Empire College School of Law
Professor Rutherfurd
Business Organizations – Final
Tuesday, April 18, 2017

Student ID#_______________

QUESTION 1
(One hour)

Spy, Incorporated ("Spy") is a Delaware corporation that manufactures surveillance equipment. Listening Inc. ("Listening"), which is also a Delaware corporation, owns 60% of the outstanding stock of Spy. The stock of both corporations is traded on the New York Stock Exchange. Listening elects five of the nine directors serving on Spy's board. Gus serves as a director of both Spy and Listening, as do the other four individuals Listening appoints to Spy's board.

During a meeting of the Spy directors in January 2017, the head of Spy's research department reported that Spy had developed technology (referred to as "Safe Cracker") capable of identifying and downloading information from any cellular phone within a 60 mile radius.

A few days later, the directors of Listening met. Gus reported on Spy's new technology. The Listening directors wanted Listening, not Spy, to have the exclusive right to sell and distribute Safe Cracker. Listening's CFO hastily made some calculations as to how much Listening might pay Spy for Safe Cracker. She told the Listening directors that her numbers were low and that Safe Cracker was worth much more to Listening. In particular, she had ignored the fact that having Safe Cracker in Listening's product line would increase sales of other Listening products as well. The Listening directors approved the offer based on the CFOs calculations and forwarded it to Spy.

Spy's directors appointed the four directors not elected by Listening to evaluate the offer. The committee regularly consulted with Gus even though he was not a member. Gus attended meetings of the committee and drafted reports analyzing potential sales of Safe Cracker and its value. Neither Gus nor anyone else from Listening told any of the independent Spy directors about the narrow scope of the CFO's analysis or that she had lowballed the price.

The special committee approved the transaction, and Spy sold Safe Cracker to Listening. After an investigative reporter wrote about Listening's purchase of Safe Cracker, referring to it in the article as the "Steal of the Century," an angry Spy shareholder initiated a derivative action for breach of fiduciary duty against Spy, Listening and the five directors (including Gus) that served on the boards of both corporations. The plaintiff alleged that he was excused from making a demand on Spy before filing the lawsuit because the directors named as defendants had failed to disclose the method Listening employed to determine the purchase price for Safe Cracker.

The defendants brought a motion to dismiss the complaint, claiming that the plaintiff lacked standing due to his failure to make a demand on Spy's board before filing the complaint. Please evaluate whether or not that motion should be granted? Also, please discuss the merits of the plaintiff's case.

QUESTION 2
(One hour)

Linda and Dolly each owned 50% of Tucson Records, a California corporation ("Tucson") that manufactures audiophile-quality vinyl records. Linda also was a board member of Best Music, Inc. ("Best"), the largest manufacturer and distributor of music compact discs in the world. Best has approximately 1,000 shareholders and $15 million dollars of assets.

At a board of directors meeting held on September 28, 2016, the President of Best, Joan, reported that sales of compact discs continued to decline. The Wall Street Journal (the "Journal") had, said Joan, interviewed her about the drop in sales of CDs and the resurgence of the vinyl record market. Joan warned the board members that the Journal would soon run a front page story proclaiming that "CDs are dead, Vinyl Lives!"

Linda saw the article as a huge boost for Tucson's business. But on September 1 2016, Linda had purchased 100 shares of Best stock at $100 per share ($10,000 total), and Joan's news made Linda think that was a bad investment.

Linda met Dolly for lunch the day after the Best Directors meeting. Linda told Dolly that she was willing to purchase all of Dolly's Tucson stock for $250,000. Dolly accepted. Linda said nothing to Dolly about the forthcoming Journal article and how the publicity would help Tucson's business.

On October 1, 2016, Linda sold her 100 shares of Best stock for $120 per share ($12,000 total proceeds). Feeling guilty about the deal she had made with Dolly, Linda told Dolly that some bad news about Best would soon break and that Dolly should sell all of her Best stock too, which Dolly did. The Journal article ran two days later. As Joan had predicted, the value of Best's stock dropped significantly. Believing that the worst was over, Linda bought 200 shares of Best stock on November 1, 2016 for $50 per share ($10,000 total).

Meanwhile, sales at Tucson rose after the Journal article appeared, and by March 31, 2017, Tucson was worth $2 million. Dolly's lawyer wrote a letter to Linda alleging that she had defrauded Dolly and threatening to file a lawsuit against Linda.

Please evaluate whether or not Linda broke any laws by her conduct and whether or not she has any liability to Dolly, Best, or to the shareholders of Best. Does Dolly face any liability for following Linda's advice and selling her Best stock?

QUESTION 3
(One hour)

Big Plates, Inc. (“Big”) is a Delaware corporation with approximately 3000 shareholders and $30 million in assets. Big owns restaurant franchises throughout the United States and Europe. Friends and Food (“Friends”) is a Delaware corporation that owns high-end Sushi restaurants in California. Friends has about 1000 shareholders and $8 million in assets.

On July 30, 2016, Big offered to purchase 51% of Friend’s outstanding stock for $50 per share. The directors of Friends met the next day to consider Big’s proposal. Of the twelve (12) board members, six (6) were executive employees of Friends, and the other six (6) were outside directors. During the meeting, Friend’s investment banker informed the board that the price proposed by Big was generous, and a restaurant industry analyst praised Big’s business plan. The directors, however, worried that Big lacked the specialized knowledge necessary for operating sushi restaurants and that earnings and dividends to the shareholders of Friends would suffer if Big gained control of Friends.

Friends’ board recommended that the shareholders not accept Big’s offer and instead made its own proposal: Friends offered to redeem 25% of its outstanding common stock for $60 per share, even though the CFO of Friends warned the directors that paying that much would exhaust most of Friends’ surplus capital and hurt the corporation’s credit standing.

Friends sent all of its shareholders a letter recommending that the shareholders not tender their stock to Big and instead take advantage of Friends redemption offer. The notice assured the shareholders of Friends’ solvency, making no mention of the CFO’s concerns.

Big countered by increasing its offer to $65 per share. The directors of Friends responded by granting another restaurant chain, Fancy Foods, an option to purchase Friends’ LA area restaurants--considered some of the best in the world--if Big’s tender offer was successful.

When Big heard about the option, it withdrew its offer. Friends’ offer was over-scribed, and as Friends’ CFO had predicted, the large payout damaged Friends’ credit rating. The price of Friend’s stock fell dramatically.

Your firm represents Friends. A senior partner asks you to analyze whether the directors of Friends may be liable to its shareholders or to Big as a result of these events. Please do so.