

Empire College School of Law

Spring Semester 2013

Monday, April 15, 2013

Business Organizations

Final Examination

Professor: Rob Rutherford

Instructions

This examination consists of 3 essay questions. Your answers to each question will be weighted equally when determining your grade. You have three (3) hours in which to complete the exam. The recommended time for each question is one (1) hour. Please budget your time so you can adequately answer each question.

Before starting to write, you should read each question carefully and spend some time organizing your answer. Your goal should be to identify the issues, recite applicable law and then apply and analyze the facts. Strive for precision and brevity and avoid getting stuck on one issue or topic.

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Question 1

Bumbershoots, Inc. (“Bumber”) is a Delaware corporation that manufactures umbrellas. Hook, Inc. (“Hook”) is a Delaware corporation with 1200 shareholders and \$600 million in assets. Hook's Articles of Incorporation provide that the liability of directors for breaches of fiduciary duty is limited to the fullest extent allowed by law. Hook manufactures the handles for Bumber's umbrellas.

In August 2012, Bumber made a tender offer for 51% of Hook's stock at \$70 per share. Bumber's announcement said that if its offer was successful it would later merge Hook into Bumber; in the merger, the remaining Hook shareholders would receive subordinated Bumber debentures for their Hook stock.

Hook's board of directors met the day after Bumber announced its tender offer. The Hook board consisted of 4 members of Hook's executive management team and 5 outside directors. During the meeting, Hook's investment banker opined that the \$70 price was adequate but that the debentures paid to Hook shareholders in the second tier of the transaction would be worthless if the merger of Bumber and Hook failed to increase Bumber's profitability. Hook's directors then adopted an amendment to Hook's Articles of Incorporation allowing Hook's existing shareholders to buy additional shares at \$30 each if any party acquired more than 30% of Hook's stock without the prior approval of Hook's board. A shareholder meeting was scheduled, and Hook sent proxy solicitations to its shareholders asking them to approve the amendment. The proxy statements said that Bumber had reported losses for its last three fiscal years. That was false. Bumber had lost money in only two of the last three years. The Hook shareholders approved the amendment.

Bumber responded by increasing its offer to \$80 per share and asked the Hook board to approve its offer. Instead, the Hook directors approved a merger with Umbrellas, Inc. (“Umbrellas”). Hook would be the surviving entity after the merger, but 51% of its stock would be owned by Umbrella's parent corporation, Consolidated Holdings, Inc. (“Consolidated”). Dwayne James, a famous umbrella designer, owns 100% of Consolidated's stock. The Hook board agreed to submit the merger to the shareholders for approval even if they felt their fiduciary obligations prevented them from recommending the deal.

Please evaluate the actions of the Hook directors and discuss what action, if any, Bumber or the Hook shareholders may take against them.

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Question 2

Fred owns 51% of the issued and outstanding stock of Fantastic Mixers, Inc., a Delaware corporation (“Mixers”). Fred is the President of Mixers and elects 5 of its 9 directors.

In January 2013, Fred sold some of Mixers' special milkshake machines to the McDowell Brothers, who owned a burger restaurant in Southern California. Intrigued by why the McDowell Brothers purchased so many machines, Fred visited their restaurant. When he told the McDowells how much he admired their operation, they asked if Mixers would be interested in purchasing their business. Fred responded by saying that Mixers lacked the cash for such a purchase because it recently had modernized its manufacturing facilities. But he guaranteed the McDowell Brothers that he would find a way to get the deal done.

After leaving his meeting with the McDowell Brothers, Fred called his lawyer and told her to form a new corporation called Delicious Burgers, Inc. (“Delicious”). All of the Delicious stock was issued to Fred. Delicious then obtained a bank loan and used the proceeds to buy the McDowell Brothers' restaurant. At Fred's request, the directors of Mixers approved resolutions pledging the assets of Mixers as collateral for the bank loan to Delicious and agreeing to sell milkshake machines at a special discounted price to the Delicious restaurants Fred planned to open across the United States.

Adhering to the McDowell Brothers operating procedures, Delicious prospered. Mixers, on the other hand, struggled because it lost money on the machines it sold to Delicious. Judy, who has owned stock in Mixers for years, filed a derivative action against Fred and the directors of Mixers alleging that they breached their fiduciary duties to Mixers and its shareholders. In her complaint, she alleged that making demand on the board before filing the lawsuit was futile because the board was controlled by Fred. Mixers responded by appointing a special litigation committee to evaluate the lawsuit. The committee included Fred's lawyer and the banker who made the loan to Delicious for acquisition of the McDowells' restaurant.

The committee concluded that Judy's lawsuit should be dismissed. Judy asks for your opinion as to whether or not the court is likely to follow the committee's recommendation and dismiss the lawsuit. She also asks that you evaluate the merits of her claim against Fred and the directors of Mixers.

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Question 3

Janice worked in the accounting department of Diamond Mines, Inc. (“Diamond”), a Delaware corporation with 750 shareholders and \$20 million in assets. On July 15, 2012, Janice processed invoices for new drilling equipment. Janice asked her boss, Bill, who was Diamond's Chief Financial Officer, if this meant Diamond was opening a new mine. Bill had heard nothing about a new mine and told Janice so. Janice believed Bill, but still wanted to invest in the company she worked for. Later that day, Janice bought 1000 Diamond shares at \$50 each.

While Bill had heard nothing about a new mine, he knew that Diamond would not buy equipment unless one was being developed. A month earlier, on June 15, 2012, he had sold all of his Diamond stock, 50,000 shares, at \$100 each. Until he spoke with Janice, he thought Diamond's best days were behind it. But this news excited him. He wrote a note to himself that read, “New mine discovered. Buy Diamond stock.” At lunch, he visited his broker and purchased 100,000 shares at \$50 each. Then he called his friend Martha and told her she should buy Diamond stock, though he could not tell her why. She did so, buying 100 shares later that afternoon at \$50 each.

That evening, Rick, a member of the janitorial crew, found Bill's note while cleaning Bill's office. He put the note in his pocket. The next day he bought 100 shares of Diamond stock at \$50 each. Then he went to the laundromat, where Bill's note fell out of this pocket and was picked up by Tammy. She promptly called her broker and bought 100 Diamond shares at \$50 each.

One week later, Diamond announced that it was opening a new mine. Diamond's stock quickly rose to \$90 per share. On July 24, 2012, Janice, Bill, Martha, Rick and Tammy sold all of their Diamond stock.

Please discuss whether Janice, Bill, Martha, Rick or Tammy face any civil or criminal liability for their actions. None of them owned any Diamond stock when they made these made the purchases described above.