BUSINESS ORGANIZATIONS SPRING 1996 FINAL EXAM

(Professor Hamermesh)

INSTRUCTIONS

- 1. <u>IMPORTANT!</u> After an exposition of background facts, the exam poses several questions which vary in complexity. In each of your answers, 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, note and explain that conclusion as part of your answer.
- 4. Legible writing and clear sentences will make your depth of knowledge and analytical ability easier to perceive.

MEMORANDUM

TO: Spring 1996 Business Organizations Students (Sections B and W)

FROM: Professor Lawrence Hamermesh

DATE: June 24, 1996

RE: Final Exam Reviews

The materials accompanying this memorandum are intended to facilitate resolution of any questions concerning your exam grade. They include (1) a model summary answer which I prepared and (2) two student exams. If you have requested a review of your exam, the materials also include (3) a copy of your exam and (4) a copy of the grading sheet I completed for your exam.

My expectation and experience suggest that a careful review of these materials will explain the basis for the grade. If you still have any questions about the grading of your exam after you study these materials, however, please leave your name and phone number with my secretary, Maureen McGovern (302-477-2137). I will then be in touch with you to set up a time to discuss the exam with you.

· Background

Elizabeth Street graduated from the Massachusetts Institute of Technology ("MIT") in 1994 with an advanced degree in electrical engineering. Her doctoral thesis explored a novel method of computerized data encryption and transmission. After graduation, she found employment as a software designer with Axxia, Inc. ("Axxia"), a small firm located in downtown Boston. Axxia's principal business has been the design and implementation of database management systems for municipal functions such as trash collection and disposal.

Axxia, a Delaware corporation, was founded in 1990 by three then recent MIT graduates, Steven Schiffman, Paul Barron and Nancy Jessup. Axxia's common stock is now owned of record as follows:

Steven Schiffman	25%	Nancy Jessup	25%
Paul Barron	25%	Others	25%

Immediately after Axxia was organized, and while they were still the only stockholders of Axxia, Schiffman, Barron and Jessup signed an agreement providing, among other things, that they (or others unanimously designated by them) would constitute the Board of Directors of Axxia, and that they would hold offices within Axxia as follows:

Schiffman -- President and Chief Executive Officer

Barron -- Vice President and Chief Financial Officer

Jessup -- Vice President of Operations

They were re-elected to these offices most recently in connection with Axxia's last annual meeting of stockholders on July 15, 1995.

About five months before that meeting, Street described her doctoral thesis to

Barron, who became quite interested and encouraged Street to revisit it and consider its commercial possibilities. With Barron's personal financial support, and with an agreement to split equally any profits on the project, Street developed an encryption software package (named "Bidsecure") permitting secure on-line transmission of contractors' bidding and related financial and other proprietary information. In connection with the further development of the package, Street acknowledged to Barron that she would consult with him about marketing opportunities and would not transfer any rights in the package without Barron's advance consent.

In March 1996, with Barron's concurrence, Street presented to Schiffman a proposal to license the Bidsecure software to Axxia. Under her proposal, Axxia would acquire the exclusive rights to sell Bidsecure in North America, in exchange for an initial fee of \$250,000 and 1.75% of the net revenues from sales during the 10-year term of the license. Schiffman rejected Street's proposal outright, stating his belief that Bidsecure would be obsolete before it could even be brought to market.

Street and Barron, severely disappointed, determined to present the license proposal to Axxia's full board of directors. Street did so at the next regularly scheduled board meeting, on April 12, 1996, at which all three directors were in attendance. Following thorough and sometimes heated discussion, in which Schiffman denounced the proposal as a "white elephant" and a "waste of money," the board voted 2 to 1 (Schiffman dissenting) in favor of entering into the license agreement with Street, which Barron signed on behalf of Axxia. At the time of the board vote, however, neither of the other two directors was aware of Barron's involvement with Bidsecure.

Schiffman did learn of Barron's involvement with Bidsecure a week later in an informal encounter with Street. He thereupon took swift, unilateral action: first, he wrote Barron a letter informing him of his termination as an officer and employee of Axxia; second, he hired counsel to commence an action against Barron and Street seeking a declaration that the Bidsecure license agreement was unenforceable, and seeking recovery of the amount already paid by Axxia under the agreement; and finally, he sent a notice to Axxia's stockholders that a special meeting would be convened two weeks later, on May 3, 1996, to vote to remove Barron as a director of Axxia.

Initially, the vote to remove Barron as a director seemed certain: when Schiffman told Jessup of Barron's role with Bidsecure, she vowed to vote at the May 3 stockholders' meeting for Barron's removal as a director. On April 29, however, Barron persuaded her to enter into the following agreement: in exchange for \$5,000, Jessup gave Barron a one-year option to acquire her stock for a total of \$1,250,000 in cash payable within 90 days after exercise of the option; at the same time, Jessup executed and gave to Barron a one-year proxy to vote her shares, which proxy stated on its face that it was to be irrevocable.

At the May 3 meeting of stockholders, Barron voted his shares against his removal as a director, and attempted to vote Jessup's shares the same way, invoking the proxy he had received from her several days before. Jessup, however, had had a change of heart: offering to return to Barron the \$5,000 he paid for the stock option, she directed that the shares registered in her name be voted in favor of removal. Excluding the Jessup shares, 40% of the outstanding shares voted to remove Barron, 27% voted against removal, and 4% abstained.

The bylaws of Axxia have at all relevant times included the following provisions:

- 1.10. Except as may be required by applicable law, no action required to be taken or which may be taken at any annual or special meeting of stockholders of the corporation may be taken without a meeting, and the power of the stockholders of the corporation to consent in writing, without a meeting, to the taking of any action is specifically denied.
- 4.4. The president shall be the principal executive officer of the corporation and, subject to the control of the board of directors, shall in general supervise and control all of the business and affairs of the corporation.
- 6.1. The corporation shall indemnify and hold harmless, to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended, any person who was or is made or is threatened to be made a party or is otherwise involved in any action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that such person is or was a director or officer of the corporation against all liability and loss suffered and expenses reasonably incurred by such person in connection with such action, suit or proceeding.

Invoking Section 6.1 of Axxia's bylaws, Barron wrote a letter to Axxia in which he (I) demanded that Axxia advance his defense costs in Axxia's suit against him, and (ii) undertook to repay all sums advanced to him by Axxia if it were later determined that he was not entitled to indemnification.

The Axxia litigation quickly took a substantial financial toll on Street, who was terminated as an Axxia employee shortly after the litigation was commenced. To raise money, she managed to interest a group of British investors in the Bidsecure program and induced them to lend her \$500,000 in exchange for (I) a promise, both individually and on behalf of Barron, to repay the loan upon demand, and (ii) the exclusive right to market Bidsecure in the United Kingdom, subject to a percentage license fee. Shortly thereafter, Street informed Barron of this arrangement. Barron, who had been attempting on his own to explore the licensing of Bidsecure in the U.K. and elsewhere in Europe, reacted

dramatically: he told Street that she should consider their association terminated, and he wrote a formal letter to the British investors stating that the agreement they had reached with Street was invalid and unenforceable, and that he would not be responsible for repayment of the \$500,000 they had loaned.

Questions

- 1. Was Barron effectively removed as an officer of Axxia? Set forth and evaluate all of the principal arguments supporting your conclusion. Would you evaluate any of those arguments differently if Axxia were incorporated in a jurisdiction adopting the Model Business Corporation Act? Explain why or why not.
- 2. Was Barron effectively removed as a director of Axxia? Set forth all of the principal arguments supporting your conclusion.
- 3. If Schiffman had come to you for advice about how best to remove Barron as an officer of Axxia, what alternative, potentially more effective procedure would you have suggested? Explain fully.
- 4. If Schiffman had come to you for advice about how best to remove Barron as a director of Axxia, what alternative, potentially more effective procedure would you have suggested? Explain fully.
- 5. Articulate the theory or theories which Axxia's complaint against Barron and Street should advance to challenge the validity of the Bidsecure license agreement.
- 6. Is Axxia obligated to advance to Barron his costs of defending Axxia's suit against him? Would your answer be the same if Axxia were incorporated in a jurisdiction

- adopting the Model Business Corporation Act? Explain your conclusions.

- 7. To what extent, if any, is Barron obligated to contribute to Street's costs of defending Axxia's suit against her? Explain your answer fully.
- 8. Under applicable business organization law, is the promise to repay the \$500,000 loan from the British investor group enforceable against Barron? Explain your answer fully.