

## **NOTE TO UC CORPORATIONS I LAW STUDENTS:**

Set forth below are two essay questions from past Corporations I examinations. I am providing them as illustrations of the kind of essay questions I have written in the past. While the coverage in the previous courses is roughly comparable to what we have covered this fall, the coverage was not identical and there may have been differences in emphasis in past courses. In addition, I reserve the right to change the structure of the questions in any way.

In each previous exam, there was a mixture of essay questions and short-answer (usually multiple-choice) questions. I expect to follow the same format this year, although I have not yet decided on the exact breakdown between the two types of questions.

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### **QUESTION ONE (2 hours)**

**THE CORPORATION:** Gooley Glazed Donuts, Inc. (Donuts) is a Delaware corporation whose stock is traded on the New York Stock Exchange. Its certificate of incorporation contains no provisions other than those required by Del. §102(a).

Donuts owns and operates (both directly and through franchises) a chain of donut shops across the country, using its original recipe for glazed donuts and its distinctive "Famously Fresh" neon signs to attract customers. Donuts was founded by Emmy Lou Rice, now retired but still a member of the board of directors. Both her children are officers and members of the board of directors: Donald Rice is currently the President/CEO and chairman of the board of directors, and Angela Rice is currently the Executive Vice President. The Rice family collectively owns about 30% of the common stock; no other stockholder or stockholder group owns more than this. Until the events described below, investors considered Donuts a "hot stock" and thought the company was well-managed, largely because the corporation always met its earnings projections.

**THE BOARD OF DIRECTORS:** The board of directors throughout the relevant period consists of seven people. Besides the three Rice directors, they are:

Former U.S. Senator Samson Steele, who devotes most of his time since retirement to serving as a director on the boards of twelve publicly traded corporations. The Rice family was a major donor in Steele's last unsuccessful reelection campaign.

Mark Merchant, a consultant with McKinsey, a large management consulting firm. Last year Donuts paid McKinsey a \$50,000 fee for services rendered.

Paul Preston, the CEO of another publicly traded corporation on whose board Donald Rice sits.

Robert Jackson, the dean of Stamford Business School. A few years ago, Donuts made a charitable contribution of \$ 5 million to Stamford toward the construction of a new health club facility for its M.B.A. students.

According to Donuts' most recent proxy statement, each non-employee director receives \$50,000 a year in directors' fees, plus stock options (the amount depending on the number of years of service on the board). All of the non-employee directors were initially nominated to the board by the Rice family.

**THE EVENTS** (in chronological order):

In early 2004 Donald and Angela Rice realized that the corporation had opened too many donut shops and the market had become over-saturated. Donuts had opened so many stores they were competing with each other for business, as well as with other donut stores, bakeries, coffee shops, delis, etc. The situation was so serious that many of its franchisees were having difficulty meeting their payment obligations to Donuts, both for funds advanced to open the stores and the normal franchise fees. Angela Rice, who had recently been visiting college campuses with her high-school son and observed that college students ate lots of cereal at all hours of the day and night, thought that the corporation should open up a chain of cereal shops that would cater to the college crowd. In this way, the corporation could maintain its growth.

Donald Rice then called a special meeting of the board of directors without telling them the agenda for the meeting. At the meeting, which all the directors attended, Angela Rice orally described the proposal to open a chain of cereal shops, describing it as a "sure-fire" way to revive the corporation's profitability. Jerry Barnes, a marketing expert retained by Donald, was present at the meeting and was more cautious in his assessment, recommending further studies of the costs involved. One director, Mark Merchant, expressed great skepticism: "how much cereal can kids eat, after all?" he asked. He urged that the board retain the services of his employer, McKinsey, to conduct further studies. Angela and Donald insisted that the corporation had to act quickly in light of declining profitability. The other board members expressed surprise, since this was the first they had heard about the decline, but did not discuss it further. Six of the seven directors (Merchant opposing) voted in favor of the proposal.

The corporation then issued a press release, in which Donald Rice stated that the company would experience a slow-down in its growth and earnings because of the popularity in the U.S. of low-carb diets, resulting in many Americans cutting back on their consumption of donuts. "The Atkins diet is killing us," he stated. But he also had encouraging news, stating that the company was opening a chain of cereal shops ("Seriously Cereal") near college campuses because of college students' craze for eating cereal at all hours of the day and night. "This is the 'next big thing,'" he stated.

A few weeks later, the corporation issued another press release announcing that James Brown, Donuts's Vice President for Finance, had admitted to federal investigators that for over two years Donuts's internal accountants excluded from the company's

financial statements about \$2 billion of its bank debt, thus overstating the net worth of the company. The accounting staff also overstated the company's revenues and understated its liabilities. Donald Rice stated: "We regret that Brown's malfeasance has sullied the corporation's fine name. We have fired him and believe this sad chapter is closed."

Although the board of directors regularly spent a portion of one board meeting a year reviewing the company's financial statements and meeting with the outside accountants, Awesome Accounting, none of the directors knew anything about the accounting irregularities. One of the directors -- Robert Jackson, the dean of Stamford Business School -- publicly stated: "The board did its job. This is the fault of Brown and Awesome Accounting. They did not fulfill their duty to us. We do not manage the company, and we are not detectives."

After his firing, Brown wrote to the board of directors and told them that he had instructed the accounting department to "fudge the books" because of pressure from Donald Rice to meet the company's earnings projections. He also told them that Donald and Angela had used approximately \$12 million of corporate funds to purchase vacation properties in Colorado and Mexico and New York City apartments for their own use and to pay off Rice family debts.

At a special board meeting (at which the three Rice directors were absent), the board considered Brown's allegations and determined that they were true. It decided that although these revelations were troubling, Donuts needed the management talent and expertise of Donald and Angela at a time when Donuts was opening the chain of cereal shops. Accordingly, the board instructed the company's attorneys to draw up the paperwork to treat these transactions as interest-free loans from the company to the Rices and to negotiate with the Rices to arrange for a repayment schedule. It also instructed the accountants to implement internal controls to prevent any of this from ever happening again. The board also agreed to pay Brown a \$10 million severance package that contained a confidentiality agreement. None of these transactions was publicly disclosed.

By late 2004 it became clear to the board that the "Seriously Cereal" shops were not catching on with the college crowd, and the board decided to close all of them, at a substantial loss to the corporation. Merchant complained to his fellow directors: "I knew this was a disaster, and I wish we'd quantified the loss in the first place."

Before the public announcement of this decision, Donald suggested that his daughter, Judy, a high school French teacher, sell her Donuts stock, which she did through her broker. Her broker also sold his own Donuts stock.

A. Your client is Rebecca West, a law school classmate who is the in-house counsel for a foundation that owns stock in a number of corporations. It purchased Donuts stock about three years ago and has held it continuously ever since. West asks you to prepare a succinct memo, citing relevant authority, discussing the important issues relating to the advisability of bringing a shareholders' derivative suit in the Delaware Court of

Chancery. (She is not interested in bringing claims against the now bankrupt Awesome Accounting, so do not waste time on these.) Specifically, she tells you that the Foundation does not want to make a demand on the board, and she wants to know whether Donuts could make a motion to dismiss for failure to make a demand or what other responses by Donuts could be anticipated. No matter how you answer that question, she also wants your opinion as to the merits of any claim or claims.

B. West also tells you that the Foundation considered selling its Donuts stock in early 2004, but decided not to after reading the first press release. She asks you to advise her briefly whether the Foundation could bring a claim for misleading disclosure under either federal or state law.

C. Assume now that you are an SEC attorney, and your supervisor asks you to prepare a succinct memo, citing relevant authority, discussing possible federal securities law violations presented by this fact pattern. (Again, do not consider claims against Awesome Accounting.)

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### **QUESTION ONE ( 2 hours)**

Smart-Mart, Inc. is a Delaware corporation whose stock is traded on the New York Stock Exchange. Smart-Mart owns and operates almost 3,000 discount stores in the United States. Smart-Mart was founded by Martha Martin, 60 years old, who has always been its President and CEO, as well as chairman of the board of directors. Martha is also the principal spokesperson for Smart-Mart and is featured in almost all of its advertising, both print and television. Martha is the corporation's largest shareholder, owning about 20% of the stock.

The corporation and its stock have a record of solid performance on Wall St., with a reputation for focusing on keeping costs down. Analysts, however, have expressed concern because the corporation's public image is identified so closely with Martha. In addition, concern has been expressed because the corporation has not identified and trained any possible successor for Martha and in fact has made no plans for an orderly transition in the event that Martha should leave the corporation for any reason.

Recently, newspapers reported that federal officials rounded up more than 300 illegal workers at about 60 Smart-Mart stores located in 21 states, just as the workers finished cleaning the floors at the end of the night shift. The roundup was part of the government's crackdown on businesses that use undocumented workers. The workers were employed by independent contractors that Smart-Mart contracts for janitorial services. The workers typically worked 7 days a week, at least 56 hours per week, for below-minimum wages, and with no benefits. Government officials also raided Smart-Mart's national headquarters and took documents from the office of the Human

Resources vice president. A few days later, Smart-Mart announced that it was the target of a federal grand jury investigation into the hiring of illegal workers. The press also reported that a class action on behalf of the undocumented workers was filed against Smart-Mart, accusing it of failing to pay overtime, withhold taxes, and make workmen's compensation contributions. The lawyer representing the workers told reporters: "We're looking at this as a slavery case for the 21<sup>st</sup> century."

In response, Smart-Mart issued a statement stating: "We are cooperating fully with the government's investigation and as far as we know no Smart-Mart employee had any knowledge of the illegal workers or any alleged labor violations." While the price of the stock had fallen after the bad news broke, it remained steady after the company's statement.

Martha has also suffered from recent bad publicity. One of her best friends, Elias Henderson, is the CEO of Pillpushers, Inc., a pharmaceutical manufacturer whose stock is also traded on the NYSE. Henderson recently pled guilty to federal charges of insider trading and admitted that he sold large amounts of his Pillpushers stock just before the public announcement that the Food and Drug Administration denied approval of a diet pill that the corporation had spent many millions in developing and testing and which it had hyped to the press as a "revolutionary breakthrough." Martha and Henderson use the same stockbroker, Russell Jones. Although Henderson did not tell Jones why he was selling the stock, Jones figured that Pillpushers must be about to release bad news and called Martha to tell her about Henderson's sales. Martha told Jones to sell her Pillpushers stock as well, and Jones did so. As a result, the Dept. of Justice indicted Martha and Jones for insider trading, and the price of Smart Mart stock dropped drastically. Martha made numerous appearances on television, stating "I want Smart-Mart shareholders to know that I have done nothing wrong -- I would never do anything to destroy the good name and reputation of Smart-Mart." In addition, she made up a story that Jones sold her Pillpushers stock because of a prior agreement between them to liquidate her non-Smart Mart stock holdings. After Martha's public appearances, the price of Smart Mart stock went back up.

The Smart-Mart board also recently approved a series of transactions between Smart-Mart and a "special purpose entity" (SPE) owned by Sam Malone, Smart-Mart's Executive Vice President. The board thought that the purpose of the transactions was for Smart-Mart to sell certain underperforming assets to the SPE so that Smart-Mart would not have to carry the assets on its financial statements. The board did not know that Smart-Mart would also be buying other assets from the SPE at prices favorable to the SPE. The board thought it was best for the corporation to enter into these transactions with someone like Malone who would look out for Smart-Mart's interests. At the board meeting where the transactions were approved, an opinion from the company's accountants, Admiral Accountants, about the tax and accounting aspects of the transactions was distributed to the directors, but not discussed. Malone made over \$5 million from these transactions.

The following facts are also true:

1. Federal authorities have conducted two previous investigations into two contractors using undocumented workers to clean Smart-Mart stores. These investigations, in 1998 and 2001, led to 13 felony indictments and \$5 million in fines against the two contractors. No action was brought against Smart-Mart as a result of those investigations.
2. Employers who knowingly hire illegal immigrants face stiff penalties. Contractors are liable for ensuring that their workers are legally allowed to work in this country. If Smart-Mart knowingly chose contractors using undocumented workers, it could face civil penalties of \$250 to \$2000 per violation. If it were found to have a practice of violating the law, it could face criminal charges and fines of up to \$10,000 for each illegal worker.
3. Prior to founding Smart-Mart, Martha was a stockbroker for many years. She also was on the Board of Directors of the New York Stock Exchange.
4. The Smart-Mart board of directors throughout the period consists of six people. Besides Martha, they are:

Sam Malone, Executive Vice President of Smart-Mart. He has worked for the corporation since graduating from college and has been on the board of directors for the last five years. The Human Resources vice president reports to him. His annual salary, plus benefits, is \$500,000, and he has stock options for 3 million shares, the profitability of which depends on the Smart-Mart stock price.

Former U.S. Senator Samson Steele, who devotes most of his time since retirement to serving as a director on the boards of twelve publicly traded corporations. Martha was a major donor in Steele's last unsuccessful reelection campaign.

Mark Merchant, a financial consultant at Merrill Lynch & Co., the largest securities firm in the world. Last year Smart-Mart paid Merrill Lynch a \$50,000 consulting fee for services it rendered to the corporation.

Paul Preston, the CEO of another publicly traded corporation on whose board Martha sits.

Robert Jackson, the dean of Stamford Business School. Martha's adult children attended Stamford, and, a few years ago, Martha made a charitable contribution of \$1 million to the school to endow a chair for a Professor of Business Ethics.

According to the corporation's most recent proxy statement, each non-employee director receives \$50,000 a year in directors' fees, plus stock options (the amount depending on the number of years of service on the board). All of the directors were initially nominated to the board by Martha.

5. Smart-Mart's certificate of incorporation contains no provisions other than those required by Del. § 102(a).

Your client is Alicia West, general counsel for a church-based foundation that owns 2% of Smart-Mart stock.

A. West asks you to prepare a memorandum discussing the important issues relating to the advisability of bringing a shareholders' derivative suit in the Delaware Court of Chancery against Smart-Mart, Martha, Sam Malone and the board of directors. She tells you that the Foundation does not want to make a demand on the board, and she wants to know whether Smart-Mart could make a motion to dismiss for failure to make a demand or what other responses by Smart-Mart can be anticipated. No matter how you answer that question, she also wants your opinion as to the merits of any claim or claims.

B. West also asks you to prepare a separate memorandum discussing the important issues relating to the advisability of bringing a federal securities fraud class action against Smart-Mart, Martha and the board of directors.

C. West also asks you whether the Foundation could include the following resolution in Smart-Mart's next proxy statement for the annual meeting of shareholders. (You can assume that the Foundation will meet all procedural and timing requirements.)

"RESOLVED, it is a disgrace that the nation's largest retailer exploits the labor of the most vulnerable members of the work force, and the corporation should appoint a special committee of immigration experts to propose and lobby for changes in immigration and labor laws and to provide restitution for the victims of these practices."

D. What is the likelihood that the Dept. of Justice will be successful in its criminal insider trading action against Martha and Jones? Discuss the important legal issues in that case.