Law 6060-02
Business Associations
Jonathan Klick

The Armageddon

November 29, 2004
8:30-12:30
Room 103

This final exam consists of four questions (with subparts). Each question will be given equal weight in determining your final grade.

This is an open book and open note exam. You may use your casebook, class notes, casebook supplements, commercial outlines, commercial supplements, lucky charms, and any other printed or written materials you believe will be helpful in completing your answers.

You will be given four hours to complete this exam, and you may allocate your time among the questions as you see fit. There is no answer sheet for this exam. You may write/type as long or as short an answer as you believe is necessary to completely answer the test questions. If you need extra bluebooks, please quietly request them from the proctor. If you finish early, please submit your bluebooks or computer disks to the exam proctor and quietly exit the room.

If you perceive an ambiguity or error in any test question, please proceed to answer it, noting the ambiguity/error and making any reasonable assumptions you believe are necessary to answer the question. Please state these assumptions in your answer and provide your justification for the assumption.

Since some students have arranged to take the exam at a later date, recognize that any information you provide them about the exam will adversely affect your own grade because of the law school's grading curve.

Good luck and have a nice break.

1. In some sense, cases like *Smith v. Van Gorkom* (p.320) and *Brehm v. Eisner* (p.339) present a biased perspective of what kind of incentives executives and directors of a firm face in their decision making process. That is, while in each of these cases the plaintiffs argue that the firms' directors invested too few resources and paid too little attention to the advice of outside experts in making the decisions at issue in the cases, it is more likely that in most situations directors devote "too many" resources to obtain outside expert opinions and advice (let's call it the "over-investment" hypothesis).

1.a Provide an economic explanation for this "over-investment" hypothesis.

1.b Relying on the standard legal definition of a director's fiduciary duty, if you were a plaintiff's attorney who wanted to bring a derivative lawsuit against the directors of a given firm on the basis of this "over-investment" hypothesis, how would you frame your claim?

1.c What is the most likely response a court will give to your claim in 1.b?

2. Merck & Co., Inc. is a New Jersey Corporation that is one of the leading producers of pharmaceutical products in the U.S., generating $22.5 Billion in sales during 2003. One of Merck's top selling drugs, Vioxx, represented 11 percent of the firm's revenue in 2003. Vioxx is a COX-2 inhibitor which is used to reduce the pain of arthritis and has the benefit of not inducing the gastric damage and pain that is common with other anti-arthritis drugs.

Throughout Vioxx's history, there have been questions about its safety. Internal Merck studies suggested that prolonged Vioxx use might lead to adverse cardiac events in patients. Further, in 2001, an article in the *Journal of the American Medical Association (JAMA)* relayed the results of studies that suggested that the relative risk of an adverse cardiac event, which included everything from the severe myocardial infarction to the less severe unstable angina, was 2.38 relative to subjects who were treated with a placebo and was greater than 1 compared to patients taking an alternate COX-2 inhibitor, such as Celebrex, which is produced by Pfizer, Inc. That is, patients taking Vioxx were more than 2 times as likely to suffer an adverse cardiac event than those patients taking no medication and were more likely to suffer an adverse event (but not twice as likely) than patients taking Celebrex.

After the study's release, an FDA spokesman stated that studies suggest that there are cardiac risks associated with all COX-2 inhibitors, and that doctors should closely monitor their patients who are taking these drugs. However, given the benefits of Vioxx and the other COX-2 inhibitors, the FDA official indicated that the risks were not significant enough to warrant removing the drugs from the market. Merck added a warning label to Vioxx indicating the increased risk of cardiac problems.

In the interim, Merck's own continued testing of Vioxx indicated that the relative risk of severe cardiac events (heart attack, sudden death, stroke, etc) for Vioxx users was 1.4 (i.e., Vioxx users suffered these outcomes 40 percent more often) relative to those given placebos over a short period of time, and there were indications that the long term risks may be even greater. Despite the fact that most epidemiologists use a relative risk of 2 or greater in determining whether a study provides sufficient evidence that a drug "causes" an adverse event (and this standard has been used in many courts when determining causation in products liability cases), Merck's President and Chairman of the Board of Directors, Raymond Gilmartin, decided to have Merck voluntarily pull Vioxx off the market.

In the wake of this decision, Merck's stock price dropped 40 percent in the course of a month. Further, in the wake of the decision, a number of plaintiff's class action suits have been filed on behalf of Vioxx users who suffered adverse cardiac events citing Merck's decision to pull the drug as evidence of its negligence in selling the drug for more than five years. Experts estimate that the lawsuits could end up costing Merck $18 billion. Also, the drug companies that produce competing COX-2 inhibitors, such as Pfizer, observed a significant increase in their share prices as former Vioxx users were expected to substitute to the other drug companies' products.

At an emergency meeting, Merck's board of directors decided to issue a statement indicating that the board fully supported Gilmartin's decision to pull Vioxx off the shelf, though the statement only garnered support from a slim majority of board members. Of the board members, Gilmartin supported the statement, as did a board member who is a large shareholder in Pfizer, two of the medical doctors who authored the 2001 JAMA article (who were added to the board after the JAMA article's publication to add to Merck's credibility in the wake of the bad press that followed the article's publication), and a former FDA official who personally presided over Vioxx's original approval. Four board members objected to the statement, expressing great doubts about whether Vioxx should have been retired. Among the detractors were the two chemists who originally developed Vioxx (and who, as part of their contract with Merck, retained the right to receive 5 percent of all Vioxx revenue), a partner from one of the law firms that serves as Merck's outside counsel (who suggested that removal of Vioxx would seal the company's fate in any subsequent products liability class actions), and a prominent economist (who insisted that a better course of action would have been to strengthen the warning on Vioxx, pointing out to people that there are risk/benefit trade-offs inherent in the use of all pharmaceuticals).

2.a You work for a prominent New York plaintiff's firm. A large Merck shareholder, who held $100 million in Merck stock before the removal of Vioxx from the market and who now has lost $40 million, comes to you about the prospect of suing Gilmartin (who has a large personal fortune and substantial personal liability insurance coverage) for the loss he has incurred. Would you need to bring the suit as an individual action or as a derivative action and why?

2.b Assume that New Jersey follows the relevant Delaware rule (and assume Merck is incorporated in Delaware, so there's no ambiguity about what statutes and case law applies). What do you need to do procedurally if the case must be brought as a derivative suit?

2.c Assume you get to court with your client's claim (i.e., Gilmartin does not settle and you are able to get through any procedural hurdles described in your answer to 2.b), what decision is the court likely to make and why?

3. Hershey Foods, Inc, a Pennsylvania company, has an interesting ownership structure. A super majority of the company's voting shares were placed in a trust by the company's founder, Milton Hershey, that was to be run for the benefit of the students of the Milton Hershey School. Hershey, who died childless and who was an orphan himself, founded the Milton Hershey School to be a residential school for orphans and children from single parent families. The students attend and live at the school, which provides top quality academic and vocational educations to its students, free of cost and they receive generous stipends upon graduation that are meant to be used to pay for continued education. The assets in the trust are valued at about $5 Billion as of 2004.

The Milton Hershey School Trust has complete power to install individuals on the Hershey Foods Board of Directors, and the trustees are vested with a fiduciary duty to act in the best interests of the School's students, past, present, and future. In 2002, the trust expressed interest in divesting its controlling interest in Hershey Foods. The trust indicated that the trust's portfolio was not well diversified given its large holding of Hershey Foods stock.

Though the trust did not publicly mention it, another factor is likely to have informed their decision to investigate divestiture. By most analysts' accounts, Hershey Foods is a poorly run company. Hershey management has repeatedly given in to excessive labor demands (Hershey is a closed union shop, meaning that all non management employees must join the union). Further, Hershey has been hesitant to exploit the cost savings available by moving its production activities out of Hershey, Pennsylvania to locales with lower production and land costs (i.e., cheaper labor, better location with respect to supply and distribution lines, etc). Many argue that Hershey's executives are too embedded in the Hershey PA community and therefore are unwilling to demand labor concessions or to undertake a move that would seriously hurt a large percentage of the town's labor force. All of these factors, according to analysts have contributed to Hershey's poor performance relative to its main competitors, Mars and Nestle. In theory, it is likely that the trust believed it could receive a premium by selling its controlling interest to investors who may be better able to select executives and board members who could better manage the company.

Once the possibility of divestiture was raised, however, the public outcry in Hershey PA was deafening. Community activists decried the trust's decision, claiming that a sale would devastate the Hershey PA community, given the high likelihood that a buyer would move many of Hershey Food's operations to other locations. They argued that such a move would decimate the Hershey PA labor market. Further, since Hershey Foods is a large contributor to local causes, Hershey residents would lose the amenities they have come to rely on (e.g., Hershey has a much larger and nicer theatre than one might expect a town of its size to have primarily because Hershey Foods subsidizes its operation; same thing with respect to the local hospital, etc). Also, Hershey's management loudly protested the sale, suggesting that the new owners would immediately use the threat of leaving the community as leverage in demanding concessions from labor.

Within less than two months of this public haranguing (which also included a threatened action from the state's attorney general to "force" the trust not to sell), the trust dropped any plans to sell its controlling interest in Hershey Foods, and a majority of the trustees immediately stepped down, indicating that they had become pariahs in the local community. Community activists and the management of Hershey Foods declared victory.

On the day that the trust suggested it was considering the sale, the price of Hershey shares appreciated by more than 20 percent (from 60 to 75 in the midst of a bear market); on the day the trust announced it would not pursue a sale, the stock reverted to $60 a share.

3.a Using Henry Manne's "market for corporate control" hypothesis, explain why the Hershey Foods stock price moved in the way it did (i.e., rose upon the announcement that the trust was considering a sale and then fell back down when it announced it would no longer pursue a sale).

3.b Adopting Manne's perspective, provide an argument that Hershey Foods' non-trust shareholders are harmed by vesting control of the firm in the Milton Hershey School Trust?

3.c How do agency costs also make the control set-up sub-optimal for the beneficiaries of the Milton Hershey School Trust (i.e., past, current, and future Milton Hershey School students)?

4. In the early 1990s, Iowa passed a law that prohibited franchisors from terminating their relationship with an Iowa franchisee without cause. Assume, for the reasons provided in the Paul Rubin article ("The Theory of the Firm and the Structure of the Franchise Contract" JLE 1978) we read in class, that a firm like McDonald's prefers not to manage its own restaurants (i.e., it prefers to franchise them, all other things equal).

4.a What is the likely effect of such a law on the growth of franchised McDonald's outlets in Iowa (i.e., compared to the hypothetical case in which Iowa does not pass this law)? Do you suspect that the rate of franchising went up, went down, or stayed the same as a result of this law and why?

4.b What is the likely effect of this law on the growth of franchisor operated outlets in Iowa (i.e., the restaurants that McDonald's actually runs itself)? On net, do you suspect that the growth rate of the total number (i.e., franchised outlets plus franchisor operated outlets) of McDonald's restaurants in Iowa went up, down, or stayed the same as a result of this law change? Why?

4.c Economists have hypothesized that fast food franchisors are more likely to operate the units located in areas frequented by tourists (e.g., McDonald's near Disney World, or McDonald's along highways that are used primarily by vacation travelers as opposed to regular commuters) than they are in other areas (e.g., stable communities, near office complexes, etc). Give an explanation for this hypothesis drawing on the insights of Paul Rubin's article.