## BUSINESS ORGANIZATIONS SPRING 1995 FINAL EXAM (Professor Hamermesh)

## **INSTRUCTIONS**

- 1. <u>IMPORTANT!</u> The exam consists of questions which vary in complexity. In each of your answers, however, identify any statutes that are controlling, and explain the effect of the statute upon your analysis of the question posed.
- 2. Above all, answer the questions posed. Time and words spent answering questions not posed do not receive grading credit; to the contrary, they detract from your opportunity to demonstrate your ability to answer the questions that are posed.
- 3. Do not assume facts not specified in the question. If you conclude that the question cannot be answered without knowing additional facts, however, note and explain that conclusion as part of your answer.
- 5. Since professors are only human (more or less), legible writing and clear sentences will make your depth of knowledge and analytical ability easier to perceive.

1. Todd Martinez and Linda Cerullo are graphic arts students in Long Beach, California in 1989. Playfully sketching fantasy scenes in the cafeteria one day, they notice a cluster of children admiring their work, and explain that they are developing a game in which fantasy creatures do battle with each other. The children are fascinated.

Entrepreneurial instinct takes over: Martinez and Cerullo copyright their creatures and the game rules they concoct, and begin marketing it under the name "Creed of the Sorcerer," or "Creed," for short. They find they need some money to produce the game in quantity, and they persuade Martinez' uncle (Nick Rodriguez) and Cerullo's older sister (Agnes DiBlasi) each to invest \$5,000, on the understanding that all profits from the business will be shared equally among the four participants. (At no point is any formal agreement among the participants prepared.)

By mid-1990, the game is a big hit in the Long Beach area, and Rodriguez suggests that an effort be made to expand the business into new geographic areas. The other participants concur, so Rodriguez gets in touch with two of his friends (one in Anaheim and the other in San Diego) and persuades them to develop and market Creed in their home towns based on a \$5,000 cash investment from each. They, too, are quite successful, and by June 1991, Martinez and Cerullo are delighted that their one-sixth shares of profit (profit now being divided among all six participants) are sufficient to pay for their entire tuition.

Rodriguez is delighted, too, and begins to take an even more active role in

the business. He pursues contacts in San Francisco, San Jose and Phoenix and establishes relationships with those contacts essentially identical to those established in Anaheim and San Diego. The San Jose contact, however, turns out to be a problem. She is fined \$60,000 by the San Jose Consumer Affairs Commission for improper practices in promoting the game among school children; she only has \$20,000, and the Commission seeks the balance from Martinez and Cerullo, even though they had no knowledge of the practices in question.

- a. Is the Commission entitled to recover from Martinez and Cerullo, and, if so, on what legal theory?
- b. If the Commission recovers the balance from Martinez and Cerullo, what rights, if any, do those two individuals have against Rodriguez?
- 2. After the San Jose incident comes to light -- within weeks after Rodriguez establishes the relationships with the Phoenix and San Francisco contacts -- Martinez and Cerullo announce to all of their business colleagues that their association with the business is over, and that they will be setting up their own corporation in order to continue the business. Having only recently been persuaded by Rodriguez to invest \$5,000 in the San Francisco business area, Ellen Peterson is quite upset at this news, and has no desire whatsoever to do any further business with Rodriguez. What are her rights under applicable business organization law?
- 3. By early 1992, the former business associates have settled their differences: Martinez, Cerullo, Rodriguez and DiBlasi have established MACE

Creed, Inc. ("MCI"), a California corporation, as the vehicle to pursue the marketing of the Creed game. MCI has 1,000 shares of authorized common stock, of which 500 shares are issued and outstanding. Martinez and Cerullo each own 75 shares, and Rodriguez and DiBlasi each own 155 shares; they have entered into a stockholders' agreement providing that upon the death of any party to the agreement, MCI will have the option to acquire the deceased party's stock at a formula-based price. The former business contacts in Anaheim, San Diego, Phoenix and San Francisco have also become stockholders of MCI, each owning 10 shares.

The balance sheet for MCI as of December 31, 1992 shows the following:

s	Liabilities	
\$122,000	Accounts payable Debt under line of	\$21,000
\$ 17,000	credit	\$43,000
\$ 32,000	Total liabilities	\$64,000
\$171,000	Stockholders' Equity Stated capital (500 shares, \$.10 per	0
	share)	\$ 50
	Capital surplus	\$ 29,950
	Earned surplus	\$ 77,000
	\$ 17,000	\$122,000 Accounts payable Debt under line of credit 32,000 Total liabilities  \$171,000 Stockholders' Equity Stated capital (500 shares, \$.10 per share) Capital surplus

- a. Assuming that this balance sheet fairly reflects the values of the assets and liabilities of MCI, how much may the board of directors declare as a cash dividend on the stock of MCI?
  - b. With the same assumption, and further assuming (solely for purposes

Assume that California has adopted the Revised Model Business Corporation Act verbatim.

of this subquestion) that MCI is incorporated in Delaware, and its stock has a par value of \$0.10 per share, how much could the board of directors declare as a cash dividend?

- 4. 1993 is an eventful year: Martinez and Cerullo exchange wedding vows in February. On May 16, 1993, however, the parties are saddened to learn that DiBlasi, Cerullo's sister, has passed away. After the funeral, on May 22, 1993, Martinez convenes a special meeting of the MCI board of directors -- then consisting of Martinez, Cerullo and Rodriguez -- on 24 hours' notice (the bylaws of MCI require 2 business days' advance notice). Rodriguez participates by telephone. What he hears disturbs him considerably: over his vocal objection (he says nothing else during the entire meeting), Martinez and Cerullo resolve not to exercise MCI's option to acquire DiBlasi's stock; they express the view that MCI needs the funds for expansion. They explain further that DiBlasi's estate is happy because Martinez and Cerullo have agreed to buy the DiBlasi shares from the estate on an installment basis at a price substantially above the buyout formula price.
- a. What steps would applicable corporation law require Rodriguez to take in order to bring suit against Martinez and Cerullo on account of their purchase of the DiBlasi stock?
- b. If MCI were a Delaware corporation, would those required steps be any different? If so, what would they be?
  - c. Should the resolution that MCI not purchase the DiBlasi stock be

invalidated for failure to afford the directors the advance notice prescribed in MCI's bylaws? If so, why? If not, why not?

- d. On what other basis, if any, might Rodriguez challenge the decision by Martinez and Cerullo not to exercise MCl's buyout option? Explain in detail the arguments in support of such a challenge, and what remedy or remedies would be appropriate if that challenge were successful.
- e. Martinez and Cerullo spend about \$70,000 in defending the litigation brought by Rodriguez.
- i. After the litigation is settled, can MCI reimburse them for those defense costs?
- ii. Assuming that such reimbursement is permissible at all, who should decide on behalf of MCI whether to reimburse Martinez and Cerullo?
- 5. Despite the litigation controversy, 1993 turns out to be a year of great financial success for Creed and MCI. Recognizing the need for professional management and financial backing for a national marketing effort, the MCI directors determine to (i) bring in new financial and marketing managers; (ii) issue stock in a public offering; and (iii) apply part of the proceeds to buy back most of Rodriguez' stock of MCI. In order to facilitate these transactions, the directors and stockholders of MCI want to turn MCI into a Delaware corporation, also named MACE Creed, Inc., having 1,000,000 authorized shares of common stock of a par value of \$.01 per share, and having Martinez, Cerullo and three outside independent directors constituted as the board of directors. Suggest how this

transformation can be most efficiently accomplished under applicable corporation law.

6. In May 1994, just following the transaction(s) you have just described, Martinez and Cerullo each own 100,000 shares of common stock of MCI; Rodriguez and the four other pre-incorporation participants each own 10,000 shares. The public offering is then concluded, and 300,000 shares are issued to the public, at \$15 per share, in full compliance with the federal securities laws.

By the end of 1994 Creed is a preoccupation among all normal American children between the ages of 8 and 13. Martinez and Cerullo have succeeded beyond their wildest dreams; they sense, however, that the time has come for the business to be sold to a big, diversified company. With MCI's common stock trading at about \$17 per share on the NASDAQ (National Association of Securities Dealers, Inc. Automated Quotation system), the MCI board of directors unanimously approves an agreement with Toys R Us (a Delaware corporation) which provides for a merger between MCI and Creed Sub, Inc., a Delaware corporation which is a wholly owned subsidiary of Toys R Us, in which the shares of MCI would be converted into the right to receive \$21 per share in cash. Which stockholders, if any, will have appraisal rights in connection with the proposed merger, and why?

7. The meeting of MCI stockholders to vote on the proposed Toys R Us acquisition is scheduled for March 25, 1995. Martinez and Cerullo execute proxies, dated March 16, 1995, appointing the secretary of MCI to vote their

shares in favor of the merger, and they then depart to Cabo San Lucas for a long-overdue honeymoon. No such luck: they are greeted upon arrival by an urgent message from Elmer Johnston, the vice president for development of Mattel, Inc., another Delaware corporation. Johnston informs them that if the Toys R Us merger is not approved by the MCI stockholders, Mattel would be prepared to acquire MCI in exchange for Mattel stock worth \$20 per share (based on the current trading price of Mattel stock on the New York Stock Exchange). While the nominal price is less than the pending Toys R Us deal, the tax savings for Martinez and Cerullo in a stock for stock deal like the Mattel proposal would be enormous. (Such savings are relatively insignificant, however, for the stockholders who bought the stock at \$15 per share in the initial public offering or in the market thereafter).

With the stockholder meeting imminent, Martinez and Cerullo quickly fax a letter to MCI's secretary stating only that they no longer wish to vote for the Toys R Us merger agreement. At the meeting, 260,000 MCI shares (other than the Martinez and Cerullo shares) are present in person or by proxy. If the March 16 proxies from Martinez and Cerullo are included, 445,000 of the 550,000 outstanding shares are voted in favor of the merger. What is the result of the stockholder meeting in respect of the merger proposal?

8. At least in part because Martinez and Cerullo threaten to compete with Toys R Us if it goes forward with acquiring MCI, Toys R Us withdraws its merger proposal. The MCI board of directors then unanimously approves the

Mattel merger proposal; a stockholder meeting to vote on the merger proposal is convened, and the merger is approved. Which stockholders, if any, will have appraisal rights in connection with this merger, and why?

9. As the other directors and stockholders of MCI were informed in connection with the votes on the merger, Mattel's investment banker agreed to pay \$25,000 to one of the MCI outside directors -- a business acquaintance of Elmer Johnston of Mattel -- as a finder's fee if the merger with MCI were completed. On what legal theory could an MCI stockholder who acquired stock in or after the May 1994 public offering challenge the Mattel merger? Set forth and evaluate that theory, including your assessment of the standards under which the court would review the merger.