Gerla
Corporations
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Question I

Ed and Fred Chase ran a successful commercial electronics repair business. The business was organized as a corporation with Ed and Fred each owning half the stock in the corporation. The name of the corporation was Electronic Repairs, Inc. ("ERI"). ERI had a three person board of directors consisting of Ed, Fred, and Fran, the sister of Ed and Fred. ERI was incorporated in the State of Grace. Business was booming so much that Ed and Fred saw the need to bring a new person into the business. A distant cousin, Gerry Quail was engaged as a sole proprietor in a similar business in California. Ed and Fred urged Gerrv to sell his business in California and join them in Grace. Ed and Fred told Gerry that if the three of them joined forces, they could turn ERI into a bonanza that would "take care of them for the rest of their lives." The two brothers urged Gerry to "join our happy family." Gerry agreed to join forces with Ed and Fred.

Gerry was enthusiastic about going into business with Ed and Fred. He sold his own business, uprooted his family and moved three thousand miles to the State of Grace. Gerry took the money he received from the sale of his business, coupled it with most of his life savings and used it to buy stock in ERI from Ed and Fred so that each of the three men owned one third of ERI's stock. The stock which Gerry received was restricted in that Gerrry could not sell the stock to any other person without the permission of both Ed and Fred. The restriction on the stock was spelled out both in the articles of incorporation of the cor-poration and on the stock certificates themselves.

After the sale of stock to Gerry, ERI's board of directors was reconstituted with Ed, Fred and Gerry being elected to the three slots on the board. The board then hired Ed, Fred and Gerry as officers and paid them substantial salaries which were quite important to them given that the stock in ERI held by the three had never paid a dividend and that the salary from ERI was the sole source of income for the three men.

At first, after Gerry joined the business, it ran smoothly and prosperously. Soon, however, Gerry began to change. He seemed to become semi-tyrannical and alienated key employees and customers. He began to quarrel frequently with Ed and Fred. This was particularly disturging to Ed and Fred because the efficient functioning of their business required a close and harmonious working relationship among the principals. Finally, Ed and Fred could take no more. At a board of directors meeting, they voted two to one (with Gerry obviously dissenting) to oust Gerry as an officer of ERI.

Gerry was, not surprisingly, outraged. He attempted to withdraw from the business by selling his stock. Gerry found an outsider willing to purchase for approximately twenty-five percent less than Gerry paid for it. Ed and Fred, however, vetoed the deal on the grounds that "they did not want outsiders in what had always been a 'family' business." After Ed and Fred vetoed Gerry's proposed deal they then offered to buy the stock from Gerry for ten percent of what he paid for it. Gerry refused their offer.

Gerry has now brought suit seeking in the alternative to either (a) have the restrictions on his stock declared invalid, or (b) have ERI dissolved. The State of Grace has no statute dealing with restrictions on securities. The state of Grace does have a relevant statute on corporate dissolutions. That statute is set forth on page 1 of the statutory supplement.

Discuss whether Gerry will be successful in having the restrictions on his stock declared invalid and the corporation dissolved and why he will or will not be successful.

Question II

The Amazing Recycling Corporation ("ARC"") is a firm engaged in the business of recycling aluminum cans. The founders of the firm were interested solely in the aluminum recycling business. The firm prospered and grew and eventually became a publicly held corporation. Nonetheless, the corporation's sole business continued to be aluminum recycling. The member's of ARC's board of directors occasionally discussed, in rather general terms, getting into other businesses, but never pursued the matter beyond the level of vague discussions.

The President and Chief Executive Officer of ARC was Paula Tab. One day, Tab received a phone call at her office from an inventor by the name of Arroyo Seco. Seco claimed to have invented a machine for recycling titanium and other valuable rare metals from scrap. Seco stated that the reason he was calling Tab was that Seco believed that an aluminum recycling firm would Se particularly interested in going into the rare metal recycling business. Tab told Seco that she believed that ARC would not have the resources to go into the rare metal recycling business and would probably not be interested in the business if it did have the resources. Tab, however, indicated that she personally might be interested in exploiting the new technology invented by Seco.

Tab met with Seco and began negotiating with him. Eventually, the two agreed that Seco was to grant a group of investors headed by Tab an exclusive license to utilize Seco's patented machine in return for a substantial lump sum payment and continuing licensing fees.

Before finalizing the agreement, Tab began to be concerned that this development was something in which ARC might have an interest. She, therefore, brought the subject of her agreement with Seco before the ARC board of directors. Tab disclosed that she had an agreement with Seco to license a machine for extracting rare metals from scrap on a commercially feasible basis, but did not disclose any of the particulars of her arrangement with Seco, the process Seco had invented, or the commercial potential of rare metal recycling. After a very brief discussion that lasted less than five minutes, the board approved and unanimously passed a resolution stating that the company had no interest in Seco's machine or process.

The process Seco invented turned out to be fantastically successful and proved to be a financial gold mine for Tab and her group of investors. The process was so successful that Tab was able to resign from her position as President and CEO of ARC and retire to the Bahamas.

After Tab left ARC, the company was acquired in a hostile takeover and the board of directors was replaced in its entirety. The new directors were infuriated when they learned the facts of the Tab/Seco transaction. They are now contemplating suing Tab and the former members of the board of directors.

Discuss any causes of action the corporation might have against Tab or its former directors in connection with the Tab/Seco transaction.

Question III

Burger Biggy, Inc. ("BBI") is a publicly traded corporation which owns several chains of fast food restaurants in the Midwest. The president of the corporation is Bob Blaster. Blaster had a theory that the Midwest was in an irreversible economic decline and that the future economic locus of the country would be in the Sun Belt generally and in oil producing states more specifically. On the basis of his firm belief, Blaster wished BBI to expand into the oil-producing areas of the South and Southwest. Blaster, therefore, directed his staff to draw up a plan for expansion into those areas. The plans did not include a market survey or a local business forecast for the locales where Blaster planned to put BBI restaurants. Such surveys are routine for virtuallv any business expanding into a new area. Blaster, however, felt so strongly about the economic "prospects" for the oil producing regions that he decided market surveys would be a waste of time and money.

When the plans for expansion were drawn up, Blaster took them before BBI's seven person board of directors. Blaster brought up the plan at a regularly scheduled meeting of the board. He had not discussed the plan with any member of the board prior to the meeting. At the two and one half hour meeting the board of directors discussed the plan for expansion. While some members of the board were troubled by the lack of market and local business surveys, they were eventually won over by Blaster's charismatic style. At the conclusion of the meeting, the board unanimouslv approved Blaster's expansion plan.

The expansion into the South and Southwest proved to be a disaster for BBI. First, the market was alreadv oversaturated with fast-food restaurants. Second, when the price of oil collapsed, the economies of the oil producing regions of the South and Southwest collapsed with it. Eventually, BBI had to abandon its restaurants in the South and Southwest causing losses to BBI of between ten and twelve million dollars.

Gilbert Lewis, a stockholder of BBI both now and at the time the board made the decision to expand, has now brought a derivative suit in state court on behalf of the corporation against Blaster and the seven members of the board who approved the decision. The derivative suit recites the above facts (which you are of course to accept as true) and alleges that Blaster was negligent in the performance of his duties as president and that the members of the board of directors breached their duty of care in approving the expansion. Lewis has made no demand upon the members of BBI's board that they bring the suit directly on behalf of the corporation. At the time Lewis brought the suit, the members of BBI's board were the same seven persons who approved Blaster's expansion plans.

A week after Lewis brought the suit, two of the existing board members were replaced in an election by a distinguished professor of business at a highly-regarded local university and, a retired chief justice of the state supreme court neither of whom ever had any connection with the corporation. The board of directors appointed the two new members of the board to a temporary special litigation committee with full authority to decide whether the corporation itself should bring the suit. (You are to assume that applicable state law authorizes the delegation to board committees of decision making authority in this area.)

The special litigation committee conducted a thorough investigation of the decision to expand and the implications of litigation over that decision. In a thorough report the committee concluded that there was a better than two to one chance that the corporation could recover some six million dollars from Blaster and the directors if the corporation pursued the litigation. The committee, however, recommended against the continuation of the litigation for the following reasons:

(1) the litigation would cost the corporation one million dollars in attornev fees and court costs even if it was successful;

(2) the litigation would distract the attention of key corporate personnel;

(3) the litigation would damage the morale of employees who generally idolized Blaster;

(4) the litigation would cause both short and long-term loss of profits to the corporation by "dragging its name through the mud" and by degrading the image of wholesomeness it tried to promote to its customers.

The corporation has now filed a motion to dismiss the derivative suit on the grounds that (a) Lewis failed to make a demand upon the board of directors to bring the suit directly on behalf of the corporation, and (b) the decision of the special litigation committee ought to be determinative.

Discuss how a court would rule on the motion and why.

N.B. The jurisdiction in which the suit has been brought has adopted the rule of civil procedure set forth on page 2 of the statutory supplement.

Question IV

Rock and Roll Music, Inc. ("R&R") is a medium sized publicly traded record producing company. Recently, the giant Entertainment Corporation of America ("ECA") has sought to negotiate a friendly takeover of R&R. Negotiations between the managements of the two firms have been proceeding seriously for several weeks. While it appears that the negotiations will be brought to a fruitful conclusion, no firm agreement has been reached on the price that ECA will pay for R&R stock, or the actual structure of the deal. Throughout the negotiations, ECA has insisted on complete secrecy because it fears that a bidding war for R&R will ensue if word of the negotiations spreads. The managers of ECA have stated that should news of the negotiations become public, ECA will terminate the negotiations. The management of R&R does not want to break off negotiations because they anticipate that ECA will pay a substantial premium for R&R stock.

The management of R&R was horrified to see rumors of the negotiations between it and ECA reported in the financial press. The rumors apparently had some positive effect on the price of R&R stock. Some reporters approached Elvis John, President and Chief Executive Officer of R&R to enquire about the rumors. John stated that "We have no comment. We see no reason for the recent run-up in the price of our stock." John's statement was picked up and reported in the national financial press.

At the same time John was making his statement, Priscilla Moneypenny, the Treasurer of the Corporation, was talking to a reporter on "background" basis (a "background basis allows quotation of the information given without attribution to the particular source). Ms. Moneypenny, apparently panicked by the possible collapse of the negotiations with ECA, told the reporter that "There are no negotiations going on at the present time involving the acquisition of R&R." The reporter's information was published in the national financial press as follows:

> A reliable source has informed the Daily Financial Press that no negotiations involving the acquisition of Rock and Roll, Inc. are currently in progress.

What Moneypenny told the reporter was literally true because at the time the statement was made, the negotiations were in recess for a week because of the illness of one of the members of the ECA negotiating team. The statement by Moneypenny was completely unauthorized by her superiors at R&R or the firm's board of directors. The top managers at R&R had absolutely no idea who made the statement which was not surprising given that the firm had virtually no procedures for controlling or tracing the dissemination of information by corporate officers.

Six weeks after the release of the John and Moneypenny statements, negotiations between ECA and R&R for a merger were completed and an agreement was forged for ECA to acquire all the stock of R&R. News of the agreement caused the price of R&R stock to soar.

The Securities and Exchange Commission is now suing R&R, claiming that it violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder (both are set forth in the statutory supplement at page 3) by its behavior in connection with the merger negotiations between it and ECA. Assuming that the above facts can be established, discuss whether R&R may be liable for violation of Rule 10b-5 and why.