EXAM NUMBER ___________

# BUSINESS ASSOCIATIONS FINAL EXAMINATION

Professor Wells Spring 1992

## GENERAL INSTRUCTIONS

This examination comprises 30 short-answer questions, including a mixture of multiple-choice, true-or-false, fill-in-the-blank and brief response questions. You shall have three and one-half hours to complete it. Answer all questions on the examination paper itself. You may use bluebooks for any notes or calculations, but you should not hand them in.

The following general fact pattern is the same as that handed out earlier. Prior to this in-class examination, you should have familiarized yourself with this fact pattern. You were free to speculate about questions that might be asked, to have worked out responses, working alone or in groups as you please, and to consult any references you cared to.

The general fact pattern, like real life, is not free from ambiguity. The examination questions will usually provide additional, clarifying facts. Some of the short-answer questions are grouped under additional facts. Unless otherwise indicated, please assume only the general fact pattern and the specific additional facts to apply to each question. Choose or provide the best response possible. <u>In case of multiple choice questions only, provide some support for your choice--for example, statute(s), case(s), rule(s), logical explanation, etc.--in the space provided after such questions.</u> Be brief and to the point.

Unless otherwise instructed, you should assume that the applicable state law includes the Revised Model Business Corporation Act (RMBCA or Model Act), the Uniform Partnership Act (UPA) and the Revised Uniform Limited Partnership Act (RULPA). Opinions found in your casebook may be persuasive, but they are not controlling. Applicable federal law includes the provisions of the Securities Exchange Act of 1934 and the rules promulgated thereunder, as mentioned in the Hamilton text.

You are taking this final examination under the Mercer Law School Honor Code and under the groundrules described here and in class. That means, of course, that all your work on the in-class portions of this final examination must be your own. You should have with you the Hamilton text and the statutory supplement. You may also use other materials that you have prepared yourself or in conjunction with your classmates or have otherwise made substantially your own. You may not use commercially prepared materials, unless you have so substantially modified and annotated them that they are now principally your own work.

You should have plenty of time to complete this examination, but you will not have time to conduct original research.

Work carefully. Good luck.

## GENERAL FACT PATTERN

In early 1990, Billie Jean King, Ellery Queen and several other investors started a new business selling board games, principally chess sets and chess paraphernalia, such as clocks, analysis sets, books and computer programs. The business had one store, located in Capablanca, Georgia, a suburb of Atlanta. They called their store "The Forking Pawn."

On January 1, 1990, King and Queen incorporated the business in Georgia under the name, "Chessmeisters, Inc." ("CI"). They filed articles that provided only the information required by law. The articles authorized 1000 no-par shares and named King, Queen, Jo E. Bishop and Bob E. Knight as initial directors.

At the organizational meeting, the board authorized the sale of capital shares as follows:

| | |
|---|---|
| Ms. King: | 150 shares |
| Mr. Queen: | 150 shares |
| Ms. Bishop: | 100 shares |
| Mr. Knight: | 100 shares |

From the sale of these shares, CI began with initial capital of some $50,000. They borrowed the remainder of the capital needed to finance the business during its start-up period.

Also at the organizational meeting, the board named King as president and secretary, and Queen as vice-president and treasurer, each at a modest annual salary. Bishop and Knight did not have officer positions, but they were promised, by virtue of a shareholder agreement executed at the organizational meeting, that they would be employed by CI in positions determined by the board, for as long as they held their shares.

Owing to a chess boom comparable to the bowling boom of the 50's and the golf boom of the 80's, CI got off to a good start. Nerds came out of the woodwork to patronize the store. (The Forking Pawn found that it even had to start stocking some non-chess items, such as pocket protectors, to meet demand.) In its first year of business, CI did so well financially that the directors began to consider opening a second store in Macon, the home of some of the best chess players in the country.

SHORT ANSWER QUESTIONS. Unless otherwise indicated, any additional facts given pertain only to the questions specified. Please mark or provide the best answer possible. For multiple choice questions only, provide authority or a brief explanation.

1. Under Georgia law, CI should take care (or should have taken care), prior to commencing business, to comply with other organizational formalities, including at least the following three:

A.

B.

C.

2. In fall 1989, in preparation for opening the store, Ms. King engaged I. M. Pay, a commercial architect and designer, to draw up some plans to remodel a retail space on which she had an option to lease. In January 1990, CI's board rejected the idea of spending money on a professional designer and refused to accept or to pay for the plans. Mr. Pay sued for breach of contract. It is likely that he will prevail against:

_____ A. CI.

_____ B. King, Queen, Bishop and Knight personally.

_____ C. King.

_____ D. King and CI.

_____ E. All of the above.

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3. During fall 1989, Mr. Queen visited chess equipment suppliers to talk with them about the new business's prospective needs. To gain credibility, he handed all of his contacts a business card that said that he was the vice-president and treasurer of CI. While driving a potential supplier to lunch one day, Mr. Queen negligently crashed into a telephone pole, killing the supplier. In the ensuing lawsuit, the supplier's survivors are likely to prevail against:

_____ A. CI.

_____ B. King, Queen, Bishop and Knight personally.

_____ C. Queen.

_____ D. Queen and CI.

_____ E. All of the above.

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4. In December 1990 the CI board decided to do a little year-end planning, with special attention to a prospective $25,000 profit from business in the first year. Please identify three principal options that the board has for the disposition of this sum, and provide one significant consideration that should be taken into account in deciding whether to implement each option:

A. Option:

Consideration:

B. Option:

Consideration:

C. Option:

Consideration:

6. (A) If CI decides to terminate Bishop and Knight's employment, two legal or structural obstacles stand in the way. What are they?

1.

2.

(B) Will Bishop and Knight have any difficulty, under general principles of corporate law, exerting their rights under either of these "obstacles"? Explain.

(C) Would your answer to (B) change if CI were a Georgia Statutory Close Corporation? Explain.

7. At the first election of directors, King and Queen nominate themselves and their close friends Rook and Castle, who own no shares in CI. Bishop and Knight nominate themselves. Assuming rational voting, who will be elected as the next directors of CI? Explain.

8. At the same meeting at which the new directors were elected, Bishop and Knight propose that CI formally implement cumulative voting. Will that proposal be adopted? Why or why not?

9. Assuming for purposes of this question that CI has cumulative voting, which directors are likely to be elected at the next meeting if the same candidates named in Question 7 are nominated? Why?

10. CI and Woodworking, Inc. ("WI") (owned by Castle and Rook), enter into a joint venture to design, manufacture and sell wooden chessboards and chess pieces. CI, acting through King, informs WI that it should use local, inexpensive woods and target a broad market. Rook, acting for WI, thinks more money is to be made by producing expensive boards out of exotic woods, targeted for wealthy or fanatical chess aficionados. Rook orders $10,000 worth of exotic African hardwoods for use in making the boards and pieces.

If CI refuses to pay for the woods and the supplier sues, the supplier is likely to prevail against:

_____ A. Rook personally.

_____ B. WI only.

_____ C. King personally.

_____ D. CI only.

_____ E. King and Rook personally.

_____ F. WI and CI.

_____ G. WI, CI and Rook.

_____ H. WI, CI, Rook and King.

_____ I. None of the above.

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11. (Same facts as Question 10.) Would your answer to Question 10 change if Rook had introduced himself to the supplier as a "partner"? Why or why not?

12. (Same facts as Question 10.) Would your answer to Question 10 change if CI had contributed 51% of the capital of the joint venture? Why or why not?

13. When the CI board issued the original shares, it properly accepted the following forms of "payment" from the purchasers (check all that apply):

____ A. King's collection of antique chess sets.

____ B. Cash from Queen, Bishop and Knight.

____ C. King's promise to pay cash in the future;

____ D. Bishop's promise to perform accounting services in the future;

____ E. Queen's common shares of General Motors.

____ F. King's lease on certain retail property.

____ G. Queen's contracts with suppliers.

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In accepting some or all of these forms of payment, what formalities must the board exercise to insulate their share issuance against later accusation of corporate waste?

14. If CI's board decides to sell additional shares to King, Queen and Bishop, would Knight have a legal right to purchase additional shares also? Why or why not?

15. Assume for the moment that all CI shareholders have a right, under the Model Act, to purchase a proportional number of new shares issued. If CI's board issues new shares to Bishop as payment for a delivery vehicle he owns, would King, Queen and Knight have a right to purchase additional shares also? Why or why not?

Additional Facts Pertinent to Questions 16 and 17:

In January 1991, the CI board voted to open a new retail store in Morphy, Georgia, a suburb of Macon. To finance this store, CI's board did three things. It sold $30,000 of preferred stock (10% dividend) to Queen, Bishop, Rook and Castle; it borrowed $20,000 from Queen; and it sold additional common stock to King.

16. The decision to issue preferred stock was probably not an easy to make because (check all that apply):

_____ A. if CI were an S corporation, it might jeopardize its tax status.

_____ B. if CI were a C corporation, it might jeopardize its tax status.

_____ C. if CI were only marginally profitable, the common shareholders might see little return.

_____ D. it would shift the balance of governance power.

_____ E. it would make CI a Section 12 company.

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17. To effect the sale of the preferred shares, CI must first:

_____ A. eliminate cumulative voting.

_____ B. eliminate preemptive rights.

_____ C. institute a staggered board.

_____ D. amend its articles.

_____ E. None of the above.

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Additional Facts Pertinent to Questions 18 through 20

At the end of 1991, the Company's simplified balance sheet looked as follows:

Chessmeisters, Inc.,
Year ending Dec. 31, 1991

| Assets | | Liabilities | |
|---|---|---|---|
| Cash | $30,000 | Note to Trust Co. | $10,000 |
| Marketable Securities | 200,000 | Accts. Pay. | 5,000 |
| Accts Rec. | 55,000 | Note (to Queen) | 10,000 |
| Inventory | 100,000 | | |
| Store & Equip. | 95,000 | Equity | |
| | | Common Stock (600 sh. no par) | 60,000 |
| Vehicles | 135,000 | Pref. Stock ($100 par) | 30,000 |
| TOTAL | $615,000 | | |
| | | Ret. Earn. | 500,000 |
| | | TOTAL | $615,000 |

18. If at the end of 1991, CI's board determined that CI would pay the $10 preferred dividend and a $800 common dividend, under the Model Act,

_____ A. the common dividend would be illegal.

_____ B. the preferred dividend would be illegal.

_____ C. both dividends would be illegal.

_____ D. neither dividend would be illegal.

_____ E. One would need more information about their upcoming debt payments to know about illegality of the dividends.

19. If it turned out that the board voted unanimously to pay and actually paid excessive dividends to the common shareholders, (choose all that apply)

____ A. Director Knight might have to compensate CI for the total amount of the overpayment from his own pocket.

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____ B. Director Knight would only have to return his pro-rata share of the excessive dividend.

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____ C. The preferred shareholders would have to return their dividends first.

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20. If the dividends described in question 18 are technically legal, could CI pay them? Of so, how?

Additional Facts Pertinent to Questions 21 through 23:

In January 1992, CI expanded its operation dramatically by buying the larger Woodworking, Inc., outright (by issuing new CI shares to WI's 853 shareholders, all Georgians) and by opening several new stores throughout Georgia. After these transactions, CI's net worth rose to $1 million and its assets to over $6 million, but it had a considerable debt load.

21. In preparation for the upcoming annual meeting, CI has canvassed its common shareholders and found that nearly all will be attending. In noticing the meeting,

____ A. CI will not have to conform to Regulation 14A because it does need to solicit proxies.

____ B. CI will have to comply with Regulation 14A.

____ C. CI will not have to comply with Regulation 14A because all of its shareholders reside in a single state.

____ D. CI will not have to comply with Regulation 14A because it is not a Section 14 company.

____ E. None of the above.

22. Because Knight and Bishop have been transferred by CI to the tiny store in Nimzo, Georgia, they intend to unseat directors King and Queen, who ordered their transfer. They decide first to write to all the shareholders to decry the vindictive basis for their transfers to Nimzo. If they do so,

_____ A. they need not worry about the application of Regulation 14A, for the same reason as given in Question 21.

_____ B. they need not worry about the application of Regulation 14A because they are not soliciting a proxy, consent or authorization.

_____ C. they need to worry about Regulation 14A only if they seek assistance from some of the shareholders in obtaining corporate records.

_____ D. None of the above.

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23. The next step in Knight and Bishop's plan is to submit to the CI shareholders a proposal to be included in CI's proxy materials (assuming that CI mails out such materials). Their proposal is that the store in Nimzo be closed because it is unprofitable.

_____ A. The proposal is valid.

_____ B. The proposal is invalid because Knight and Bishop are not individually eligible to submit such proposals.

_____ C. The proposal is invalid because Knight and Bishop together own too high a percentage of CI shares.

_____ D. The proposal is invalid because it pertains to the actions of directors who are up for reelection.

_____ E. The proposal is invalid for other reasons.

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24. If you were advising Knight and Bishop about ways to lessen the power that King and Queen exert in corporate affairs, which of the following approaches would you not recommend? (Choose all that have a reasonable prospect of success)

_____ A. Entering into a voting agreement with several other major shareholders (if such exist).

_____ B. Amending the articles to classify (stagger) the board.

_____ C. Amending the articles to institute strato-cumulative voting.

_____ D. Amending the articles to choose statutory close corporation status (assuming other major shareholders exist).

_____ E. Encouraging the board to adopt a poison pill.

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Additional Facts Pertinent to Questions 25 through 27

Completely disgruntled with CI and its current board (of which they no longer are members), which has left them unemployed but still collecting sizeable dividends as shareholders, Knight and Bishop decide to open up their own business, in direct competition with CI. Knight invests $10,000 and Bishop $5,000 in the new business.

25. (True) (False)

Knight and Bishop are breaching their fiduciary duty to CI by starting a competing business. (Explain)

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26. (True) (False)

Absent another agreement, they will share profits and losses 2:1 in their new business. (Explain)

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27. (True) (False)

If Bishop and Knight approach Queen with the idea of Queen's going in with them to open a new store in the affluent, chess-crazy Macon suburb of Karpov, Queen may make the investment, so long as he uses his own money and informs CI of his plans ahead of time. (Explain)

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28. If King decides to lease her gold and silver chess set to CI for a travelling display it is planning,

_____ A. the contract must be approved by a majority of disinterested directors.

_____ B. the contract must be approved by a majority of disinterested shareholders.

_____ C. the contract must be fair to CI.

_____ D. All of the above.

_____ E. Any of A, B, and C.

_____ F. None of the above, because the contract is de minimus.

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29. If CI acquires 90% of the stock of Gamesellers, Inc. ("GI"), and handpicks a new board of directors for GI,

_____ A. GI's directors will owe their principal duties to those whom they represent, namely CI and its shareholders.

_____ B. GI's directors must take care to meet in the same room or by telephonic hook-up in taking all board actions and decisions.

_____ C. GI's directors have a duty to pay out dividends if GI makes profits.

_____ D. All of the above.

_____ E. None of the above.

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30. (True) (False)

In the CI - GI relationship, CI's board may actually owe a fiduciary duty to <u>GI's</u> shareholders.

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