

Examination No.

University of Dayton School of Law

Corporations
Final Examination

(Part 1 of 2 Parts)
Essay Questions

Professor Harry S. Gerla

December 19, 2001
1:00 p.m.—5:00 p.m.

Special Instructions

This part of the examination consists of two questions. The two questions are weighted equally. All answers are to be written or typed legibly in complete English sentences. Illegible or outline answers will not receive credit. Please read each question carefully and answer the question that is asked.

You have two hours to complete this part of the examination. Please turn in your answers and all “scrap paper” at the end of this part of the examination. Please retain your examination “statutory supplement” for use on the next part of the examination.

EXAMINATION CONTINUES ON NEXT PAGE

Question 1

Olive, Part and Queen were the founders of the CED Corporation (“CED”), a corporation incorporated under the laws of the State of Franklin. CED was in the business of designing and making custom pollution equipment for various types of facilities. Olive, Part and Queen were the holders of the single class of common stock of CED, each owning one third of the stock. They also were the members CEDs three person Board of Directors. Olive Part and Queen were officers of the corporation and were employed full time as officers of CED.

While CED was quite successful and prosperous, Olive, Part and Queen all realized that the corporation’s future success and growth required some significant expansion of the business. After studying all their options, the three shareholders decided that their best option was to find an investor who was willing to put up substantial capital in return for a share of equity ownership in the corporation.

Olive, Part and Queen had a mutual friend, Reno, whom they thought could provide the needed capital and would be interested in taking an equity position in the corporation. They approached Reno with their idea, and as they suspected he was very interested and quite willing to invest money in the corporation in return for stock.

Reno had absolutely no interest in sitting on CED’s Board of Directors, or becoming an officer or employee of CED. He did, however, have certain concerns which he expressed to Olive, Part and Queen. Specifically, he was concerned that the three shareholders who were active in the business might pay themselves excessive salaries, or declare excessive dividends, or cause the corporation to enter into unjustifiably risky ventures. He was particularly concerned that any of these actions, or a number of other actions would leave CED with insufficient resources to take advantage of any “golden opportunities” that might come along.

Eventually the four were able to work out a deal which seemed to satisfy all of them. First, Reno would invest a substantial amount of money in CED. In return he would receive stock sufficient to give him 40% ownership of the common stock of CED (the other 60% was owned by Olive, Part and Queen in equal portions).

The four also entered into several other agreements as part of the arrangement, only one of which is relevant to the present problem. The four signed an agreement (the “Control Agreement”) gave Reno an “absolute and unconditional” veto over all major corporate decisions.

The arrangement seemed to work well for almost a year, but then things began to go sour quite quickly. It seems that Reno decided that CED could make a fortune by selling its products in the Eastern European and South American markets. He proposed an ambitious plan

EXAMINATION CONTINUES ON NEXT PAGE

of expansion to Olive, Part and Queen. Olive, Part and Queen listened respectfully, but rejected the plan. First, they noted that they had no experience in these markets and that they were hesitant to take such a major risk. Second, they noted that Reno's plan would require so much of CED's resources that no money would be left for dividends, salary increases, new-hires or other more modest domestic expansion plans. Reno kept insisting that his plan was a veritable "gold mine" and that if CED followed it, they would all be rich beyond their wildest imaginations. The three other shareholders stood firm and, acting in their capacities as directors, unanimously rejected Reno's plan.

Reno was infuriated. He decided he was going to make all the shareholders rich in spite of themselves. Reno began to use his veto power to veto anything that would take cash out of CED. He vetoed the declaration of dividends. He vetoed all increases in employee salaries. He vetoed all new hires. The other three shareholders protested that he was really hurting CED. CED employees were growing tired of no salary increases and were threatening to quit. Needed work was not getting done because new employees couldn't be hired to do it. Finally, to add insult to injury, CED was hit by the Internal Revenue Service with a penalty for retaining too much of its earnings in the corporation rather than paying it out in salary or dividends. All along, Reno kept insisting, apparently sincerely, that these problems and costs were "chicken feed" compared to the money they could make if his plan was followed.

Olive, Part and Queen, at a meeting of the CED directors, voted to hire several new employees for CED. When Reno was informed he trotted out the Control Agreement and exercised his usual veto. This time, however, Olive, Part and Queen told Reno that they believe that the agreement was invalid and that they were simply going to ignore him.

Reno has now brought suit seeking to enforce the Control Agreement. Olive, Part and Queen, of course, argue that the Control Agreement is invalid. Discuss how a court might rule in Reno's suit and why it would so rule.

Note: In answering the question you are to ASSUME that no statute has any effect on the answer to this question.

Question II

The 4D Corporation (“4D”) is a publicly owned corporation, incorporated in the State of Anywhere, whose stock is traded in the over-the-counter market. The business of 4D is making virtual reality game machines for both commercial (arcade) and home use. The driving force behind 4D was James Portals. Portals’ acumen, hard work, and talent took 4D from a small start up company operating out of Portals’ garage to a \$5,000,000,000 company. Indeed, Portals had developed a widespread reputation throughout the industry as a “genius.”

In the virtual reality game business there are four keys to success:

- (1) make something new and different that will excite home users and the users who patronize arcades;
- (2) get it to market before your competitors get theirs to market;
- (3) always have enough supply to meet demand; and
- (4) make it cheaper than your competitors’ products.

There were four members on 4D’s board of directors. They were Portals, Fred Woods, Bill Fields and Jane Forrest. Forrest was Portal’s sister. Woods and Fields were long time close friends of Portals. In fact, the friendship among Portals, Woods and Fields was particularly close. They considered each other “best friends” and their families regularly vacationed together. None of the other directors, however, received any form of compensation or remuneration from Portals.

Portals personally owned an electronics plant in the small Central American nation of Nuevo Tejas (“NT”). Portals had the idea of having 4D make a contract with his NT plant to produce 4D’s latest line of video games. Portals accurately saw a tremendous advantage in this for 4D when compared to production at the Far Eastern plants which had been producing game machines for both 4D and its competitors. First, both labor and transportation costs were significantly lower at Portal’s NT plant than those at Far Eastern plants. Second, thanks to the North American Free Trade Agreement (aka “NAFTA”), games imported from NT were not subject to high tariffs. All this translated into an ability on the part of 4D to sell its games much more cheaply than its competitors could sell theirs. Moreover, the closeness of the NT plants compared to their Far Eastern counterparts allowed games to be brought to market much more quickly.

There was, however, one problem. A rebellion was raging throughout NT. So far the rebels had not attacked foreign owned properties such as Portals’ plant. This, however, might

change. After a series of bloody sweeps by the NT army, the rebels had vowed to extend their attacks to American-owned properties. News of these developments was widely reported in the U.S. news media, but they were far from front page news or lead stories.

The night before a regularly scheduled board meeting Portals supplied each board member with a 150 page report (the “Report”) setting forth the all material facts about the transaction. Among the facts contained in the Report was an up-to-date detailing of the political and military situation in NT including the threats made by the rebels against American-owned properties.

Portals also supplied each board member with a copy of the proposed contract and 5 page “executive summary” of the Report. The executive summary contained no mention of the military or political situation in NT.

At the board meeting (which Portals did not attend and took absolutely no part in) the members discussed the proposed contract for two hours and voted 3-0 to approve the contract between 4D and the Portal owned NT plant. None of the board members at the meeting actually read the report, and the political and military situation in NT was not brought up during the discussion. The three other members merely read the contract and the executive summary and relied on Portals’ “proven” judgment in deciding that it was a good deal for 4D. The three other members of the Board also have admitted that they had neither read nor seen news reports on the political and military situation in NT.

After 4D entered into the contract, the plant began production, but didn’t get very far because it was attacked and destroyed by NT rebels. The consequences for 4D were catastrophic. 4D was forced to find alternative production sources, an endeavor in which it was only partially successful. 4D’s products were (a) introduced late, (b) more expensive than its competitors’ products, and (c) only sporadically available. 4D’s reputation among its customers and suppliers was irreparably damaged. A dissident shareholders revolt has ousted Portals, the directors and the entire 4D management team.

The new board of 4D now wishes to seek redress against the former directors of 4D for their decision to enter into the contract with Portals’ plant. They have caused 4D to bring suit directly against Portals.

Discuss the possible liability of Portals for the contract between 4D and Portals’ NT plant.

WARNING No. 1--Do not discuss the liability of any party other than Portals in your answer to this question.

WARNING No. 2—You are to ASSUME that the jurisdiction has a provision in its corporation code identical to §102(b)(7) of the Delaware Corporation Code (statutory supplement p. 2) and that at all relevant times 4D had a provision in its articles of incorporation insulating its directors from liability to the full extent allowed by that section. You are further to ASSUME that the jurisdiction has no other statutory provision which has any bearing on the answer to this question.

END OF EXAMINATION