Student BAGS Number _____

Florida State University College of Law
Examination Cover Sheet

Business Associations
Professor Aviram
Spring Semester 2005: May 6, 2005
Number of Pages: 11 (including this page)
Time Allotted: 6 hours (of which up to 1.5 hours are allowed for Part II)

Exam Instructions

General instructions (for both Part I and Part II of the exam):

1. **Permissible material**: This is an open book exam. You may use any materials you want, whether in hardcopy or electronic format. You may not communicate with anyone about the exam until it is over, and you may not access the internet while taking the exam. **These prohibitions apply to both the in-class and take-home segments**.
2. **Anonymity**: The exams are graded anonymously. Do not put your name or anything else that may identify you (except for your BAGS number) on the exam.
3. **"Fact" patterns are fiction**: The "facts" presented in the exam were constructed for an educational purpose, and were not intended to refer to or inform about any real person or event.

Good Luck!

Part I – Essay (80%):

Specific Instructions for Part I (Essay):

1. **Length limit**: The length of your answer to the essay portion of the exam is limited as follows:
    a. If you type the exam on a computer, it should not exceed 1,500 words. If you handwrite your exam, it should not exceed 150 lines.
    b. **For every 10 words (typed exams) / 1 line (handwritten exams) in excess of the length limit (rounded up), one point will be taken off the exam's raw score**.
    c. If you type your exam, please write at the end of it the word count (e.g., "Word Count: 989 words"). If you handwrite your exam, please do a similar line count. The words/line used in reporting the word/line count are not calculated in the word/line count itself. **Failure to do so will result in a reduction of one point from the raw score**.

2. **Legibility**: If you handwrite your exam, please write legibly. I will do my best to read your handwriting, but will have to disregard (and not give you points for) writing that is too small to read or otherwise illegible.

3. **Writing the exam**:
    a. You should give appropriate case and statutory authority for your answers, stating how each cited case/statutory provision relates to your answer.
    b. Length limit permitting, answer all issues that arise from the fact pattern, even if your conclusion on one of the issues is dispositive to other issues.
    c. If you think a question is unclear or cannot be decided without additional facts, state clearly what facts you believe to be necessary to answer the question. Length limit permitting, try to discuss the applicable rule and result for the various possible fact patterns.

4. **Applicable law**:
    a. If a question specifies the applicable law, then assume that the relevant jurisdiction applies that law.
    b. If a fact pattern specifies the applicable law (and the specific question does not specify applicable law), then assume that the relevant jurisdiction applies that law.
    c. If neither the question nor the fact pattern specified the applicable law, then apply the law we addressed in the course. If the issue was addressed differently in different jurisdictions, then state the rule, application and result in each jurisdiction we addressed.

Essay fact pattern:

Movies R Us, Inc. ("MRU") is a corporation, and its common stock is traded on the New York Stock Exchange. MRU is the nation's largest video-rental chain, and offers customers movies for rent in VHS and DVD format. The second and third largest video-rental chains (and MRU's main competitors) are **Flix Corp**. ("Flix"), a statutory close corporation, and **The Film Firm** ("TFF"), a general partnership. MRU has a market share of about 60%, Flix has 15%, TFF has 5%, and numerous smaller rivals have the remaining 20%.

MRU has only one type of stock – common stock. MRU has 100 million shares of common stock outstanding. **Anne**, who founded the company, owns 9 million shares. No other individual shareholder owns more than one million shares, and most shareholders own between a few hundred and a few thousand shares.

MRU was among the pioneers of video rentals, and the company did very well in the 1980s and into the 1990s. A decline in the mid-1990s was reversed when MRU renegotiated its contracts with Hollywood studios to allow MRU to stock more copies of hit movies.

Video rental generates a lot of cash and requires relatively few new investments beyond the cost of opening new branches. Since MRU is almost ubiquitous, it does not need to open many new branches, and therefore has little use for the money it accumulates. In 1998, MRU's board of directors approved a decision to distribute each year as dividends no less than 90% of the annual profits.

Soon after entering the new millennium, the video rental market faced increased competition from cable companies offering video-on-demand, Internet-based mail-order rentals, websites offering (legal or illegal) downloading of movies to one's computer, and large discount retail chains that sold movies at prices that tempted away potential renters. The video retail market, which has been stable and slowly growing for many years, began a slow but steady decline. Market-wide revenue decreased by 17% between 2001-2005, and analysts estimated that the market will continue to decline at a pace of 3% a year for the foreseeable future. MRU's revenue tends to decrease proportionately to the decrease in market-wide revenue.

Flix was in an even more dismal situation than MRU, pressed between a larger rival (MRU) and a shrinking market. **Brad**, who is the CEO of Flix and the owner of 80% of its stock, approached Anne and offered to buy her shares in MRU for $20 a share, representing a 100% premium over the price that MRU stock traded for that day on the stock exchange. Anne, who knew that MRU's declining revenue would soon require the company to reduce its dividends, happily agreed. All of Anne's shares in MRU were sold to Brad.

Brad then called **Carol**, MRU's CEO, and told her that he has become MRU's largest shareholder. He also offered her that MRU and Flix sign a Joint Supply Agreement ("JSA"). Under the terms of the JSA, a new corporation called Cinematic Supply, Inc. ("CSI") will be formed. 60% of CSI will be owned by MRU and 40% by Flix. CSI will acquire all the movies for both MRU and Flix, make copies of the movies, and rent those copies to MRU and Flix at retail price (the price MRU and Flix charge their customers). This means that MRU and Flix would make zero profit in renting the movies, but CSI would make large profits, which it would distribute back to its shareholders – MRU and Flix – as dividends. The proposed JSA required both MRU and Flix to purchase all of its movies through CSI and to rent all movies to customers at the price that CSI charged the companies.

Carol told Brad that she would be amenable to presenting the JSA to MRU's board if MRU's share of CSI were raised to 70%. Brad agreed and said that he would fax Carol the JSA by the end of the next day.

Carol convened a meeting of MRU's board of directors. MRU's board consisted of five directors – Carol, **Dave** (MRU's Chief Financial Officer), **Edna** (Anne's daughter, who is a professor of finance at a prestigious university), and two independent directors (i.e., directors who were not related to the management or shareholders). Carol received the faxed JSA ten minutes before the board meeting. She skimmed the 50-page agreement to get a sense that it followed the lines of the understanding that she and Brad reached over the phone, and then presented it to the board. One of the independent directors was ill, and could not attend the meeting. Carol and the remaining three directors attended.

At the board meeting, she told the other directors of the content of her phone conversation with Brad, and informed them that Brad bought Anne's shares and is now the largest MRU shareholder. She also told them that Brad was the CEO of Flix and owned 80% of its shares. Since Carol received the JSA just before the board meeting, she did not have an opportunity to make copies of it, so the directors passed the faxed JSA between them and each briefly reviewed it. The entire meeting lasted one hour (30 minutes of which were spent on Carol's presentation).

At the end of the meeting, before the board of directors voted on the JSA, Edna informed the board that the agreement under which Anne sold her shares to Brad allowed Brad to rescind the sale within 30 days if MRU declined the JSA. Independent of that, said Edna, she thought that the JSA would be good for MRU and its existing shareholders. The board then voted, unanimously (4-0), to authorize Carol to sign the JSA. Later that day, Carol met with Brad and they signed the JSA on behalf of MRU and Flix, respectively.

When the details of the JSA were made public, several of MRU's shareholders were furious. They claimed that since MRU's market share was four times that of Flix, its share of CSI should also be four times as large (i.e., MRU should own 80% of CSI). At the next MRU shareholder meeting the shareholders voted on a resolution that stated that "MRU should not have entered the JSA and should find a way to rescind it." MRU's management did not object to a shareholder vote on this proposal. To their surprise,

eleven million shares (11%) voted in favor of the resolution while ten million shares (10%; including all of Brad's shares in MRU) voted against it. When MRU's board convened again after the shareholder vote, it voted unanimously (5-0) for a resolution stating that MRU will not seek to rescind the JSA because it is in the best interest of all of MRU's shareholders.

Meanwhile, the U.S. Department of Justice began investigating whether the JSA violated antitrust laws. At the conclusion of the investigation, it pressed criminal charges against MRU and Flix. Both companies entered a plea bargain under which they each paid a fine of $200 million.

Fred, an MRU shareholder, sued the four MRU directors that voted in favor of the JSA (in the first vote) for damages, alleging breach of fiduciary duty in approving the JSA. Fred alleges that the JSA should not have been approved, because it is flawed in two ways: (a) it violates federal antitrust laws, and as a result of this violation the company was fined $200 million; (b) MRU should have insisted on a larger share of CSI – 80% rather than 70%, reflecting the fact that MRU had a market share four times larger than Flix's.

Gloria, another MRU shareholder, sued MRU and its five directors for an injunction ordering them to follow the resolution approved in the shareholder meeting and rescind the JSA.

Both suits were derivative, and the defendants did not challenge that the suits were made properly (in other words, do not discuss in your answer whether the suits should be direct or derivative; also, assume all requirements for filing a derivative suit have been met).

1. Analyze Fred's suit. [65%]

2. Analyze Gloria's suit. [15%]

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Business Associations Final Exam
Part II – Multiple Choice (20%):

Specific Instructions for Part II (Multiple Choice):

1. **Mark the best answer to each question on the bubble sheet**.
2. **Use a pencil to fill the appropriate bubble on the sheet**. Make sure that you completely fill the chosen bubble.
3. **Do not mark more than one answer per question**. Filling more than one bubble for the same question will count as an incorrect answer.
4. **Scoring:** You will receive two points to your raw score for each correct answer and zero points for each incorrect answer.
5. **You must return the questions (i.e., part II of the exam form) together with the bubble sheet**. A student who did not submit the questions at the time the bubble sheet was submitted will be seen as if he/she did not submit the bubble sheet, and will receive zero points for the multiple choice portion of the exam.
6. **Applicable law**:
    a. If a question specifies the applicable law, then assume that the relevant jurisdiction applies that law.
    b. If a fact pattern specifies the applicable law (and the specific question does not specify applicable law), then assume that the relevant jurisdiction applies that law.
    c. If neither the question nor the fact pattern specified the applicable law, then assume that the relevant jurisdiction applies the following laws: Restatement (Second) on Agency, RUPA, the Delaware GCL and all Federal laws.
    d. If (c) should apply but we did not discuss in class the rule according to the jurisdictions mentioned in (c), then apply the law we discussed in class.

[**My policy is to maintain confidentiality of the multiple choice portion of my exams and the answers to them. The multiple choice portion is therefore omitted.**]

Business Associations – Spring 2005
Memo on the Final Exam

Grades:

Raw scores were calculated out of a total of 100 points – 65 for part I (1), 15 for part I (2), and 20 for part II (Multiple Choice). Below are the average, median, lowest and highest grades for the exam and for each question separately:

	Average	Median	Lowest	Highest
Entire Exam	43.44	43	21	78
Part I(1) [65%]	28.35	27	11	55
Part I(2) [15%]	5.16	4	0	15
Part II (Multiple Choice) [20%]	10.06	10	2	16

Grades were given based on the percentile ranking of the exam's total raw score, fitted into the mandatory curve required under the College of Law Bylaws (as explained in the exam preparation class). Therefore, a grade depended not on the absolute raw score of the exam, but on the relative ranking of a given exam's raw score compared to all other exams' raw scores).

Below is an outline of what would constitute an excellent exam. This is only an example, not the example; i.e., some students received credit for very different, but well explained and correct responses.

Part I (Essay)

1. **Fred's Suit [65%]**

The directors may have violated their DoC by insufficiently considering the JSA's potential to violate antitrust laws and the appropriate share of CSI that MRU should receive. Also, Edna may have violated her DoL by voting for the JSA when her mother may be disadvantaged (by Brad's rescinding the stock purchase agreement) if MRU declines the JSA.

(a) DoC:

(i) BJR: BoD's business decision is protected by the BJR. BJR may be rebutted when BoD did not reach a business decision (*Francis*), when the board fails to monitor an issue that is essential to the company (*Caremark*), or when (given a decision's importance) the board spends an insufficient amount of time and effort considering it (*Van Gorkom*).
In this case, the board reached a business decision regarding the JSA, but failed to address the antitrust risk. Unlike the industry-specific law in *Caremark*, antitrust laws are generic and therefore it is possible that compliance with antitrust laws is not so central to MRU's business as to

require compliance monitoring by the BoD. However, in this case BoD did not just avoid monitoring compliance; it actively violated antitrust laws. Further, *Caremark* suggests that the monitoring duty depends on the magnitude of expected harm from lack of compliance – in this case, lack of compliance cost MRU $200M.

If BJR is not rebutted under *Caremark*, it likely is under *Van Gorkom*. While the JSA is not a merger, it shifts a significant amount of MRU's business activity, and possibly all of its profits, into CSI. MRU's share in CSI is equivalent to the merger price in *Van Gorkom*. MRU's directors clearly did not pay enough attention to the agreement by considering the 50-page document for only one hour (and having only one copy of it). On the other hand, MRU's directors are experienced businesspeople (McNeilly's dissent in *Van Gorkom*).

Three of the directors may claim to rely on Carol's assessment under DGCL §141(e) & MBCA §8.30(e), but this will likely not immunize them from liability. Carol merely conveyed her communications with Brad. She is not an expert in legal issues or in company valuation, and did not have sufficient time to study the JSA herself. Thus, they cannot reasonably rely on her assessment. Unlike *Van Gorkom*, however, Carol is not retiring so this is not an endgame situation. Edna may have the expertise to be an expert in company valuation, but since she learned of the JSA in the same meeting she voiced her opinion, the opinion is likely not a report, nor is relying on it 'reasonable'.

(ii) Standard of care: If BJR is rebutted, DoC is breached if the directors were less attentive in reaching the faulty business decision than "a person in a like position would reasonably believe appropriate under similar circumstances" (MBCA §8.30(b)). The standard for breach is "gross negligence" (*Van Gorkom*). This seems to be the case here – the JSA was a crucial event for MRU, but directors only spent one hour considering it (of which only 30 minutes were available for all of them to read the same single copy of the JSA) and did not consult other experts.

(iii) Ratification: BoD vote cannot be considered ratification, because all directors have breached their DoC. Shareholders did not ratify. Therefore, Fred should succeed in this prong of his suit.

(b) DoL:

(i) BJR: BJR is rebutted in cases of fraud, illegality or conflict of interest. Since the JSA was found to violate antitrust laws, BJR may be rebutted due to illegality. Also, Edna has a CoI because the share sale contract her mother entered can be rescinded if MRU declines the JSA (similar to *Bayer* – there vote affected CEO/director's wife).

(ii) Even if BJR is rebutted, DoC is breached only when the transaction is unfair (*Bayer*, DGCL §144(a)(3), MBCA §8.61(b)(3)). In this case, the transaction seems unfair to MRU: there is a significant antitrust risk to the company, and market share proportions suggest that CSI should be owned 80%/20%, not 70%/30%.

(iii) Ratification: Shareholders did not ratify. Did BoD votes ratify Edna's breach of DoL? Under DGCL §144(a)(1) & MBCA §8.62(a), a majority of disinterested directors may ratify after full disclosure of the CoI. In this case, there are four disinterested directors (all but Edna), so a majority means three disinterested directors. A quorum is required – majority of disinterested directors (MBCA §8.62(c)) or a majority of all directors (DGCL §141(b)). Edna's vote does not invalidate the ratification (DGCL §144(a)/MBCA §8.62(c)). In this case, three disinterested directors voted in favor, after Edna fully disclosed her CoI, so the ratification is valid. *Cinerama v. Technicolor* suggests that even without ratification, liability is not possible when the interested director did not control a majority of directors, but *Bayer* suggests that absent fairness or ratification, liability in this situation is still possible.

(iv) Under MBCA, ratification fully cures breach of DoL. Under Delaware law (*Wheelabrator*), ratification of breach of DoL does not fully cure the breach, but shifts BoP to plaintiff. Court may still consider whether an interested director transaction amounted to corporate waste. As evidenced by *Brehm* and *Kamin*, even stupid decisions leading to significant losses are usually not considered corporate waste. A 14% difference in valuation (80% vs. 70%) will likely not be considered corporate waste. The antitrust risk is a more difficult case, and the court could go either way on this.

(v) Conclusion: DoL was breached by Edna, but ratified by the BoD. A Delaware court might nonetheless find Edna liable if JSA amounted to corporate waste.

2. **Gloria's Suit [15%]**

DGCL §141(a) and MBCA §8.01(b) vest all of a corporation's powers in the board of directors, unless otherwise stated in the law or in the articles of incorporation (and, under the MBCA, in a valid shareholder agreement). We have no information that MRU's article of incorporation opted out of this default rule, nor do we know of a shareholder agreement addressing the board's powers.

There is also no requirement in either law for a shareholder vote on the approval of alliance agreements. DGCL §251(c) and MBCA §11.04(b) require a shareholder vote for a merger, but the JSA is likely not to be considered a de facto merger because it combines only the movie acquisition activities of MRU and Flix, but not their retail renting activities.

Since the board has the authority to enter alliance agreements and the shareholders do not, their vote against the JSA is irrelevant. Directors may want to comply with the shareholders' vote for public relations reasons or to avoid being replaced in the next

shareholder election of directors, but they are not obligated to comply with the shareholder vote on this matter. In ignoring the shareholder resolution, the BoD did not trigger the *Blasius* test, because unlike in *Peerless*, they did not interfere with the "shareholder franchise" (since shareholders had no right to decide this issue).

The shareholder resolution itself is flawed – only 21% of shareholders voted, which is below the default requirement of "a majority of the votes entitled to be cast" (MBCA §7.25(a) & DGCL §216(1). DGCL §216 specifically prohibits a quorum requirement of less than one-third.

Note that there was no need to discuss the BJR, because Gloria did not challenge the merits of the BoD decision (as Fred did), but rather petitioned to force the BoD to follow the shareholder resolution (regardless of whether the BoD's decision was defensible).