BACKGROUND FACTS:

Toilette Bowl ("TB"), is the President and Chief Executive Officer of Poo Poo Corp. ("PPC"). PPC was incorporated in Delaware in 1974, and maintains its principal offices in Oakland, California. PPC is a conglomerate which has always been engaged in the business of acquiring, operating, and selling smaller companies. PPC has traditionally targeted for acquisition only companies which are currently financially distressed or unprofitable, but which also have a history of otherwise profitable operation. Once acquired, PPC usually installs its own management team, which overhauls the acquired company. To that end, PPC usually commits a certain amount of money to loan the acquired company for the purpose of investing in needed property, plant and equipment. Usually, this means that the acquired company will have a certain amount of funds available to modernize its equipment and systems of operation. Sometimes, however, the money is also used to pay current liabilities as well.

TB owns 40% of the stock of PPC, the remaining shares are publicly traded. Usually TB oversees all acquisitions; and the final word on whether or not to proceed with an acquisition is always hers alone. TB is aided in acquisitions by her Chief Financial Officer, a C.P.A., Hot Water ("HW"), and the general counsel of PPC, Muddy Puddle ("MP"). To date, PPC has bought about 30 companies, all but 10 of which became profitable within six (6) months of acquisition. Of the other ten (10), 4 became successful after 12 months, 4 were sold (for a loss) within 18 months of acquisition, and two are now the subject of litigation with the former owners.

On January 1, 1993, TB was approached by Ilova Bidet ("IB"), the Chief Executive Officer and controlling shareholder of Armed Forces Poopers, Inc. ("AFPI"). AFPI had been founded in 1934 by Aru A. Bidet ("AB") (an immigrant from France) to manufacture bathroom products for use on aircraft and seagoing vessels. AFPI was incorporated in New York, which, for purposes of this exam, you will assume has adopted the Revised Model Business Corporation Act. AFPI holds over 20 patents on distinctive and unique bathroom products for use on air and sea vessels. Although originally marketed only to the very wealthy in the private sector, during World War II and thereafter, the business was expanded to include bathroom products for use on military aircraft and naval/merchant marine/coast guard vessels. Since 1962, military contracts accounted for 70% of the income of AFPI. IB has been active in the business since its founding, primarily with respect to financial matters, and assumed her current positions in 1992 after her husband died suddenly when he was flushed out of a defective aircraft toilet manufactured by AFPI.
The manufacturing plants of AFPI were originally located on Long Island, New York. However, since 1959, most of the manufacturing has been moved to Los Angeles, California. AFPI continues to own the facilities on Long Island and keeps a small staff to maintain the plant, which is used primarily for special projects. AFPI employs 60 people in California and 25 people in New York. AFPI maintains its headquarters in New York in a small building at the New York manufacturing facility. The manufacture of bathroom products requires the use of petrochemical resins, paints, turpentine and the like. The machinery requires constant maintenance and lubrication. All excess chemicals have traditionally been kept at the facility in barrels behind the building. The company has never had an environmental audit.

For many years, AFPI, whose financial statements are based on an accounting year ending December 31, had been profitable, and held an excellent reputation for product quality and contract performance in both private and public sector work. However, since 1988, the annual profits of AFPI have decreased. For the years ending December 31, 1990, and December 31, 1991, AFPI barely broke even. Because AFPI usually does not prepare its financial statements until May of the year after the close of the year, the financial statements for 1992 were not prepared until May 31, 1993. However, most of the financial information which is used to prepare the financial statements is available within a few weeks after the end of a fiscal year.

During the later part of 1992, IB began to seek a buyer for AFPI. None appeared interested until IB contacted TB. After a preliminary meeting with IB in Oakland, TB visited the Los Angeles facilities on January 14-17, 1993, and the New York facilities on January 17-19, 1993. During that time TB also met AFPI's key personnel. After a series of meetings, TB and IB, on behalf of their respective companies, agreed orally to the key provisions of an agreement pursuant to which PPC would purchase all of the assets and assume all of the liabilities of AFPI and instructed their respective lawyers to negotiate the terms of the agreement. The parties anticipated a March 1, 1993 closing date.

Prior to the closing date, PPC commenced its investigation of the prospective acquisition. This consisted primarily of reviewing the records of AFPI. Additionally, HW and MP spent eight (8) days at the Los Angeles and New York facilities of AFPI where each was given access to all parts of the facilities and to all of the records (including financial information for the 1992 fiscal year) of AFPI. In accordance with the terms of the Purchase Agreement, HW was given financial statements prepared by AFPI personnel. In the Purchase Agreement, IB and AFPI represented that "the financial statements constitute substantially true and correct statements as of the dates thereof of the financial condition of AFPI and of their assets, liabilities and income, prepared in accordance with accounting principles consistently applied."

PPC consummated the purchase of AFPI on March 1, 1993 through its wholly owned subsidiary, AFPI (the subsidiary bought also the right to use the AFPI name, and
old AFPI agreed to change its name or dissolve). By October 1, 1993, PPC had shut down all of the operations of AFPI. As it turned out, AFPI was not merely temporarily unprofitable, it was, for all practical purposes, beyond any help. PPC arrived at its decision on the following basis:

1. Since 1989, the number of military contracts had decreased from 45 to 10, due in some part to the end of the Cold War (see also point 4, below). On April 1, 1993, AFPI received formal notice from the Pentagon that all 10 of the remaining contracts would be suspended pending an investigation of falsification of quality control records and cost overruns. IB had mentioned to TB prior to closing that AFPI has encountered some quality control problems, but noted that "the problems were small, and after a little investigation at relatively small cost, were solved." In actuality, the problems had never been solved. Since 1989, AFPI had experienced increasing quality control problems. In 1991, it hired outside consultants which, after generating fees of $200,000, presented a report indicating that AFPI would have to overhaul its entire manufacturing process to overcome the quality problem. Unwilling to make that kind of investment, AFPI had instead begun to manufacture certain troublesome components through a manufacturer in Thailand. To date, the cost of this alternative has been about $700,000. Neither the Thai manufacturer nor the consultants have been paid by AFPI.

2. In addition, based on the allegations of a former employee, the military was commencing an investigation of cost padding on all contracts commenced or completed since 1985. The military investigators have suggested that the Pentagon might seek at least $4,000,000 in overpayments, plus civil penalties. In addition, the Pentagon is considering eliminating the Company from the list of eligible private contractors. While HW was given the military contracts to review, PPC relied on the word of AFPI management that things were "going as well as could be expected."

3. Although the Purchase Agreement gave PPC the right to terminate all employees of AFPI, only about 40 of the employees had been terminated. Unfortunately, labor-management relations between the old management of AFPI and its employees had deteriorated badly since the death of AB. As it turned out, the termination of the 40 employees appeared to be the last straw. The remaining employees, on August 1, 1993, voted overwhelmingly to join the Teamsters Union. On September 1, 1993, after unsuccessful negotiations, the Union went on strike. In addition, a number of terminated employees have filed actions for age discrimination, race discrimination, religious discrimination and sexual harassment. A number of these lawsuits arose after AFPI management dismissed their complaints as insubstantial. PPC knew, at the time of the purchase of AFPI, that it was AFPI policy to resist all discrimination claims. In addition, while it had been rumored that neither IB nor AB liked people other than French folk, no one from PPC took this seriously.

4. On May 1, 1993, AFPI sold the facilities in Long Island, New York, to
Suffolk County, Long Island, for the purpose of building low cost housing units on the site. The Units were completed on June 1, 1993 and all units were occupied two weeks later exclusively by families with young children. The County has now discovered that the site is contaminated with a variety of highly toxic substances. It has notified the E.P.A., which is now studying the site for designation as a Superfund cleanup site. By September 1, 1993, AFPI had received a number of letters from lawyers representing some of the tenants at the housing units complaining of various long term injuries allegedly caused by exposure to the toxic substances at the site.

5. At the time the military suspended its contracts with AFPI, the Wall Street Journal published an article announcing that the military had entered into a contract with Aboo Daboo Corp. ("ADC") to supply all of the armed forces with toilets and bidets. The reason for the contract was that, in December, 1990, ADC had announced that it had patented and perfected a toilet and bidet system which rendered all prior toilet and bidet technologies obsolete. The new system is also easier and cheaper to produce than conventional toilet and bidets for naval and air use. While it has taken a while for this new technology to win general acceptance in the marketplace, it has been rumored in the industry since at least January 1, 1992, that, once accepted, all companies marketing the old technology would be "in trouble." ADC has refused to license the new technology. Indeed, in retrospect, it turns out that one of the reasons that both military and civilian contracts had declined in recent years was that customers were switching over to ADC toilets and bidets. At no time, however, had either AFPI proposed or AFPI's accountant's suggested, that its inventory be revalued. Moreover, through the date of consummation of the transaction, the prior management of AFPI continued to purchase raw materials for inventory at the rate at which it had been purchasing such materials since 1987.

6. While preparing the financial statements for the year ending December 31, 1992, PPC discovered that after January 1, 1991, AFPI had decreased the reserve for bad debts by 50%, though the actual history of bad debts indicated that a greater number of accounts receivable were not being paid during this period. It had also been accepting checks post-dated by up to six months from the time tendered and treating such checks as "CASH" for balance sheet purposes received on the date tendered (even though they could not be "cashed" for additional six month period). At least 70% of these checks "bounced" when tendered after March 1, 1993.

Question 1
(30 minutes; 17%)

You represent Itzall Right ("IR"). IR, his wife and seven (7) children under ten years of age were among the first families to move into the complex built on the Long Island property formerly owned by AFPI. Within two weeks after moving into the apartment, four of his children went into convulsions and his wife miscarried.
Extended medical analysis reveals that the entire family is at significantly greater risk for a variety of cancers, and that all of the injuries suffered by the family was likely caused by exposure to the substances found on the Long Island property.

You would like to recover damages for your client. You know that under state law (the State Environmental Act of 1972 (the "Act"), all "owners" of a property onto which hazardous substances were placed are liable for damages to anyone injured by such substances. Sale of property to another person does not terminate liability, nor can an owner avoid liability if he was not responsible for the placing of hazardous substances on the site. All owners, from the time the hazardous substances were placed on the property are liable. However, owners may seek contribution from those persons (whether or not owners) who deposited the materials on the site. An "owner" means any person or entity holding legal title to the subject property, or any person or entity otherwise liable for the acts or obligations of such person or entity.

After two weeks of informal investigation, you have been able to discover the following:

1. From the founding of AFPI through the date of sale to PPC, every director and officer of AFPI, and particularly Aru A. Bidet, the sole shareholder of AFPI, knew that AFPI employees were dumping and otherwise storing a variety of chemicals and other substances, all of which are implicated in the injuries of your client. Indeed, you have several memos in your possession which indicate that it was affirmative company policy to dump such substances onto the ground on Company land. You also know that, at the time the dumping started, no one thought the substances were particularly harmful. However, after the passage of the Act in 1972, no-one at the Company attempted to change the dumping policy. Rather, a decision was made to continue dumping because the cost of hauling the substances away was too great.

2. Old AFPI dissolved two months after the sale of its assets and assumption of its liabilities by PPC. After paying off a number of remaining liabilities, the corporation distributed, in liquidation, all remaining assets and $500,000 cash to IB.

3. The members of the board of directors of new AFPI (after March 1, 1993) was the same as that of PPC. The Officers of PPC were TB, HW, and MP. Each of these people served as an officer in the same capacity in AFPI. However, AFPI had two additional officers -- Carmen Miranda ("CM") and Tooti Fruti ("TF"). The former served as Chief of Operations with responsibilities for the day to day operations of AFPI (other than financial matters), and the latter served as AFPI's Comptroller with responsibility for the day to day financial oversight of AFPI.

4. The principal offices of AFPI were located in the building housing PPC's principal offices, and AFPI's accounting, insurance, merchandising and legal work was
handled using PPC personnel. The financial accounts of AFPI were maintained separately from PPC, and, indeed, were handled through a bank which did not maintain any PPC accounts.

5. The new AFPI Board of Directors met rarely. Significant decisions were usually, but not always, approved by unanimous written consent of the Board of Directors. On occasion, these consents were written on PPC letterhead.

6. All income above expenses of new AFPI was transferred to PPC as a dividend. Advances on anticipated dividends were declared and paid monthly by the AFPI Board. AFPI was capitalized by a combination of equity ($200,000 in cash from PPC) and loans ($1,200,000). All loans were guaranteed by PPC. The average ratio of debt to equity for companies such as AFPI was 5 to 1.

WHAT PARTIES CAN YOU SUE FOR DAMAGES ON BEHALF OF IR AND HIS FAMILY? ON WHAT THEORIES CAN YOU SUE THEM? WHAT ADDITIONAL INFORMATION WOULD YOU LIKE TO HAVE, AND HOW WOULD YOU GET IT?

Question 2
(TOTAL: 90 minutes; 50%)

Assume that there are seven (7) members of PPC's Board of Directors. The inside members of the Board of Directors of PPC are TB, MP, HW. MP is engaged to TB's son, and HW has been employed by PPC for 30 years and has no other sources of income. The additional inside directors are Looky Here ("LH"), vice president of operations, and Deepdish Bowl ("DB"), TB's son and executive vice-president. In addition, Hava Banana ("HB"), and Gruesome Wart ("GW") are outside directors of PPC. HB is a Senior Vice President of the Bank which holds substantially all of the long term liabilities of PPC, and GW was a member of the Cabinet under a former U.S. President. The Bylaws and articles of PPC are silent with respect to quorum and voting requirements for Board of Directors meetings.

TB did not inform the PPC Board of Directors of her meeting with IB on January 1, 1993; nor did she inform anyone of the execution of the letter of intent at the time TB executed that agreement. Moreover, MP and HW were informed about the potential acquisition of AFPI on the day before they were sent out to look over the company. TB insisted that MP and HW "were not to look for trouble." They were also told that the transaction was confidential and that they were not to tell the other members of the Board. However, MP told DB about the transaction immediately upon her return to PPC from AFPI, and DB informed HB. Both of them discretely reviewed whatever written information had been gathered about AFPI.
On February 27, 1993, TB telephoned each of the Directors of the PPC Board and instructed them to attend an emergency Board of Directors meeting at 9:00 A.M. the next morning. She did not inform them of the agenda, even though both of the outside directors asked. On February 28, 1993, all of the members of the Board of Directors appeared at the place designated for the meeting, except Looky Here, who gave no reason for his absence. Deepdish Bowl showed up, declared that the meeting had been improperly called, that he would not attend, and that, he knew what was going to be discussed and was unalterably opposed. With that, he left.

At the meeting of the Board, TB announced that she had arrived at an agreement for the purchase of AFPI by PPC. Pursuant to the terms of the agreement, PPC agreed to purchase all of the assets and assume all of the liabilities of AFPI for the payment of $500,000, a sum substantially greater than the net worth of AFPI. While the agreement called for AFPI to make certain representations respecting the condition of the company, liability for breach of these representations terminated upon the consummation of the sale. While the Purchase Agreement had been reduced to writing by AFPI's lawyers, TB assured the Board that the agreement incorporated all of the terms that TB thought important. Unfortunately, TB did not have a copy of the agreement with her. In addition, TB informed the Board that unless the Purchase Agreement was approved "as is" within 24 hours, the Agreement would be void, and PPC could be sued for breach of contract by AFPI.

The Board approved the transaction after a brief discussion based on financial statements of AFPI reproduced above, and a two hour oral presentation by TB. TB was unable to answer several questions posed by GW having to do with environmental liabilities and the auditing of AFPI's government contracts. When GW suggested postponement of the meeting so that the answers might be obtained, TB refused, characterizing the issues posed by the questions as "insignificant," based on a number of brief conversations with IB. Indeed, at one point in the meeting TB declared, "Look, I don't know why you are being so nervous about this, PPC has approved transactions larger than this which were brought to the Board of Directors in the same manner as this one. You have trusted me in the past under similar circumstances. I trust IB, I think you should, too." No one present registered any objection to acting on the proposal at the meeting.

The Board approved the purchase of AFPI by a vote of 4-1, the assets and liabilities to be contributed to a new wholly owned subsidiary of PPC to be named AFPI. HB voted against the merger on the grounds that there was not sufficient information on which to base a decision, and that he felt he was being "railroaded into a bad decision." The transaction was closed on March 1, 1993. On May 1, 1993 the shareholders of PPC ratified the transaction.

After the closing of the purchase, the series of events, related above, forced PPC
to shut down AFPI's operations. PPC also determined that AFPI had misrepresented the condition of the company on the financial statements it had produced for PPC in connection with the acquisition, but that the misrepresentations and other problems with AFPI might have been discoverable had PPC taken a harder look at the financial statements of AFPI prior to the acquisition. AFPI's exposure to liability is estimated to be in excess of $100,000,000 and a portion of that liability might have to be borne by PPC.

**PART A**
(30 minutes; 16%)


**PART B**
(30 minutes; 17%)

HOW WOULD YOUR ANALYSIS CHANGE IF IN ADDITION TO THE FACTS ALREADY SET FORTH ABOVE, TOILETTE BOWL WAS THE SISTER OF ILOVA BIDET, AND HAD LOANED IB $1,000,000 IN 1991 TO KEEP AFPI AFLOAT?

**PART C**
(30 minutes; 17%)

1. **WHAT PROCEDURAL STEPS MUST PLAINTIFFS TAKE IN ORDER TO MAINTAIN A DERIVATIVE ACTION UNDER DELAWARE LAW AND HOW WOULD THE PPC SHAREHOLDER PLAINTIFFS ARGUE THAT THEY HAVE COMPLIED WITH THESE STEPS?**

2. **IN WHAT WAYS (OTHER THAN ON THE MERITS OF THE CLAIM) MAY THE BOARD OF DIRECTORS RESIST THE DERIVATIVE SUIT; ASSESS THE PROBABILITY OF THE SUCCESS OF EACH OF THE METHODS DISCUSSED?**

**Question 3**
In addition to their involvement in PPC, TB, HW and MP have been talking about starting another company they would like to call Flushme, Inc. ("FI") and to incorporate the company in Delaware. They have come to talk to you about this idea. Each wants to have a say in the running of the corporation, by electing one director. It is understood that each of the parties is to have an integral part in the running of the company. To that end, the parties agree that MP should be Chief Operations Officer, TB should be Chief Executive Officer and HW should be Chief Financial Officer and Secretary, and that these positions should be guaranteed. They also want a binding agreement requiring the company to pay them salaries of 10% of the company revenues to TB, 7% of such revenues to HW and 5% of such revenues to MP. In addition such salaries must be increased by 15% every year. They agree that an agreement should be drafted by which they would bind themselves to use "their best efforts" to elect each other to their respective officerships and to pay each other their respective salaries and raises. Lastly, they want to provide that unanimous shareholder approval is required for any act of the Board of directors.

The potential shareholders are worried about par value. They would like to set the par value of the stock at the price they will pay, $100.00 per share. Each shareholder will subscribe for 100 shares. While TB will contribute cash for her shares, MP has indicated that he would like to pay only $50,000 in cash, and the rest with a promissory note, while HW would like to pay $75,000 in cash and contribute the rest in the form of a credit for past services -- that is for the value of the work HW has performed in connection with the incorporation of FI.

**PART A**

(25 minutes; 13%)

WHAT DEVICES ARE AVAILABLE TO ENSURE THE BOARD REPRESENTATION WHICH EACH PARTY DESIRES? WHAT ARE THE BENEFITS AND RISKS OF EACH?

**PART B**

(25 minutes; 13%)

ADVISE THE SHAREHOLDERS HOW TO IMPLEMENT THEIR UNDERSTANDING. ARE THERE ANY IMPEDIMENTS TO THE IMPLEMENTATION OF THEIR AGREEMENT? EXPLAIN WHETHER IT WOULD MAKE A DIFFERENCE IF THE COMPANY WAS INCORPORATED IN A REVISED MODEL BUSINESS CORPORATION ACT JURISDICTION.

**PART C**
MAY THE SHAREHOLDERS PURCHASE THEIR SHARES IN THE MANNER CONTEMPLATED? WOULD IT MAKE A DIFFERENCE IF THE PAR VALUE OF THE STOCK WAS $1.00 PER SHARE? WOULD IT MAKE A DIFFERENCE IF THE REVISED MODEL BUSINESS CORPORATION ACT APPLIED?

FI was incorporated in Delaware. Like PPC, the purpose of FI is to invest in undervalued companies, restructure them and then sell them for a profit. Because there was less capital in FI than in PPC, the companies targeted are those which generally would have been considered too small for PPC to invest in. About 6 months after it commenced operations, Harry Smelly ("HS") a business broker met with TB. HS told TB that Miracle Bidet ("MB") a small company making custom fitted bidets for the glitterati in Los Angeles and Dallas had just come on the market. MB had its principal offices in Dallas and was incorporated in Delaware. It generated about $500,000 a year in revenues but had not been profitable for the last two years. HS told TB that if she acted quickly, she would be able to but MB at book value, a price substantially below the estimated going concern value of MB if properly managed.

Three weeks before her meeting with HS, TB participated at a meeting of the PPC board, in which the Board adopted a resolution appointing a special Committee for the purpose of looking for potential acquisition candidates in the area of specialty manufacturers, including manufacturers of custom home appliances. As a result, PPC is currently considering the acquisition of a manufacturer of custom sinks, and a manufacturer of custom lighting; each of these companies has recently produced revenues of $700,000.

The day after her meeting with HS, and immediately before another PPC Board meeting, TB told the other two shareholders of FI about the Miracle Bidet opportunity. They all decided that there was no reason why FI should not attempt to acquire Miracle Bidet and did not mention the opportunity at the meeting. Two months later, FI purchased all of the shares of Miracle Bidet for $1.00 per share. Twelve months later, FI sold all of its shares of MB to the public for $3.00 per share. News of these transactions made all of the financial papers.

PART D
(10 minutes; 7%)

YOU HAVE BEEN APPROACHED BY HAVA BANANA WHO RECOUNTED ESSENTIALLY THESE FACTS. HE HAS ASKED YOU ABOUT THE POSSIBILITY OF SUCCESS OF A SUIT AGAINST TB,
MP AND HW. HOW SHOULD YOU ADVISE HIM UNDER DELAWARE LAW? WHAT ADDITIONAL INFORMATION WOULD YOU NEED TO KNOW?