

Professor Matthews Exam. Number _____

Fall 1993

CORPORATIONS FINAL EXAMINATION

Instructions:

1. You have 3 hours and 15 minutes to complete this exam. I will collect your answers in the room in which the exam is handed out at 11:45 a.m. Late bluebooks will be appropriately penalized.
2. All answers must be written in bluebooks. Please write on only one side of a page, but you do not need to double space. Please number your answers to correspond to the question and sub-part you are answering, but you need not answer in any particular order.
3. This final is closed book. You are NOT permitted to use any casebook, statutory supplement, or any other materials. Any review materials in your possession should be placed at the front of the room before the exam begins.
4. Assume that Arkansas law applies to the transaction, and that any corporation is governed by the Arkansas Business Corporation Act of 1987 unless otherwise indicated.
5. Please turn in the copy of the test along with your answers, and label both with your exam identification number.
6. If any ambiguity appears in any question, state the ambiguity, make your assumption, and proceed accordingly.
7. This exam consists of the following parts, divided into subparts as indicated. Please budget your time carefully. You should apportion it approximately as follows:

Question Points Time

I 33 60 min.

II 17 30 min.

III 17 30 min.

IV (Short 33 60 min. Answer)

TOTAL 100 180 min.

Question I. (33 Points, 60 Minutes)

Drexel Corporation is a small Arkansas pharmaceutical corporation which currently has a five member board -- composed of Adams, Barnes, Carter, Duncan, and Edwards. (The articles provide for a variable board numbering from 5 to 7 members, and grant the power

to the board to make increases within that range.) A special meeting of the board was called in January of 1993 to consider hiring Zirkoff, Adams' brother-in-law, to fill the office of President for a three-year term. (The office had been recently vacated.) The bylaws state that the "President shall have authority to manage the business affairs of the corporation generally." All board members except Barnes received written notice five days before the meeting. Although Barnes also came to the meeting, he protested the lack of notice as it began.

In regard to the proposal to hire Zirkoff, the board split as follows: Adams, Barnes, and Carter voted for the proposal; Duncan and Edwards voted against it. The motion having passed, the board welcomed Zirkoff into the board room to congratulate him. In the ensuing discussion, the board made clear to Zirkoff its desire to cut back on research and development by Drexel Corporation.

Three months ago, Zirkoff signed a substantial 5 year contract for research and development with Arkansas Laboratories. No formal board approval was sought, although an initial retainer of \$10,000 has been paid by Drexel Corporation.

Last month, shareholder Shannon acquired Drexel shares as a part of an assignment for benefit of creditors by the former shareholder. He claims that Zirkoff is unfit to handle the responsibilities of President, and that the contract with Arkansas Laboratories was grossly unfair to Drexel Corporation. Shannon therefore immediately brought a derivative suit on behalf of Drexel Corporation against its directors, Zirkoff, and Arkansas Laboratories. Shannon seeks to have both Zirkoff's employment contract and the contract with Arkansas Laboratories rescinded. He further seeks damages against the directors for breach of fiduciary duty. The articles, however, provide that "The liability of directors of Drexel Corporation shall be limited to the maximum extent permitted by Arkansas law."

The board responded by creating two additional board positions, and appointing those two new members to a committee to consider the pending litigation. After a lengthy review, the committee has caused the corporation to move to dismiss the litigation on the basis that the internal dissension will hurt public relations and detract from the ability of the corporation to focus on business operations. The new board has further approved advance indemnification for expenses and attorneys' fees for the defendant board members, which Shannon claims is a further breach.

Evaluate Shannon's likelihood of prevailing in the derivative suit against the directors, Zirkoff and Arkansas Laboratories.

Question II.

(17 points, 30 minutes)

Quincy, Reynolds and Stuart currently operate a trucking firm as a general partnership.

Capital contributions were made by the partners in the following percentages: Quincy -- 20%, Reynolds -- 40% and Stuart -- 40%. Quincy has acted as managing partner, however, so the profits have been divided equally among them. They have recently become concerned about the ability of each partner to dissolve at will, and have come to you to obtain advice about incorporating.

The partners want to contribute their partnership interests for shares, and want Quincy to continue to make day to day business decisions. They also wish to continue to distribute profits equally among the three. However, Reynolds and Stuart want their shares to have voting rights consistent with their capital contribution.

Because of their concern about dissolution, the three want dissolution to require the unanimous vote of all three. They further want to require that dividends of at least 10% of after-tax earnings be distributed on a mandatory basis each year.

Furthermore, Quincy has come to you privately and expressed his concern about his potential removal as manager. He wants some assurance that he can continue to make management decisions for the next three years, at least.

The partners further desire that none of the three be able to sell his shares to an outsider without the approval of the other two, which consent could be withheld for any reason. They also would like to require the corporation to buy back shares at death of one of the three, but are concerned that the corporation might not be financially able to do so.

Finally, the partners are concerned about the income tax consequences of operating as a corporation. They have been utilizing partnership losses against their other income, and anticipate that losses will continue for another two years or so. Then they expect big profits.

Advise the partners as to whether they can achieve their goals in the corporate form, and what capital structure and documentation will be required to do so.

Question III.

(17 Points, 30 Minutes)

Certain investors including Martin decided to form a corporation for the purpose of building a small motel. Prior to incorporation, a construction contract was entered into with contractor Neal for a price of \$500,000. The contract provided that \$250,000 was to be paid down, with the balance of \$250,000 due on December 15, 1995. The contract was signed by Martin as follows: "Martin, on behalf of Motel, Inc., a corporation to be formed which will be the obligor of this contract."

The corporation was duly formed, with the articles authorizing 10,000 common shares at a Par Value of \$25. The corporation raised \$200,000 of the down payment for the motel by issuing the 10,000 shares for a consideration of \$20 each. The balance of \$50,000 was

borrowed from shareholder Olson, for which a corporate note was issued. Although the down payment was thereafter paid to Neal by Motel, Inc., the board did not adopt a resolution to approve the contract.

The motel was duly constructed, but things did not go well for Motel, Inc. Additional liabilities were incurred in outfitting the motel so that the value of the corporation's assets at completion exceeded its obligations by only \$5000. In an effort to appease shareholders, however, the board approved a distribution of \$1 per share for the third quarter of 1993, which has been paid.

The board at a recent board meeting has proposed to the shareholders that the motel be sold to Omega, Inc. The consideration to be paid for the motel will be in the form of shares of Omega, Inc. The board of Omega, Inc. will be expanded to include the old Motel, Inc. board. It is anticipated that Motel, Inc. will dissolve at some point in the future and distribute the Omega shares to its shareholders.

Contractor Neal is concerned about the entire proposal and worried about the payment of the remaining balance on his construction contract. He has come to see you. What are his rights and priorities as against (1) Martin; (2) Motel, Inc.; (3) Olson; (4) the remaining shareholders of Motel, Inc.; (5) the directors of Motel, Inc.; and (6) Omega, Inc.? Explain your conclusions.

Question IV. Short Answer

(33 Points, 60 Minutes)

A. In each case, briefly compare and contrast the designated business entities in regard to the indicated characteristic (2 points each):

- 1) Federal income taxation -- limited partnership v. limited liability company.
- 2) Transferrability of interests -- general partnership v. corporation.
- 3) Effect of failure to file formative documents with Secretary of State in Arkansas before commencing operations -- limited partnership v. corporation.
- 4) Fiduciary duties of owners to one another -- corporation v. general partnership.
- 5) Parties against whom creditor may potentially recover when process is served only upon the person designated as "General Manager" of the enterprise -- corporation v. general partnership.

B. Irving holds certain shares in Arco. The directors of Arco have submitted to the shareholders a proposal to merge Arco into Midco, Inc. Under the terms of the merger, Irving's minority shares will be cashed out at a price of \$15 per share. The market price is

currently \$12, but Irving does not want to sell her shares. Rather, she wants to enjoin the merger or at least receive shares in the survivor like the majority shareholder will receive. She further feels that the real value of her shares is closer to \$18 per share, based on earnings and asset values. Finally, she has detected some errors in the proxy solicitation materials which she feels have contributed to the erroneous cashout price. Discuss her options. (6 points)

C. Target, Inc. was to be the subject of a public tender offer. Vice-President Ferguson, concerned that certain activity by persons in the company was violating federal securities law, discussed the matter with his next door neighbor Grigg (who was also his lawyer). Grigg thereafter immediately purchased shares in Target, Inc. and sold them at a profit after the tender offer was announced. Hendrix, a contemporaneous seller when Grigg bought his shares, sues Ferguson and Grigg to recover his losses. Discuss their potential liability. (4 points)

D. Marshall is a shareholder in Chicken Processors, Inc. which is subject to the reporting requirements of the 1934 Securities Exchange Act. He wants the corporation to institute a humanitarian program to provide chicken parts to the children of Serbia, which he thinks will have a lot of public relations value to the corporation. In pursuit of his goal he seeks:

a) access to the bylaws, the accounting records of the corporation, and the record of shareholders.

b) to have the proposal included in the corporation's proxy materials for the annual shareholders' meeting under Rule 14a-8.

Evaluate his likelihood of success. (5 points)

E. Vice-President Baxter was approached about a potential new product while she was attending a neighborhood cocktail party. She prepared a proposal to the board to market the new product, which was rejected. She is considering resigning and forming a corporation to market it on her own. She asks your advice. What do you advise? (4 points)

F. It has been said that staggering is one method of undermining cumulative voting. Explain. (2 points)

G. The Articles of XYZ Corporation divide the shares into two voting groups (divided on the basis on common v. preferred status) in regard to the approval of a new auditor. There are 500 outstanding shares in each class. A quorum of the shares of each class is present at the meeting. The common shares vote 251 for and 249 against the proposal. The preferred vote 201 for, 200 against, and 99 abstaining. Does the proposal pass? Explain. (2 points)