the Defendants breached their fiduciary duties. Finally, please evaluate Plaintiffs' chance of success.

**Question No. 5 (7 points possible: 5 minutes suggested)**

Some states (e.g., New York) have adopted restrictions for "small shareholders" who bring derivative lawsuits. What is a "small shareholder" statute? What is the rationale for such statutes? Please explain. If Defendants successfully move the case to a federal court in New York, would New York's small shareholder statute apply to Plaintiff? Please explain.

\* \* \* END OF STARK QUESTIONS \* \* \*

**Question No. 6 (23 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 believes Xanadu would not be interested in the CGI opportunity. Xanadu's products are family friendly while CGI's are not. Xanadu has 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.

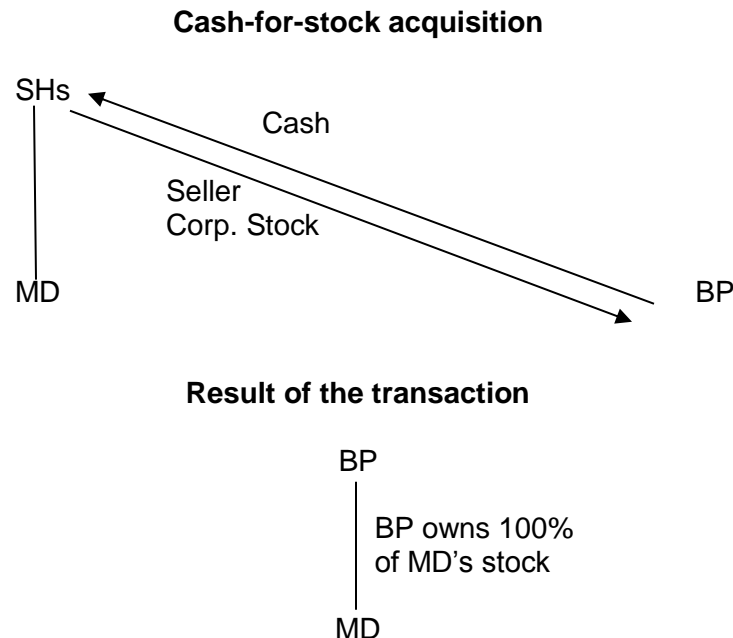
**Your Assignment:**

Can Sam pursue the CGI opportunity without breaching his fiduciary duties to Xanadu? Is Sam required to present the CGI opportunity to Xanadu's board before pursuing it? Please explain.

**Question No. 7 (30 points possible: 20 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. Two of MD's three directors were BP officers. In addition, MD went for long periods without holding board meetings.
2. BP made the major (and even some of the minor) financial decisions regarding MD.
3. BP set employment policies and wage scales for MD.
4. 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.
5. 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:**

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. 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 and analyze.

**Question No. 8 (30 points possible: 20 minutes suggested)**

Bill and John formed a consulting firm as a two-person partnership. The consulting firm provides patent valuation services. The partnership agreement did not establish a specific duration for the partnership. Bill loaned \$300,000 to the partnership, which was to be repaid out of the profits of the business.

After six months, Bill grew dissatisfied with John as a partner. John tried hard, but he was not very good at his job. John's valuation work was sloppy and he sometimes missed deadlines. John also tended to get nervous during client meetings and presentations, which caused some clients to complain and demand that Bill be assigned to their accounts. Finally, John proved to be bad at cultivating new clients.

Bill does not want to work with John any longer. Instead, Bill wants to operate the business on his own. Bill is considering notifying John that the partnership is terminated.

**Your Assignment:**

Bill wants to understand the risks he would face if he unilaterally terminated the partnership. Please explain. Please also advise Bill on how, or whether, he should terminate his business relationship with John.

**Question No. 9 (37 points possible: 25 minutes suggested)**

Paula is a famous collector of Picasso paintings. Paula believes she has located one of Picasso's most famous masterpieces (the "Painting") that disappeared roughly 30 years ago. The Painting is currently located in a small museum (the "Museum") that lists the Painting as being painted by an "unknown" artist. Because Paula is a famous collector of Picasso paintings, she does not want to disclose her identity to the Museum. If the Museum knows that Paula wants to buy the Painting, the Museum will demand a much higher selling price. To get around this problem, Paula hired Ann to buy the Painting. Paula told Ann that she could pay up to \$100,000 for the Painting. Paula also instructed Ann not to disclose Paula's identity when buying the Painting. Paula specifically told Ann to simply state that she is making the purchase on behalf of another.

Ann did as she was directed and made an offer to the Museum to buy the Painting for \$75,000. The Museum thought the offer was very generous and agreed to sell the Painting to Ann provided that Ann obtained the approval of Terry. Terry was the Museum's biggest benefactor and he really loved the Painting. The Museum did not want Terry to be upset with the Museum if the Painting were sold. Ann talked with Terry and Terry agreed to give his approval if Ann agreed to pay Terry \$10,000. As a result, Ann entered into two contracts (the "Contracts"):

1. Ann entered into a contract with the Museum to purchase the Painting for \$75,000; and
2. Ann entered into a contract to pay Terry \$10,000 in exchange for Terry's acquiescence to the sale of the Painting.

After the Contracts were entered into, but prior to Paula making the payments, it was discovered that the Painting was NOT in fact a Picasso masterpiece. In fact, the Painting was painted by a struggling artist named Snooki and was probably worth less than \$1,000. Paula decided she no longer wanted to buy the Painting and refused to perform on either of the Contracts. At that point, the Museum and Terry learned of Paula's identity and both parties decided to sue Paula for breach of contract. Please answer the following questions:

- (a) Is Paula contractually liable for the \$75,000 payment to the Museum?
- (b) Is Paula contractually liable for the \$10,000 payment to Terry?
- (c) If the Museum or Terry have trouble collecting from Paula, can they hold Ann liable for the Contracts?

**Question No. 10 (7 points possible: 5 minutes suggested)**

In *Francis v. United Jersey Bank*, Mrs. Pritchard was a director of Pritchard & Baird (“P&B”). She was accused of negligent oversight of P&B. The court found:

Mrs. Pritchard was not active in the business of Pritchard & Baird and knows virtually nothing of its corporate affairs. She briefly visited the corporate offices in Morristown on only one occasion, and she never read or obtained the annual financial statements. She was unfamiliar with the rudiments of reinsurance and made no effort to assure that the policies and practices of the corporation, particularly pertaining to the withdrawal of funds, complied with industry custom or relevant law. Although her husband had warned her that Charles, Jr. would “take the shirt off my back,” Mrs. Pritchard did not pay any attention to her duties as a director or to the affairs of the corporation.

... The court found ... the reason Mrs. Pritchard never knew what her sons “were doing was because she never made the slightest effort to discharge any of her responsibilities as a director of Pritchard & Baird.”

Mrs. Pritchard was found liable for breaching her duty of care. In the case, the court never mentions the business judgment rule. Why did Mrs. Pritchard not receive business judgment rule protection? Please explain.

\* \* \* \* \*

**END OF EXAM**

**Have a wonderful semester break!!!**