July 1990
Question 6

Abby, chief executive officer of Oilco, was eating lunch with several fellow Oilco executives when she saw her business school classmate, Barb, sit down at the next table. Abby was aware that Barb was a prominent local stockbroker. In an unusually loud voice, Abby stated to her fellow executives, "I bet my former classmate would give her left arm to know that tomorrow we are going to announce a tender offer for ALT Corporation."

Barb overheard this remark and when she returned to her office, bought 10,000 shares of ALT Corporation for her own account.

Barb also telephoned the Mutual Fund Complex (Mutual) and told its chief executive officer, "If you are smart, you will buy ALT Corporation this afternoon." Within one hour Mutual placed an order to buy 50,000 shares of ALT, using Barb as a broker.

That afternoon, Barb visited Cora, a neighbor whom she intensely disliked and who, at Barb's recommendation, had recently purchased ALT stocks. Barb told Cora that she had heard that ALT shares were about to decrease in value and because she felt badly that it was upon her advice that Cora had purchased ALT shares, she was willing to buy the ALT shares from Cora at the current stock exchange price without charging any commission. Cora immediately sold Barb her one hundred shares of ALT stock.

The following morning, Oilco announced it was making a tender offer for ALT Corporation shares at a price 50% above its current market price. Approximately one month later, the tender offer was completed, with Barb and Mutual receiving profits of approximately 50% on their shares. Abby has not purchased any ALT shares for more than three years.

1. Has Abby, Barb, or Mutual violated Rule lOb-5 under Section 10(b) of the Federal Securities Exchange Act? Discuss.
2. Has Barb incurred any potential non-statutory civil liability? Discuss.

ANSWER A TO QUESTION 6

I. Rule 10b-5 Violations

A. Rule

Under Rule 10b-5, it is a violation of the Securities and Exchange Act to use the mails, an instrumentality of interstate commerce, or a national stock exchange, to make a misrepresentation of material fact, an omission of material fact, or to disclose material information under a duty not to, with regard to the purchase and sale of securities. Here, ALT is apparently a nationally traded corporation.

B. Abby's Liability

Because Abby did not purchase or sell shares of ALT by omitting a material fact or making a misrepresentation, she can only be held liable as a tipper of material information.

1. Tipper Liability

A tipper of material non-public information is liable under Rule 10b if the tipper is a fiduciary of the corporation with a duty not to disclose, and he discloses material information in violation of this duty, and tips the information recklessly or for some personal benefit.

Here, Abby is the CEO of Oilco, who was about to make a tender offer to ALT. As CEO, Abby had a fiduciary duty to Oilco not to release that information. The information is also material, as it would induce people to purchase ALT stock prior to the announcement of the offer.

Additionally, while it is unclear whether Abby revealed the information for personal benefit, perhaps to gain a better relationship with Barb, her release of the information was reckless in that she stated in a loud voice, in a restaurant, that the tender offer would take place. These words were also directly aimed at Barb, "my former classmate," which does also indicate some personal benefit purpose.

Because Barb then used this information to purchase ALT stock for her account, Abby would be liable under 10b as a tipper.

C. Barb's Liability

1. Tipper Liability

A tipper of material non-public information may also be liable under Rule 10b5 if the tipper received the information from an insider with a fiduciary duty not to disclose, knew that the fiduciary was breaching a duty by disclosing the information, and the fiduciary was tipping for personal benefit or recklessly.

Here, as mentioned above, Barb received the information from Abby, Oilco CEO, who had a fiduciary duty to Oilco.

Barb also knew, or should have known, that Abby was breaching her duty. Being a stockbroker, Barb would know that a tender offer announcement is confidential information. Furthermore, because Barb was a classmate of Abby, she knew that Abby was CEO and had a fiduciary duty not to disclose.

Finally, as mentioned above, Abby's acts were either reckless or done for the purpose of gaining some personal benefit by having Barb learn of the information.

Therefore, by using the information to purchase ALT stock, Barb is liable under 10b and must return her profit to ALT.

2. Liability as Tipper

Barb should not be held liable as a tipper for giving the information to Mutual as Barb was not under a fiduciary duty to keep the information private, as she was not connected in any way to Oilco or ALT. Furthermore, Barb did not tell Mutual what the information was.

3. Misrepresentation to Cora

Barb may be liable to Cora under 10b-5 as she made a misrepresentation of material information to Cora regarding the sale of securities.

However, because no mails, exchange or mode of interstate commerce was used, as a face-to-face transaction occurred, 10-b would not be applicable. This is true even though under 10b one does not have to be an insider to be liable when making a misrepresentation. However, all of the other above requirements must be met.

Mutual would not be liable as a tipper of non-public material information.

Mutual received the tip from Barb, who was not an insider. In addition, Mutual did not receive any of the information. All that Barb said was, "If you are smart, you will buy...." Mutual was entitled to rely on this statement, as Barb was a stockbroker, and her statement was objectively viewed as advice from a stockbroker.

Additionally, Mutual had no way of knowing that Barb received the information from an insider.

Therefore, although Mutual purchased ALT securities on the basis of Barb's tip, which came as a result of her learning about non-public material information, Mutual is not liable.

II. Barb's Non-Statutory Liability

A. Misrepresentation or Deceit

Barb may be liable to Cora under a tort theory for intentional misrepresentation.

1. Prima Facie Case

The prima facie case for intentional misrepresentation involves a misrepresentation of material fact, scienter, i.e., knowledge of the misrepresentation, intent to induce current performance, reliance, justifiable reliance, and damage.

a. Misrepresentation

Barb, by telling Cora that the ALT shares were about to decrease in value, made a misrepresentation of material fact as the shares were really going to increase. The statement was material, as it was important to a decision to sell the stock.

b. Scienter

Barb knew that the statement was false, because she had already heard from Abby about the tender offer, and any good stockbroker knows that a tender offer will make the stock of the offeree company go up.

c. Intent to Induce Reliance or Action

Here, the facts indicate that Barb purchased the stock from Cora after making misrepresentations. Because Barb knew the stocks were going up in value, it can be inferred that she intended to have Cora sell her the stock so that she could make a big profit.

d. Reliance

Cora, by selling Barb the shares, did so in reliance on Barb's misrepresentation, because it is unlikely that Cora would have sold without Barb's statement, and had she known the truth, she certainly would not have sold.

e. Justifiable Reliance

Cora's reliance was justified because she knew that Barb was a stockbroker and was experienced in stock matters. Additionally, Cora bought the stock upon the advice of Barb. Therefore, Barb's statement that "she felt badly" supplies justification for Cora to rely on her statements as Barb's explanation for wanting to purchase the shares is very plausible.

f. Damages

By selling the shares to Barb, Cora suffered damages, because the next day the tender offer was announced, and the stock was being bought at 50% higher than its market value.

B. Remedies

Barb should be liable to Cora for the amount of profit that Cora lost as a result of the misrepresentation. Or in the alternative, Cora should be allowed to have a constructive trust imposed on the shares that Barb got from Cora, if Cora still holds them.

A constructive trust is an equitable remedy to prevent unjust enrichment of a party who obtains property wrongfully.

ANSWER B TO QUESTION 6

1. Abby's Liability under Rule 10b-5

The elements of Rule 10b-5 require the following.

First, there must be a transaction involving the purchase or sale of stock in interstate commerce. While Abby did not, in fact, buy or sell any stock of ALT in the last three years, the stock of ALT is presumably traded over a national exchange because Barb, a broker, was able to execute trades in the stock. In addition, because Abby will probably have liability as a tipper of stock in the sales and purchases by Barb, Cora and Mutual, there is a purchase or sale of stock which is sufficiently related to Abby's statements that were heard by Barb to satisfy this element.

Second, there must be a misrepresentation or omission of material fact. A material fact is one that a reasonable investor would consider in making a decision as to whether to buy or sell the stock. Certainly, the fact of ALT being bought by Oilco is such a material fact, because it would clearly affect the decision to purchase or sell ALT stock, as most tender offers are at a price higher than the then current market price of the stock. The issue is whether there has been a misrepresentation or omission. There is clearly no misrepresentation, as the facts stated by Abby were true. However, the courts have taken the position that giving out material inside information to some people but not others by a person with a duty to disclose is an omission. Therefore, Abby's telling her fellow executives of the tender offer loudly enough so that she knew Barb would hear it was giving inside information, and was an omission of material fact so long as Abby had a duty to disclose the information. As the CEO of Oilco, Abby is an officer and therefore an insider of Oilco. As such an insider, Abby has a duty to disclose any inside information to the public generally if she discloses it to anyone. Therefore, her disclosure of the information to Barb was a material omission.

Third, Abby must be a proper defendant. This means that she must be someone who has bought or sold stock in connection with the inside information, or be a tipper. A tipper is someone who is an insider who gives inside information to another, and who benefits from having given that information. Here, Abby is clearly an insider and has given inside information to Barb. She has benefited from this information presumably, or she would not have given it. The benefit does not need to be monetary and, here, the benefit presumably is that she had the opportunity to show off to Barb as to her knowledge about pending transactions and her importance. Therefore, Abby is a proper defendant.

Next, there needs to be a proper plaintiff. This is anyone who bought or sold the stock. This would include Cora, any others who sold their stock at the time that Barb or Mutual were buying, the SEC, and the corporation.

Next, these plaintiffs had to have relied on any misrepresentations that were made.

However, since this is a case involving an omission rather than a misrepresentation, no reliance is necessary.

Finally, the plaintiffs have to have suffered injury. Here, clearly Cora and the people who sold their stock to Barb and Mutual have suffered injury as, if they had not sold their stock because of Barb and Mutual's use of inside information, they would have made 50% on their stock the next day.

An interesting issue is whether Abby should really be considered an insider since she was an insider of Oilco and the stock that was being sold on insider information was the stock of ALT. While a close call, Abby should probably be considered an insider of ALT as a constructive insider, because she was someone in a position of confidence with ALT because she knew this information regarding the proposed tender offer. In addition, the courts have found people who know about the future acquisitions of stock by tender offers to be insiders for 10b-5 purposes.

The final element that must be proven is scienter, or intent on the part of Abby. Here, it is clear that she had the appropriate scienter since she clearly intended that Barb be given inside information and spoke loud enough to insure that Barb, in fact, heard the information.

2. Barb's Liability under 10b-5

Barb could be liable under Rule 10b-5 for three separate transactions. These are: buying stock on her own account as a tippee, buying stock from Cora, and tipping Mutual to buy stock.

Tippee Liability

Turning first to the tippee liability, Barb will be liable under the same elements as Abby if she was found to be a tippee. Here, the other elements are clearly present. She bought stock on an exchange, making it a purchase of stock using the instrumentalities of interstate commerce. She did not disclose material facts before making the purchase, there were defendants who were proper, she had scienter, as she intended to trade on inside information, and there was damage to the persons she bought the stock from.

The issue here is whether she was a tippee so that she had a duty to disclose the inside information before purchasing ALT stock such that her failure to disclose was a material omission. The elements for a tippee is that you must get inside information from an insider or a constructive insider, you must know that the information is inside information, you must act on the information, and the person who gave you the information must have benefited from giving you the information. Here, as discussed above with respect to Abby, Abby is an insider, and Abby benefited from the passing of the information to Barb. In addition, Barb knew the information was inside information based on the way that Abby told it to her and based on the fact that she was able to get away with lying about it to Cora. Therefore, Barb is liable under 10b5 for buying the stock on her own account as a tippee.

Purchase from Cora

Here, the elements of 10b-5 are even more clearly complied with.

First, there was a purchase and sale of stock, from Cora to Barb. The issue is whether it involved interstate commerce. Here, it is unclear whether Barb used any instrumentalities of interstate commerce to buy the stock, **as she** did not use an exchange and visited Cora in person, presumably in the same state. But, interstate commerce is easy to find, and if Barb called Cora to tell her she was coming over, or arranged for the stock she bought from Cora to be transferred to her name on the corporate records of ALT through the mail or the phones, interstate commerce will be found.

Second, there was a material misrepresentation here. Barb misrepresented the facts about ALT's future value. However, an argument can be made that this was merely a statement of opinion, not of fact. But, due to the way it was presented to Cora, it should be viewed as a fact. It was certainly material because it went to the value of ALT's stock.

Third, there was reliance by Cora on the misrepresentation by Barb, as she sold her stock to Barb based on it.

Fourth, there was scienter because Barb intended Cora to rely on the misrepresentation and sell the stock, which she did.

Fifth, Cora is a proper plaintiff because she was damaged by selling the stock to Barb.

Finally, Barb is a proper defendant because she was the one who made the misrepresentation to Cora.

Tipper Liability

Barb's tipper liability is based on the same elements as Abby's with two exceptions. First, there is a closer question as to whether Barb is an insider of ALT, because she has no confidential or deemed confidential relationship with ALT. But, it may be that her relationship with Abby is enough. In addition, her benefit from tipping Mutual of the stock transaction is that she made commission for buying ALT stock for Mutual. Therefore, Barb is probably liable under 10b-5 for tipping to Mutual.

3. Mutual's Liability

Mutual could be liable under 10b-5 as a tippee for having purchased ALT stock on inside information from Barb. Here, there is a purchase of stock by Mutual in interstate commerce because it was bought through a broker.

In addition, there will be an omission found, and Mutual will be a proper defendant if Mutual has tippee liability. Here, mutual probably does not have tippee liability, because there is no indication that it knew that Barb's recommendation to buy ALT stock was based on inside information.

4. Barb's Common Law Liability

Under the common law, all corporate insiders have a duty to existing shareholders who purchase or sell stock. Here, Barb bought stock from Cora, an existing shareholder. Therefore, if Barb was an insider, she had one of three duties to Cora, depending upon the jurisdiction.

In one type of jurisdiction, Barb had no duty to Cora and would have no liability.

In another type of jurisdiction, Barb would be obligated to disclose any special facts before buying stock from an existing shareholder. Here, the fact that Barb knew that ALT was to be a tender offer prospect was special facts, so Barb had a duty to disclose that to Cora.

In the last type of jurisdiction, Barb had a duty to disclose any material facts she knew. Again, the facts here would be material facts, so Barb had a duty to disclose them to Cora before buying.

The issue is whether Barb is an insider for these purposes. Under the common law, insiders were only officers, directors, controlling shareholders and majority shareholders. Since Barb was none of these, she had no duty unless she could be found to be a constructive insider under the analysis described above.

If Barb was an insider of ALT, she would also be liable, under the Diamond doctrine, to ALT for all of her profits on all of her stock transactions as there is a duty from insiders to corporations not to trade on inside information.

In addition to common law insider trading, Barb may also be liable to Cora for intentional misrepresentation. This tort requires that Barb intentionally misrepresent a material fact. See above for the analysis of these factors with respect to Barb's statements to Cora. In addition, the statements had to be false, as these were, and there had to be justifiable reliance on the facts, which Cora had since she was reasonable in relying on the statements made about a stock by a prominent local stockbroker. Cora actually relied because she sold the stock, and she was injured by losing the profit she would have made had she held the stock one more day.

July 1997
Question 5

Artis, a respected computer engineer, invented a unique computer device, but she lacked sufficient financial resources to manufacture and market it. Artis presented to Ben, a wealthy acquaintance, a business plan for producing and selling the device. Ben and Artis agreed that: 1) Artis would form a corporation named "Compco" to manufacture and market the device; 2) Ben would provide the financing by contracting with the corporation to loan it $1 million; and 3) Ben would receive periodic loan payments, a number of shares of the corporation equal to the number that would be issued to Artis and 20% of the net profits of the corporation for ten years.

Artis caused the articles of incorporation to be prepared for the corporation as a close corporation. She also caused to be prepared a loan agreement in which Ben and Compco were the parties. The agreement contained the provisions to which Artis and Ben had agreed. Artis signed the agreement as president of Compco, and Ben promptly funded the $1 million loan. Under state law, legal existence of the corporation would begin only when the articles were filed with the secretary of state. However, through inadvertence the articles were not filed with the secretary of state until ten days after the loan agreement was executed and the loan funded.

Artis was duly elected as sole officer and director of Compco. Thereafter, the computer device was manufactured, Compco enjoyed some initial business success, made payments on the loan and paid 20% of its net profits to Ben.

Compco authorized only 1,000 no par common shares for an issue price of $1,000 per share. Compco issued 200 shares to Artis in return for her assignment of all rights in her invention to Compco and 200 shares to Ben pursuant to the loan agreement. Compco issued 500 shares to others in return for their payment of $1,000 per share. Artis caused the remaining 100 shares to be issued as a gift to her friend, Carla, a busy and successful computer marketing expert, in an attempt to induce Carla to provide free marketing advice to Compco, which was facing increasing competition. However, after receiving the stock, Carla refused to provide any advice.

Recently, Compco has operated at a loss, and Ben has not received any further payments under the loan agreement.

1. Are Compco and/or Artis liable to Ben for the payments due under the loan agreement? Discuss.
2. Is Artis liable to Compco for having issued stock to herself and to Carla, and if so, what is the basis of any such (liability? Discuss.
3. Is Ben liable to Compco because he was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.
4. Is Carla liable to Compco because she was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.

July 1995
Question 5

Dan is the president of Exco, a closely held corporation. He is also a member of its board of directors and a 10% shareholder of the corporation. For the past five years, Exco has averaged annual net pre-tax earnings of 50% of its gross sales. During this period, Exco has not paid a dividend or made any other distribution to its shareholders. This was planned so that Exco will have substantial retained earnings to enhance the chances of its sale to another company.

With the approval of his fellow directors, Dan has just started negotiations with officers of Morcorp to sell Exco to Morcorp. Dan wants to complete arrangements for the sale of Exco to Morcorp on an expedited basis within the next 45 days, because he believes that a brief, present high demand for Exco's products will increase Exco's sale price. He has neither submitted the plan to Exco's shareholders for approval, nor has he obtained a review of the proposed terms of sale by outside consultants.

After the negotiations started, Dan was interviewed by a reporter for *The Stock Market Times,* a financial newspaper with nationwide circulation, about persistent rumors that Exco is for sale at a price which exceeds the book value of its stock. Dan is accurately quoted in *The Stock Market Times* as saying "There are no pending discussions regarding the sale or merger of

Exco."

Polly owns 5% of Exco's shares. Polly is concerned that she has received no dividends on her Exco stock despite Exco's recent earnings. Polly has commenced a lawsuit against Dan and the other Exco board members seeking a decree compelling the defendants to declare and Exco to pay a dividend on its stock. In response to Polly's suit, Dan and the other directors voted to have Exco indemnify them for costs of defense. While her suit is pending, Polly has learned of the recent negotiations for sale of Exco to Morcorp. She has amended her complaint to enjoin the sale and obtain damages from Dan and the other directors for alleged breaches of fiduciary duty in the negotiations for an expedited sale and for Dan's false assertion reported in *The Stock Market Times* that Exco was not for sale.

1. How should Polly's attempt to compel payment of a dividend be decided? Discuss.
2. Can Exco lawfully provide indemnity to Dan and the other Exco directors for their legal costs incurred in defending Polly's suit? Discuss.
3. Are Dan and the other Exco directors liable to Polly because of Dan's statement quoted in *The Stock Market Times* and if so, to what relief is Polly entitled? Discuss.
4. What responsibilities do Dan and the other Exco directors have in seeking to effect the expedited sale of Exco to Morcorp, and have they fulfilled those responsibilities? Discuss.

ANSWER A TO QUESTION 5

1. Polly's Attempt to Compel Payment of A Dividend

In general, the directors of a corporation are responsible for overall management of the corporation and for setting the major policies.

Although shareholders must participate and assent to fundamental corporate changes, declarations of dividends are not fundamental changes, and are considered in the full discretion of the directors to decide to declare and pay them.

Direct Suit

Polly is suing Dan and the directors in her individual capacity as a shareholder, and not derivatively for the corporation, because she will benefit primarily if her suit succeeds.

Directors Declare Dividends

As stated above, it is the directors' discretionary responsibility to declare and pay dividends out of retained earnings.

In general, courts grant directors broad discretion in deciding when and if to declare dividends, since the directors are in the best position to determine corporate policies in the best interest of the corporation.

Therefore, Polly has a strong burden to overcome to convince a court to compel corporate directors to pay dividends.

Exception for Looting and Oppression

On the other hand, courts will order directors to declare dividends if the plaintiff can prove that the directors have been benefiting themselves at the expense of the shareholders by paying themselves bonuses or conferring upon themselves benefits out of retained earnings while not paying dividends to shareholders.

Polly will argue that Exco has made enormous profits (50% of gross sales annually for several years), has accumulated substantial retained earnings, yet has not shared or distributed any of these earnings to shareholders. If Polly can also prove that Dan and other directors have been benefiting themselves through those retained earnings, a court might compel dividends to be paid.

However, Dan will argue that there is a good faith rationale behind Exco's decisions not to pay dividends. It is the directors' judgment that large retained earnings will increase the value of the company to other companies looking to purchase it. If another company does buy Exco, then all shareholders will benefit, not just the directors.

Furthermore, as a 10% shareholder, Dan will argue he has no incentive to decrease the value of his shares.

Conclusion

In brief, Polly's attempt to compel the directors to pay dividends is very unlikely to succeed, because the directors' decision is based on a seemingly rational judgment that is intended to benefit all shareholders, not just the directors themselves.

2. Can Exco Lawfully Indemnify the Directors?

A corporation can indemnify directors against litigation costs and judgments arising from the director's duties as director. There are situations in which indemnification is prohibited; others in which it is mandatory; and still others in which it is permissive.

Prohibited Indemnification

A corporation cannot indemnify its directors where the directors have either been held liable to the corporation or are liable for receiving an improper personal benefit.

In our case, if Polly succeeds in her claim to compel the directors to pay dividends, and further, the court finds that Dan and the others have improperly benefited, perhaps by looting retained earnings or self-dealing, then Exco could not indemnify their legal costs and judgments.

Mandatory Indemnification

On the other hand, Exco must indemnify the directors if the case ends in judgments favorable to the directors, either on the merits or not.

Therefore, if Polly's suit to compel fails (which is highly probable), Exco must indemnify Dan and the other directors for all expenses incurred in defending against Polly's action.

Permissive Indemnification

Finally, Exco may legally indemnify the directors if neither of the above scenarios plays out, but the directors have acted in good faith and in a way they believe is in the best interests of the corporation.

For example, if Exco ultimately settles Polly's claim against them, then Exco may indemnify the directors for their legal costs, as long as the decision to indemnify was made by a majority of the disinterested directors, disinterested shares, or by an independent legal counsel.

Therefore, Exco may lawfully indemnify in this instance where a majority of disinterested shares or independent legal counsel so decides, since Polly brought suit against all directors.

3. Liability to Polly for Dan's Statement

Polly could bring suit against Dan for his statements reported in the Stock Market Report either directly as an Exco shareholder or derivatively for the benefit of the corporation.

A. Polly's Direct Suits

Polly's direct suits against Dan could take several forms: state securities laws, federal securities laws, or state common law of corporations.

1. State Securities Laws

In a state securities law cause of action, Polly could sue Dan for either misrepresentation or nondisclosure of special facts.

a. Misrepresentation

Misrepresentation consists of a misrepresentation of fact by the defendant about which the defendant was aware, for the purpose of inducing action or inaction on the part of the plaintiff, justifiable reliance by the plaintiff upon the defendant's misrepresentation, and damages.

Polly can prove that Dan misrepresented facts about Exco's negotiations with Morcorp. However, at common law, Dan must have made the misrepresentation to Polly. In other words, there must be privity. Furthermore, Polly must show that she justifiably relied to her detriment.

Yet, since no privity exists, Polly's cause will not succeed. b.

Nondisclosure of Special Facts

Corporate insiders have a duty to disclose all facts that would be important to a reasonable investor in their investment decision when dealing with them.

Since, again, no privity exists (no sale of securities) from Dan to Polly, Polly's claim will fail.

2. Federal Securities: 10b-5

Polly can make a successful 10b-5 claim if she can prove that Dan made a misrepresentation of material fact through an instrumentality of interstate commerce, in connection with a purchase or sale of a security, and there was reliance that led to damages.

Polly's action will succeed or fail on her federal claim depending upon whether or not she bought or sold securities ("in connection with") in reliance on Dan's misrepresentation of material fact.

Since merger negotiations are material, Polly could receive a damages award if she traded on this information.

Conclusion

In brief, Polly's best chance for recovery for Dan's statement is under 10b5 federal securities action.

4. Directors' Responsibilities

Directors of a corporation owe the corporation the fiduciary duties of care and loyalty. We must analyze each to determine whether Dan and the Exco directors have fulfilled their responsibilities to Exco in the expedited merger negotiations.

Duty of Care

A director owes the corporation a duty of care. The director must act as a prudent person, with reasonable care and skill, as he would in the management of his own business.

If a director acts unreasonably and causes the corporation losses due to this unreasonableness, the director will be liable to the corporation.

Where business decisions and judgments are grounds for a director's liability under the duty of care, a director has fulfilled his duties by using his best business judgment, including using reasonable diligence, inquiry, and investigation.

Therefore to fulfill their duty of care to Exco, the directors must use their best business judgment. Simply because the transaction may be expedited does not necessarily mean the directors are acting unreasonably.

Dan and the directors must do the necessary due diligence to insure that the merger with Morcorp is in the best interest of Exco.

Dan's failure to submit the proposal to the Exco shareholders is not a breach, because

Dan does not need to get shareholder approval until the merger negotiations have been completed and the directors of Exco pass a resolution of merger.

Finally, Dan's failure to get outside consulting can be a factor if Dan and others at Exco have not fully analyzed the deal.

Duty of Loyalty

Finally, a director owes the corporation a duty of loyalty, to act in good faith and to the best interests of the corporation.

The facts do not indicate that Dan has acted in bad faith in his decision to merge with Morcorp.

As long as the directors continue to act in good faith and refrain from self-dealing or usurping corporate opportunities they will fulfill their duty of loyalty to Exco.

ANSWER B TO QUESTION 5

1. POLLY V. CORPORATION

Compel Payment of Dividends

Any distributions which are made by a corporation, including payments of dividends are determined by the board. A shareholder does not have a right to any distributions. However, in some instances a court may compel the corporation to pay dividends to their shareholders. Plaintiff must establish not only a past failure to pay dividends but also unfairness by the board in refusing to make the distribution.

Here Polly may argue that there has been a failure to pay dividends for the past five years and considering that the corporation has averaged annual net pre-tax earnings of 50% of its gross sales, the failure to pay amounts to unfairness by the board and, thus, payments should be compelled. Furthermore, failure to pay was because the directors hoped to resell the corporation, not to increase productivity, therefore, showing improper purpose.

However, the Court would likely refuse Polly's request to compel payment of dividends. First, the reason for the nonpayment was to enhance the chances of sale to another company, which is not an improper purpose. Secondly, as noted above, the decision to issue any distributions rests with approval by a majority of the board. The court is unlikely to interfere with the board's decision without a greater showing of unfairness and misconduct by the board.

Shareholder Derivative Suit

A shareholder derivative suit is a suit brought by a current shareholder, against the board, asserting the corporation's cause of action.

Here it appears that Polly's claim for dividends is her own cause of action and, thus, would not reflect a shareholder's derivative suit.

2. INDEMNIFICATION OF DAN AND DIRECTORS

A corporation is prohibited from indemnifying its directors/officers whenever a judgment is issued against those directors/officers. A corporation must indemnify when the directors/officers obtain a judgment on the merits in their favor. In all other instances indemnification is allowed if directors/officers were under a reasonable belief that their actions would benefit the corporation and a majority of disinterested directors and shareholders approves the indemnification.

Here, in the likely event that the court holds in favor of the directors that a dividend payment is not required (see above), then the directors are entitled to indemnification by Exco.

However, if court holds that Polly is entitled to a dividend payment, then Exco will be prohibited and barred from indemnifying Dan/directors, even if they were acting in good faith.

If the case is dismissed or settled then Exco has the option of indemnifying the directors. Here, it appears that the nonpayment of dividends was in good faith as the reason was to increase the value of the company in case of future sales of the corporation.

On the other hand, a majority of disinterested directors and shares might find that the nonpayment of dividends for five years when the profits were so high was not in good faith because the money/profits were not being pumped back into the corporation to better the products produced and sold. Instead profits were kept "on books merely to entice a buyer for the corporation."

However, in all likelihood, the directors' actions were in good faith as the sale of a corporation is not, per se, improper as long as the proper percentage approve the transaction.

Therefore, a majority of disinterested directors/shares could approve the indemnification. This means that Dan and the directors named in the suit cannot vote on whether Exco will indemnify.

3. LIABILITY OF DAN AND DIRECTORS FOR STATEMENTS QUOTED IN THE "STOCK MARKET"

There may be several bases for Dan's/directors' liability to Polly for such statements including (1) common law fraud; (2) 10b-5; (3) duty of care; and (4) duty of loyalty.

Common Law Fraud

In order to recover under common law fraud, the plaintiff must establish (1) material misstatement of fact; (2) made with scienter; (3) made with the intent of inducing reliance; (4) actual reliance; and (5) justifiable reliance.

Material Misrepresentation

Here Dan told the paper that there "are no pending discussions regarding the sale or merger of Exco." However, Dan had actually started negotiations with the officers of Morcorp to sell Exco to Morcorp. In fact, he hoped to "close the deal" quickly - within the next 45 days.

Thus, there was a misstatement to the paper. The misstatement was material as a reasonably prudent investor, including Polly, would consider this information important. For instance, Polly would be certain not to sell her stock if she had notice of the pending sale. Dan's statement to the paper would bar this option.

Scienter

Dan made the statement to the paper intentionally, thereby fulfilling the scienter requirement.

Intent of Inducing Reliance

Dan made the statement to the paper in order to ensure that the current value of Exco was not reduced to insure sale at the highest price. Furthermore, Dan did not want current shareholders going out and selling their stock at a reduced value because it might interfere with the current valuations of Exco. Thus, statements were made intending to induce reliance.

Actual Reliance

Polly must establish that she actually relied on the statements in the newspaper. There are no facts to indicate actual reliance, however, Polly could likely establish that she neglected to sell her shares/stock - which did not pay a dividend in five years based on the statement in the paper.

Reasonable Reliance

Polly's reliance is likely to be reasonable as it was in the Stock Market Times, a nationwide financial newspaper which is arguably established.

Polly's Recovery

Polly would be entitled to the actual loss she suffered as a result of the misrepresentation or the reasonable value of her stock prior misrepresentation minus value after misrepresentation.

10-b 5

In order to establish a 10-b5 situation, Polly must establish (1) a material misstatement or failure of defendants to disclosure material information; (2) sale or purchase of stock; (3) interstate communication.

Here, Polly did not sell or purchase stock in reliance on the statements in the paper. Therefore, there is no 10-b5 liability.

Duty of Care

Directors and officers have a duty of care to the corporation. The director/officer must act as a reasonably prudent person would who was running the business.

Here, plaintiff argues that Dan/directors failed to act as a reasonable person when he made the statement to the paper because a reasonable person would not lie to the public and the shareholders of a corporation regarding a pending sale/merger.

Business Judgment Rule

If the directors' actions were based on a reasonably well informed and rational basis, then directors' actions are justified, even if they cause a loss to the corporation.

Here, the defendant would argue that the wrong information was conveyed to the newspaper in order to ensure that the value of the corporation did not decrease, thereby ensuring the highest price for the shares.

This does appear to be a reasonable interpretation on Dan's part as news of the potential merger might cause value of the stock to go down, in effect harming Polly.

Thus, it appears that there is no breach of duty of care.

Remedy for Polly

If the court does find a breach, on the other hand, directors are liable for all loses to the corporation based upon the breach.

Duty of Loyalty

A director owes a duty of loyalty to the corporation. He must act in good faith and in the best interest of the corporation.

Here, Polly can argue that the directors/Dan breached duty of loyalty by making the misstatements to the paper because this was not in good faith but was in fact an affirmative misrepresentation.

However, the defendant would counter that the statements to the paper were in fact made in the best interest of the corporation to ensure the highest price for the stock in the event of a sale.

In all likelihood, the court would find a breach of loyalty by Dan and the other directors because although their interest might have been to help the corporation, they were not acting in good faith but with the intent to deceive.

Remedy

Polly would be entitled to any actual loss which she suffered as a result of the statement to the corporation.

4. RESPONSIBILITIES REGARDING SALE

In order to make a sale of Exco to Morcorp, Dan and the directors must (1) ensure sale is not a breach of duty of care; (2) ensure sale is not of an amount to breach the duty of loyalty; (3) obtain approval from a quorum of directors; (4) give notice to shareholders and majority shares entitled to vote approval; (5) respect dissenting shareholders' right to their appraisal; (6) investigate to ensure that Morcorp directors are not looters.

Duty of Care

See definition above.

Before the sale can occur, Dan/directors must ensure that approval of the sale does not breach the duty of care they have to the corporation.

Here, a reasonably prudent director would submit the plan of the sale to the shareholders of Exco. Furthermore, a reasonable director would also review the proposed sale with either consultants in-house or outside to ensure that the best deal was acquired.

Because Dan and the directors failed to do either, they have breached their duty of care to the corporation regarding the sale. The business judgment rule would not protect their conduct because their decision to sell was not informed.

Duty of Loyalty

See definition above.

Here, the directors would also likely be liable for a breach of their duty of loyalty to the corporation regarding the sale. Although the terms of the sale may be beneficial to the corporation, the directors have not acted in good faith as they are rushing the sale, without inquiring with consultants.

The defendant/directors strongest claim that they have not breached their duty of loyalty is that the corporation will benefit.

Board Approval

Before the sale, the majority or quorum of the board must also vote for and approve the sale of the corporation.

Notice to Shareholders

The board must also provide the shareholders with notice of the impending sale and board approval.

Here, thus far, Dan/directors have failed to provide any notice to the shareholders of the pending sale. Thus, they are in breach.

Shareholders' Approval

A majority of shares must approve the sale. However, because, defendants have failed to provide notice and proposals regarding the sale, the shareholders' vote is not at issue.

Sale Looters

Directors in close corporations are also under duty to make a reasonable investigation of the purchaser to avoid selling to looters.

Thus far, Dan and the directors have failed, or at least facts indicate, to undertake the investigation of Morcorp's purposes.

February 1996

Question 2

Art, Bob and Cora each signed a pre-incorporation share subscription agreement to incorporate Widgco. The agreement provided that: (1) there would be a total of 3,000 authorized shares having a par value of $10 per share; (2) Art would receive 1,000 shares to be paid for by Art's future services to Widgco; (3) Bob would purchase 500 shares at $20 per share; (4) Cora would purchase the remaining 1,500 shares at $20 per share; (5) no shareholder could, without the consent of the other two shareholders, sell Widgco shares to anyone but Widgco; and (6) the redemption price to be paid Widgco was $20 per share.

Prior to Widgco's incorporation, Art contracted to supply 10,000 widgets per year to Salesco. He signed the contract with Salesco, "Art, on behalf of Widgco." Bob and Cora knew of the widgets contract but never approved it.

Upon incorporation, the three shareholders elected themselves directors and officers of Widgco. The corporation flourished financially, in part because management found a buyer of widgets at a higher price than Salesco's and repudiated the Salesco contract before beginning performance.

Art has provided hundreds of hours of service to Widgco and has received his 1,000 shares of stock. Cora has paid for her shares at the price agreed upon in the pre-incorporation subscription agreement. Bob, however, has refused to pay for his shares, stating that he does not have the money but that he is willing to give the corporation an unsecured promissory note payable without interest at $2,000 a year.

Cora attempted to sell her shares to Dan for the $30 a share price offered by Dan, but Art has demanded that any sale be to Widgco at $20 a share. Cora thereupon refused to allow the corporation to take any action against Bob unless Art allowed her to sell her shares to Dan and threatened that, if Art persisted in his refusal, she would cause the dissolution of Widgco.

1. What, if any, are Salesco's rights and remedies? Discuss.

2. What, if any, are Widgco's rights and remedies against Bob? Discuss. 3. What, if any, are Cora's rights and remedies? Discuss.

ANSWER A TO QUESTION 2

1. Salesco's Rights and Remedies

A. Salesco v. Art: A promoter is liable in contract for any pre-incorporation contract signed by the promoter. Art apparently executed the contract "on behalf of Widgco." However, unless the promoter expressly limits his liability in the contract, merely signing on behalf of future corporation is not sufficient to avoid liability.

The promoter is not liable if there is a complete novation. No such novation occurred. Salesco could sue Art for breach of contract - due to the anticipatory repudiation. Since the UCC would govern, Salesco has a duty to mitigate by attempting resale of the goods. Salesco can then recover either 1) the difference between resale price and contract price, or 2) the difference between contract price and market price at the time of breach (assuming they choose not to resell). Since it appears that these widgets are not unique, there is no grounds for specific performance.

B. Salesco v. Widgco: The corporation is not liable for the contract of a promoter unless 1) the corporation expressly ratifies the contract, or 2) impliedly ratifies the contract (e.g. by accepting the benefit of the contract).

Bob and Cora, the other two directors, did not approve the contract, either in their capacity as promoters or directors or shareholders. There has been no express adoption of the contract.

The corporation never received the widgets. Although Salesco may argue that the corporation received a benefit by getting a better buyer, this is not accepting the benefit of the contract. The facts indicate the company flourished expressly because they repudiated the contract. Although this may be an indication of bad faith, it does not rise to the level of fraud or deceit, and Salesco has to pursue its remedy against Art.

2. Widgco v. Bob: Bob subscribed to purchase 500 shares, but now refuses to perform the contract and seeks to discharge his duties by giving Widgco a promissory note.

A. Breach of Contract: A subscription agreement is an enforceable contract. If made before incorporation, the contract matures upon incorporation. Bob signed the agreement, and Widgco has now incorporated. He is liable for breach of contract if he refuses to perform.

Bob may defend based on unconscionability, since the purchase price of $20 was twice par value. But the court will not accept the quantity of consideration (so long as above par value) as a valid defense.

Widgco is entitled to the full contract price.

B. Modification: Bob may argue he is offering adequate consideration to support the original contract or a modification. It is inadequate to support the original contract (see above). Whether Widgco can accept his promissory note as a valid modification depends on whether it is acceptable quality and quantity of consideration for stock.

Quality: A subscriber may pay cash, real property, or past services as consideration for stocks. Although the law in this area is changing, generally a debt does not satisfy consideration, unless the court finds it to be a promise to pay a sum certain.

Quantity: If the promissory note satisfies quality, it is unlikely to satisfy quantity. However, if Bob intends to repay his entire contract obligation, the Board may accept such payment, barring conflict of interest problems.

C. Duty of Loyalty: Widgco may sue Bob for breach of the duty of loyalty. As a Director, Bob is now obligated not to place his interest in conflict with the interest of the corporation. This duty includes the duty not to self-deal. The trier of facts would have to examine the circumstances of the transaction. Does Bob really not have the money, or is he changing the terms to benefit himself financially.

If the trier of facts finds that Bob is not acting in good faith and has breached his duty of loyalty, Bob is personally liable to the corporation for any actions taken in his capacity as director.

3. Cora's Rights and Remedies: Cora seeks to sell her shares to Dan, and if she cannot do so, to block action against Bob or cause the dissolution of Widgco.

A. Sale to Dan: The subscription agreement contained a clause restricting any sale (except to Widgco for $20) without approval of the other two shareholders. Shareholders may validly restrict the transfer of shares as long as such restrictions do not unreasonably restrict alienation. The right of first refusal is a reasonable restriction. A subscription agreement would be binding on the shareholders.

Cora does have a valid defense, however, against the $20 price limit. Generally, the right of first refusal requires purchase at market value. However, in this closely held corporation, market value may be difficult to evaluate. Cora would have the burden of showing (by appraising corporate worth) that the $20 price was patently unfair.

B. Blocking Action against Bob: As a director and officer, Cora owes a duty of loyalty and care to the corporation.

Duty of Care: The duty of care requires Cora to act as a reasonably prudent person in similar circumstances. If a reasonable person would conclude that taking action against Bob is the prudent policy, Cora may be breaching her duty of care by trying to block this action.

Duty of Loyalty: (see above for definition) The duty of loyalty also includes the responsibility to avoid conflict of interest transactions or actions. Cora seeks to block the action against Bob simply to preserve - gain leverage - for her personal desire to sell her shares. There is no indication that this action would benefit the corporation. By attempting to promote her interest to the possible detriment of the corporation, she would breach her duty of loyalty.

Cora should not try to block action against Bob.

C. Dissolution: A director may not generally cause the dissolution of the corporation. Cora could file a derivative suit in her capacity as shareholder to dissolve the corporation. In order to do this, Cora must be a contemporaneous share holder, must petition the Board for action first (unless futile) and in some jurisdictions must post a bond.

A shareholder can sue for dissolution only if the Board appears so deadlocked that they cannot act, or the Board refuses to act. Cora's problem is that Art does not want her to sell to Dan. The problem here seems to be that Bob, who has not paid for his shares, should not be considered a valid shareholder (or director, for that matter). Since Cora has 1500 shares, and Art 1000, and they are the only two shareholders, it is not clear whether she can actually be blocked from selling. If Art can indeed block her based on the transfer restriction agreement, Cora's best remedy is to challenge the price.

If Cora can show that between her and Art the Board is effectively deadlocked, she could sue for dissolution. However, courts are reluctant to dissolve a profitable corporation.

D. <u>Suit against Art:</u> Art apparently received his shares for future services - an invalid quality of consideration for shares. Cora may have a claim that Art is not a valid shareholder, thereby breaking the deadlock and solving her problems.

ANSWER B TO QUESTION 2

1. Salesco's Rights and Remedies

Salesco should try and collect under a breach of contract theory.

Salesco v. Art

Generally a promoter is liable on a valid pre-incorporation agreement. It appears that this contract was validly formed and a writing was signed by Art so there should be no statute of frauds problem. Widgco repudiated the contract and did not provide the widgets as provided for in the agreement. This is a total breach of the contract and the promoter is liable.

Novation

Art may claim he is not liable because there was a novation, i.e. a new agreement between Salesco and Widgco, and Art is no longer liable. This argument will fail and Art is still on the hook for breach of the pre-incorporation agreement.

Remedies

Salesco can sue for damages which would be the market or cover price less the contract price. Thus, if Salesco has to pay more, which is likely because Widgco was able

to sell at a higher price than in the contract, Salesco can recover its damages from Art.

Salesco v. Widgco

Salesco may also sue Widgco for breach of contract. A corporation is generally not liable for pre-incorporation agreements unless the corporation adopts the contract or accepts the benefits under the contract. Widgco did not accept any benefits under the contract because it was repudiated before any widgets or payments.

Did Widgco Adopt the Contract?

Bob and Cora knew of the agreement, but never approved it. In order to adopt the contract, the corporation should take some sort of formal measures and sign a resolution adopting the contract. Salesco will argue that because Bob and Cora knew of the contract, and said nothing, it was adopted and the corporation is liable. This argument should fail and the court should find the contract was not adopted by the corporation.

Corporation by estoppel

Salesco might argue that it dealt with Widgco thinking it was a corporation, and Art held it out as a corporation, and therefore the corporation should be bound under the contract. Bob and Cora's knowledge of the contract does not make it unfair for the corporation to be liable. This argument should fail because Salesco could have found out if Widgco was incorporated and there were no defects or other reasons it wasn't. This was just a pre-incorporation agreement. The corporation should not be liable.

Remedies

If Widgco is liable, Salesco would be entitled to damages in the same amount that Art is liable. Specific performance should not be available in either of these actions because damages are an adequate legal remedy and can protect Salesco's expectations.

2. Wid4co's Rights and Remedies v. Bob

Widgco should attempt to enforce the subscription agreement against Bob. The subscription agreement appears valid as it was signed by all parties.

Rescission

The corporation can rescind a subscription agreement if the party fails to perform. Bob has failed to pay the $ 20/share agreed upon and Widgco should be able to rescind the agreement as it relates to Bob.

Can Corporation Force Bob to Pay?

Generally, the corporation cannot force the shareholder to pay under the subscription agreement and the only remedy will be rescission. Some jurisdictions may allow the corporation to force Bob to pay, but most likely, Widgco will only be able to rescind.

Defenses

Bob may try to argue that he was released from the agreement, or that there was fraud involved. These arguments will fail because there was never a release and the terms of the agreement were not fraudulent.

Bob's Offer to Give an Unsecured Note

Cash, property, and other items are proper consideration for shares of stock. However, an unsecured note is not valid consideration and the corporation should not accept that in lieu of the $20 called for in the subscription agreement. Even though Bob agrees to pay interest the consideration is no good and he cannot claim that is a fair substitute for the $20 a share.

Remedies

The corporation should be able to rescind the subscription agreement as it applies to Bob.

3. Cora's Rights and Remedies

Invalid Transfer Restriction

Cora may argue that the subscription agreement is an invalid restraint on alienation and cannot be enforced. Transfer restrictions are valid if they are reasonable and appear on the face of the stock certificate.

Cora may argue that there was no restriction on the certificate. Bob and Art should argue that the restriction is reasonable because this is a closely held corporation, and it is important that control be maintained in a group that people get along with. If the court agrees with Cora, the restriction will be held invalid as a violation of policy and Cora could transfer the shares to Dan.

Cora v. Art for Breach of Shareholder's Duty

Shareholders in a closely held corporation owe a duty of good faith to one another and a controlling shareholder cannot take advantage of another shareholder. Cora should argue that Art has breached this duty by not allowing her to sell to Dan.

Art will argue that the agreement was valid and Cora must follow the terms of the agreement. Cora should lose in her argument because she cannot show Art has not acted in good faith given the agreement.

Derivative Suit

Cora may also bring a derivative action on behalf of the corporation arguing that the corporation is damaged. This will fail because the corporation does not suffer any damage in this sale between shareholders.

Dissolution

Cora may bring an action for involuntary dissolution arguing that there is deadlock and oppression because she and Art cannot agree. Cora's threats to not take action against Bob and Art's refusal to allow the sale of Cora's shares may be enough to create deadlock. However, the court may be reluctant to order the dissolution because the corporation has flourished financially.

Corporation v. Board or Cora v. Board

Cora may bring a derivative action on behalf of the corporation to enforce the subscription agreement against Art and Bob. Art's future services are not valid consideration for shares and therefore the corporation should rescind the agreement with respect to Art. A demand on the Board would be futile because Art and Bob are both members and have not paid for their shares.

Cora may prevail in a derivative action to rescind the agreement as it relates to Art and Bob.

February 1997
Question 2

Graphic, Inc. (Graphic), is a California corporation that sells office copying equipment. Its Articles of Incorporation prohibit Graphic's sale of paper products. Graphic's common stock is registered for trading on a stock exchange. Frank, Graphic's president, recently signed a contract with Papco on behalf of Graphic to buy a paper mill owned by Papco. Frank intends to reveal the contract for the first time at a Board of Directors meeting next week.

Frank recently received a letter from Alice, who owns 9.2% of Graphic's common stock. Alice has asked to "look at a list of Graphic's shareholders and all contracts signed by Graphic in the past three months." Frank directed the corporate secretary to write to Alice denying her request, which was done.

Graphic's accountants advised Frank that Graphic will report a $5 million loss for its current fiscal year, which will be the only loss in its twenty year history. Frank then sold 100,000 shares of his Graphic common stock through his broker for $25 per share. The sale included 20,000 shares he had purchased two months ago by exercising a stock option at $22 per share.

Frank called a press conference at which he stated that "Graphic has signed a major contract and will have other news to announce after its Board of Directors meeting." Alice heard about the press conference and purchased 5,000 additional shares of Graphic common stock at $28 per share through her broker. When the news of Graphic's fiscal year loss became public, the price of Graphic stock declined to $20 per share.

Alice wishes (1) to compel Graphic to make available for her inspection the shareholders' list and all contracts signed in the last three months, (2) to recover her loss on her recent stock purchase, (3) to force Frank to disgorge the profits on his stock sale, (4) and to have the Papco contract declared invalid.

What are Alice's rights and remedies, if any, with regard to (1) through (4) above? Discuss.

ANSWER A TO QUESTION 2

1. Whether Alice can compel Graphic to make available for her inspection the shareholders' list and all contracts signed in the last three months.

Generally, a shareholder has a right to examine corporate shareholder voting lists and general corporate information, so long as it is for a proper purpose and the inspection request is in writing, and the inspection will be in a reasonable place such as in the corporate headquarters. In this case, Alice wants to look at a list of shareholders and see all contracts Graphic signed in the last three months.

Alice should probably be allowed to look at the Graphic voting list. Alice wrote to the Graphic corporation regarding her request to look at the voting list; the facts do not indicate what her purpose for inspecting the voting list would be, but so long as it is for something proper a court will enforce this right, such as if she is soliciting proxy voting rights or some activity relating to the benefit of the corporation. Traditionally, some corporate laws required that a shareholder have at least a 5% interest in the corporation for the right to inspect voting lists, but the modern trends do not require a certain percent, just merely that the request is by a shareholder. Therefore, because Alice is a shareholder and if she is making a proper request to see the voting list, a court will require Graphic to let Alice, the shareholder, inspect the voting list.

Alice, however, will probably not get to inspect every Graphic contract signed in the last three months. This is not a reasonable right of shareholders to scrutinize the job of officers or directors. Hence, Alice cannot force the officers to report directly to her by forwarding all contracts they have entered into on behalf of Graphic for the purpose of satisfying a particular shareholders wishes. Officers answer to the directors, and directors to shareholders. As a result, Alice cannot get to look at all the contracts from the last three months, and this was probably properly denied by Frank.

2. Is Alice entitled to recover her loss on her recent stock purchase?

The federal act governing fraud in securities, section 10b5 may allow Alice to recover her loss if she can establish that her buying was a result of a material misstatement or omission by Frank at the news conference. A 10b5 action requires a plaintiff to have actually bought or sold stock in reliance on a party's material misstatement or omission. Here, Alice did purchase 5,000 shares of Graphic in response to Frank's major news; and the facts indicate "Alice heard about the press conference and purchased..." thus demonstrating the reliance factor necessary for a 10b5 action.

Another requirement for a 10b5 action is that there be some use of an interstate instrumentality to perpetuate the fraud. In this case, Frank's news conference which was assumingly broadcast out to possibly viewers in other states or FCC controlled instrumentalities would be sufficient to constitute an interstate factor to satisfy this requirement.

On the other hand, Frank would argue that his statements at the news conference do not qualify as a material misstatement or omission subjecting him to liability under 10b5. Frank would assert that he merely indicated that he had signed the Papco contract and that he would be announcing other news later. This would most likely be the news of the Graphic report by the accountant's $5 million loss for its current fiscal year.

Alice would probably prevail in showing that this "other news to announce" is a material omission; because the major loss is the first in the corporation's 20 years, and Frank sold

100,000 shares of his stock--indicating his loss of confidence in Graphic's value. Hence, Alice would point out the fact of Frank's selling and withholding material information he acted upon as constituting a material omission.

Therefore, Alice would most likely be entitled to recover in a 10b5 suit. Frank would be liable for his fraud to her and would repurchase her 5,000 shares at her purchase price of $28. Thus, restoring her to her prepurchase position. Although she may elect to recover the damages of the lost value for the stock of $8 price per share.

Also, Alice may be able to bring a common law action for fraud by Frank, a corporate officer, since she was in privity with him, and he had a fiduciary duty to shareholders. This would basically be the same as the above action except it does not require the federal instrumentality for the interstate commerce connection. The common law stock fraud action, however, does require the privity issue, and in this instance, because Alice was a Graphic holder already, she would fulfill the privity requirement with Frank, an officer of Graphic.

3. <u>Whether Alice can force Frank to disgorge the profits on his stock sale.</u>

Directors, officers, and 10% shareholders of corporations that are registered for trading on a stock exchange are subject to a short swing regulation of federal law under section 16(b) of the SEC act. Rule 16b is a strict liability type regulation that forces a director, officer, or 10% shareholder to disgorge profits from buying and selling stock within a six month period. This rule is strictly construed to apply so even if the sale came first and then the subsequent buy is within six months from the sale and the buy is at a lower rate the director, officer, or holder (10% previous to the buy) will be liable and have to return the difference between the sale price and the lower buy price.

The facts here indicate that Frank, an officer of the corporation purchased 20,000 shares within six months of the sale of his stock, so the short swing of buying and selling the 20,000 will make Frank liable to the corporation for the difference in the purchase and sale price. Frank bought at $22 a share multiplied by the 20,000 and, then sold for $25 a share; so the profit was $3 a share multiplied by 20,000 shares yielding a total of $60,000 profit Frank took from his short swing, 16b trading that he must disgorge to the corporation.

4. <u>Whether Alice can have the Papco contract declared invalid.</u>

If a director or officer is acting contrary to a corporation's interest or objectives, a shareholder may bring suit to remedy the injury situation to the corporation. A shareholder can bring a derivative suit to enjoin a corporation from performing an <u>ultra vires</u> act. There are four requirements for bringing a derivative suit: the party must have owned stock at the time the cause of action arose on through the time of the suit; the shareholder must make a demand that the directors take action to remedy the activity injuring the corporation, unless that demand on the board would be futile or if after the demand on the board of directors, the board still refuses to bring the action, and the board is not just exercising a good faith business judgment in refusing to take action, then the holder may proceed with the derivative action. Also, the holder may be required to post a bond for any possible adverse consequences to the corporation from the derivative action, and the holder may be required to have the other holders vote to ratify or reject the action of the directors.

In this case, Graphic's Articles of Incorporation prohibit Graphic's sale of paper products. An <u>ultra vires</u> act is committed when Graphic directors or officers act outside of the Articles of

Incorporation in doing business prohibited by the scope and purpose of the corporation and their authority. At common law an ultra vires act was void, but now it is voidable. If the corporation adopts or ratifies the ultra vires act then the corporation must perform the transaction, otherwise it is voidable, and they can avoid their obligation. If the corporation wants to amend its articles then the holders must do it by a majority vote and the directors cannot unilaterally modify the articles.

Alice would argue that Frank's entering the contract with Papco is contrary to the articles of the corporation and would be ultra vires because Papco is a paper company and Graphic is prohibited from selling paper products; thus, Frank should not have authority to enter Graphic into this transaction.

On the other hand, Frank would argue that Graphic's buying a mill does not constitute "the sale of paper products." Frank would claim that his contract for the mill is not ultra vires because Graphic may not "sell" paper products.

However, this argument will probably not succeed because a mill primarily produces paper for sale and profit. Hence, if the directors do not take action to set aside this contract, then Alice can bring derivative action on behalf of the corporation to set aside the contract as it is voidable on account of the ultra vires nature of the transaction. Additionally, Frank the officer that entered into this ultra vires action would be liable personally.

In conclusion, Alice will probably prevail in having the Papco contract declared invalid.

ANSWER B TO QUESTION 2

1. Shareholder Inspection Rights - Shareholders' List & Contracts

A shareholder of a corporation has a right to inspect the books and records of the corporation, provided the shareholder makes a written request for a proper purpose in its shareholder capacity. A proper purpose includes preparation for litigation. The shareholder can be a holder of even one share of stock

Alice, a 9.2% holder of Graphic's common stock, has asked to look at Graphic's shareholder list and all contracts signed by Graphic in the past three months. Alice is entitled to review the shareholders' list, provided she gives a proper purpose. The facts do not indicate whether she has stated a purpose. However, Frank improperly denied such request.

With respect to the contracts, Alice probably has a right to inspect the contracts which are inserted in Graphic's minute book as attachments to Board and shareholder resolutions. Such contracts would probably be extraordinary contracts, outside of the ordinary course of business. However, Alice has requested to see all contracts. This probably is too broad. Shareholders cannot manage the corporation. Thus, Alice's right to inspect is probably limited to extraordinary contracts. Those outside of such scope were properly denied review by Frank because Alice's purpose was improper (shareholder management).

With respect to the improper denial to inspect the shareholder's list and contracts contained in Graphic's minute book, Alice can seek relief from the court. Under a court order, Alice or her representative may review such documents during reasonable business hours, as well as make or receive copies of such records.

The only way that Frank/Graphic can prevent such inspection is to argue that Alice seeks to inspect the documents for an improper purpose, such as for the benefit of an outside third party.

2. Recovery of Alice's Loss on her Recent Stock Purchase

In her capacity as a shareholder, Alice can sue Frank directly for breach of fiduciary duty and on the theory of 10b-5 liability (under federal and state law).

10b-5

A buyer or seller of publicly traded stock may recover losses incurred in connection with such purchase or sale where such loss results from a public misrepresentation.

Under 10b-5 of the Federal Securities Act of 1933 (and similar state law claims), Alice must prove the following:

Instrumentalities of Interstate Commerce

Here, the stock of Graphics is traded on a stock exchange. Also, Frank's statement was released probably by use of media. Thus, the fraud used instrumentalities of interstate commerce.

possible Defendants

Alice may sue Frank, an insider of Graphics due to his service as president, and Graphics.

Possible Plaintiffs

Although the SEC may institute proceedings against Frank and Graphics, 10b-5 also permits private buyers and sellers to seek a private cause of action. Thus Alice is a proper plaintiff.

Bad Act

Frank holds a fiduciary relationship to the corporation as a result of his serving as president. When Frank made the public statement regarding Graphics major contract, he failed to disclose the fact that the company would also be posting a $5 million loss. The failure to disclose this material fact created the impression that Graphics was having a strong fiscal year. As a fiduciary to the corporation, Frank had a duty to disclose such information to prevent the public misrepresentation.

Scienter

Frank's misrepresentation to the public was done with the knowledge or reckless disregard that failure to disclose all of the material facts would mislead the public.

Of a Material Fact - Reasonable Investor

A reasonable investor probably would find that the $5 million loss for Graphic's current fiscal year was a material fact. Failure to disclose such information created the impression that Graphics was financially successful and profitable in the current fiscal year.

Intent to Induce

Frank gave the press conference most likely with the intent to induce confidence in the company's operations.

)n Connection with the Sale or Purchase of Equity

Alice bought her common stock Reliance

Reliance by Alice on Frank's press conference will be presumed because this case involves a public misrepresentation.

Damages

Alice may recover her lost profits of $40,000 (8 x 5,000).

Fiduciary Duty

Alice might also be able to recover damages from Frank for his breach of fiduciary duty. Frank improperly refused Alice's request. She may have been able to avoid her loss if she had inspected the books.

3. Disgorge Frank's Profits - Section 16(b) and Breach of Duty of Loyalty and Care a.

16(b)

Under section 16(b), an insider must disgorge profits made on short-swing sales/purchases within six months. Frank's intent is irrelevant.

Recording Company

Graphics is probably a recording company under the Securities Exchange Act of 1934. Its stock is registered for trading on a stock exchange.

Insiders

As an officer of the corporation, Frank is an insider. To be liable, he must have been an officer at either the purchase or sale of the stock. The facts show that he was an officer when he sold the 100,000 shares of stock for $25 per share. 20,000 of the shares were purchased two months ago for $22/share.

Of an Equity Security

Frank sold his common stock.

Purchase and Sale within Six Months

20,000 shares were bought and sold within a two month period. Disgorge Profits

Thus, Frank must disgorge $40,000 of the profits.

b. 10b-5

Alice may notify the SEC to pursue a 10b-5 claim against Frank for selling his shares without disclosing material inside information. Since Alice did not buy Frank's shares, she might not have a private cause of action. Assuming she can prove that she bought or sold securities during the time Frank sold his shares, or if the SEC seeks to pursue against Frank, Frank will be liable because (1) he used instrumentalities of interstate commerce (stock exchange), (2) he is an insider, (3) he failed to abstain from trading or disclose material information when he sold his stock, (4) he did so knowingly, (5) with the intent to induce, (6) reliance , and (7) caused damage/loss.

c. Derivative Suit

Alice might pursue an action on behalf of the company for Frank's breach of duty of care and loyalty. Alice has standing because she owned common stock when the wrongdoing occurred and assuming she holds the stock through litigation. Alice must make a written demand on the corporation.

Breach of Duty of Care

An officer owes the company of due care. He must act as a reasonable person would with respect to his own affairs. Frank breached this when he used inside information and sold the stock.

Duty of Loyalty

Frank owes a duty of loyalty to Graphics. He must act as he reasonably believes is in the company's best interest. He probably breached this when he sold the stock prior to public disclosure of the company's loss.

4. Papco Contract Invalid - Ultra Vires

The Articles of Incorporation expressly prohibit sale of paper products. The purchase contract is in direct conflict with this express limitation. This action would be ultra vires. The corporation is an entity created by law. It cannot exceed the authority created by law or its articles. Thus, the contract should be invalidated. The only defense would be if Papco relied on the contract to its detriment.

July 1997

Question 5

Artis, a respected computer engineer, invented a unique computer device, but she lacked sufficient financial resources to manufacture and market it. Artis presented to Ben, a wealthy acquaintance, a business plan for producing and selling the device. Ben and Artis agreed that: 1) Artis would form a corporation named "Compco" to manufacture and market the device; 2) Ben would provide the financing by contracting with the corporation to loan it $1 million; and 3) Ben would receive periodic loan payments, a number of shares of the corporation equal to the number that would be issued to Artis and 20% of the net profits of the corporation for ten years.

Artis caused the articles of incorporation to be prepared for the corporation as a close corporation. She also caused to be prepared a loan agreement in which Ben and Compco were the parties. The agreement contained the provisions to which Artis and Ben had agreed. Artis signed the agreement as president of Compco, and Ben promptly funded the $1 million loan. Under state law, legal existence of the corporation would begin only when the articles were filed with the secretary of state. However, through inadvertence the articles were not filed with the secretary of state until ten days after the loan agreement was executed and the loan funded. Artis was duly elected as sole officer and director of Compco. Thereafter, the computer device was manufactured, Compco enjoyed some initial business success, made payments on the loan and paid 20% of its net profits to Ben.

Compco authorized only 1,000 no par common shares for an issue price of $1,000 per share. Compco issued 200 shares to Artis in return for her assignment of all rights in her invention to Compco and 200 shares to Ben pursuant to the loan agreement. Compco issued 500 shares to others in return for their payment of $ 1,000 per share. Artis caused the remaining 100 shares to be issued as a gift to her friend, Carla, a busy and successful computer marketing expert, in an attempt to induce Carla to provide free marketing advice to Compco, which was facing increasing competition. However, after receiving the stock, Carla refused to provide any advice.

Recently, Compco has operated at a loss, and Ben has not received any further payments under the loan agreement.

1. Are Compco and/or Artis liable to Ben for the payments due under the loan agreement? Discuss.
2. Is Artis liable to Compco for having issued stock to herself and to Carla, and if so, what is the basis of any such liability? Discuss.
3. Is Ben liable to Compco because he was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.
4. Is Carla liable to Compco because she was issued stock in Compco and, if so, what is the basis of any such liability? Discuss.

ANSWER A TO QUESTION 5

1) LIABILITY OF COMPCO AND/OR ARTIS TO BEN FOR LOAN

COMPCO'S LIABILITY: Generally, a corporation is liable for breach of the contractual obligations it enters into, so under normal contract principles Compco would be liable to Ben for the periodic loan payments it promised, and for 20% of any net profits that have not been paid to Ben. However, Compco will assert two theories as a defense to its contractual duties to Ben in this situation. Unfortunately for Compco, it will probably not prevail on either theory.

A. CORPORATE LIABILITY FOR PRE-INCORPORATION CONTRACTS: Compco will try to argue that because Artis signed this contract with Ben before Compco was incorporated, the contract is a preincorporation contract for which Compco has no liability because it was not a party to the contract. However, there are at least two ways that a corporation can become liable for preincorporating contracts: adoption or novation. Here, Compco has adopted the pre-incorporation contract because it has 1) benefited under the contract through the receipt and use of the $1 million capital received from Ben, 2) it has acknowledged the contract by making periodic payments to Ben, and 3) it has acknowledged the contract by paying Ben 20% of its net profits. A corporation is estopped from denying its duties under a contract that it has relied on, benefited from, or acknowledged under the theory of adoption. Compco has clearly adopted this contract, and will be liable under its terms to Ben.

B. DEFECTIVE INCORPORATION: Compco will also try to argue that because Artis never filed the articles of incorporation with the Secretary of State, Compco does not legally exist as a corporation, and thus lacks the capacity to enter into a valid contract and cannot be legally bound. However, a corporation is estopped from asserting defects in its own incorporation to avoid liability to third parties, so Compco will also fail here.

Thus, Compco is liable to Ben for the payments under the loan agreement.

ARTIS' LIABILITY: In entering into the preincorporation contract with Ben, Artis was acting as a corporate promoter. Generally, corporate promoters remain liable to third parties on preincorporation contracts, unless 1) there has been a post-incorporation novation of the contract, or 2) it was the intent of the third party at the time the contract was entered into to have only the corporation and not the promoter remain liable on the contract after incorporation.

Novation: As discussed above, Compco has probably adopted the loan agreement, thus becoming liable on the contract. However, a corporation's adoption of a preincorporation does not release the promoter from also being liable on the contract. The promoter will only be released if there is a novation of the contract after the incorporation. Under general contract theories, a novation is a renewal of the contract whereby the original parties to the contract and the third party all agree that one of the original parties to the contract is released from all duties under the contract, and that the third party replaced the

original party in the contract. Here, Artis would try to argue that there was a novation in which

Ben agreed to release Artis from the obligation and replace her with Compco, and that Compco agreed to replace Artis as the party primarily liable to Ben on the contract. The facts do not indicate that such a novation occurred, so under this theory Artis remains liable to Ben.

Intent of the parties: Artis may also try to argue that because she signed the contract as president of Compco and not as an individual, and because of the understanding and intent of both her and Ben at the time the contract was entered into, that she was not intended to be held personally liable on the contract and thus should not be liable to Ben. However, given the fact that Artis has breached her duties of care and good faith as a corporate officer and director, and unless there is clear evidence on the face of the contract that Ben did not intend for Artis to remain personally liable on the contract after incorporation, Artis' argument will probably fail, and she will remain personally liable to Ben on the pre-incorporation contract.

2) <u>LIABILITY OF ARTIS FOR ISSUING STOCK TO HERSELF AND CARLA:</u>

<u>ISSUING STOCK TO HERSELF:</u> Artis should not be liable to Compco or anyone else for issuing the stock in Compco to herself. The shares have no par value under the articles, so the issuance does not raise the problem of "watered stock," which is stock issued for less than par value. Stock may be issued in exchange of any property, including intangible property such as Artis' rights in her own invention. Provided that Artis did in fact have rights in her invention, and provided that the exchange of 200 shares for those rights was a reasonably fair transaction in terms of value, Artis is not liable to the corporation for the issuance.

<u>ISSUING STOCK TO CARLA:</u> Artis may be liable to Compco for the issuance of the 100 shares to Carla. Stock may be issued in exchange for any valid property, or for past services, but it can not be issued when the consideration is a mere promise of future service. The facts indicate that Artis issued the shares to Carla "in an attempt to induce" her to provide free marketing advice to Compco. Even if the issuance had been made in exchange for an enforceable contract for such future services, it would probably subject Artis to liability. Since the stock was apparently issued for less than a full promise, Artis will definitely be liable.

Apart from the traditional prohibition on issuing stock for invalid consideration (such as future services), Artis owes the corporation both a duty of care and a duty of loyalty as an officer and director of Compco. Under the duty of care, Artis must treat the corporation as a reasonably prudent person would treat her own personal business or assets. Under the duty of loyalty, Artis must take all actions relating to the corporation in good faith and in the best interests of the corporation. Issuing 100 shares to Carla either as a gift or as consideration for vague future services would violate these duties, and would make Artis liable to Compco for her actions.

3) <u>BEN'S LIABILITY TO COMPCO FOR HIS STOCK:</u>

Traditionally, the issuance of stock in exchange to debt was prohibited because debt was considered invalid consideration for the issuance of equity securities. However, on these facts, there are several factors that probably make the issuance of stock to Ben in

-32-

exchange for his "loan" acceptable, so Ben will not be liable to Compco.

Ben gave $1 million to Compco as startup capital in exchange for 200 shares, an agreement to repay the principal, and 20% of net profits. Because this was a startup company with no other capital (other than Artis' idea), Ben's loan was very risky. The issuance of stock is partially justified by the amount of risk Ben subjected himself to in supplying the capital. Under the facts, Compco did not contract to pay Ben any "interest" on his loan, but instead agreed to pay back only the principal, plus 20% of net profits. Because this venture was new, the likelihood of substantial profits in the early years was low, and Ben subjected himself to considerable risk that he would receive little or no profits from Compco. Thus, his acceptance of the stock may have been justified in lieu of a guarantee of interest.

In conclusion, under modern and more liberal corporate codes, Ben's contribution of capital to Compco was probably sufficient consideration for his stock, even though the money he provided can be partly characterized as a "loan."

4. <u>IS CARLA LIABLE TO COMPCO FOR HER STOCK,?</u>

As a recipient of 100 shares of stock, Carla is only a ten per cent shareholder in Compco. The facts do not indicate that she is either an officer or director of Compco. Under these facts, Carla owes no special duty to Compco or to the other shareholders, and so she is probably not liable to Compco for the issuance of her stock.

However, Carla might be liable on one of two theories. First, under contract law, if Carla made an enforceable contract to provide marketing advice to Compco in exchange for her stock and then refused to perform, she might be liable. Under these facts, it does not appear that she entered a contract, as it states only that Artis "attempted to induce her" to provide such services.

Second, under tort theories, if Carla misrepresented to Compco that she would provide advice, and intentionally induced Compco reliance on the promise without intent to perform, she may be liable for fraud or misrepresentation. Again, under these facts, it does not appear that Carla will be liable under this theory.

<u>ANSWER B TO QUESTION 5</u>

<u>Liability for Loan Payments</u> <u>Artis' Liability</u>

Artis (A) acted as a promoter of Compco, since she acted on its behalf before the corporation was formed. In such capacity, A signed a contract with Ben (B) by which B made a loan and A promised to repay it, partly with Compco's profits. As promoter, A is liable on all pre-incorporation contracts she signed on behalf of Compco, until there is a novation, or agreement by which A is replaced by Compco as a party to the contract. Since there was no novation here, A remains personally liable to B under the loan agreement.

<u>Compco's Liability</u>

A corporation is not liable on any pre-incorporation contract signed by its promoter until it adopts such a contract either expressly or impliedly (by accepting benefits of the contract). Since Compco was not formed (i.e., its articles weren't filed) until 10 days after the loan agreement was made, its liability under the agreement depends on whether it adopted the contract by accepting the benefits of the contract. Arguably, it did because the loan proceeds were used by Compco to finance production. If the court finds that this is the case, Compco is liable to B for the loan payments (but note - A remains liable as well, until there is a novation replacing her with Compco as party to the contract).

A's Liability for Stock Issuance

Issuance to A

Stock can be issued for money, property, or past services. Where stock has a par value, that is the minimum issue price; with no par stock, generally the board of directors determines the appropriate price and the amount to be contributed to the "stated capital" fund.

Where stock is used to pay for property by the company, generally a good faith determination of the value of such property (and hence the amount of stock to be paid for it) by the board controls. In a close corporation (generally less than 35 share holders, stock not publicly traded), a good faith determination by the controlling shareholders, who owe fiduciary duties to minority shareholders, will control.

Here, A has caused Compco to issue 200 shares to her in return for an assignment of her rights to the invention. Thus, the requirement that money, property (which such assignment is), or past services be paid as consideration is met. In addition, A must have made a good faith determination that such an assignment is adequate consideration for the 200 shares. If so, she is not liable for such issuance. But if her determination was not in good faith, she is liable to Compco for the issuance; she has violated her fiduciary obligation to act in good faith and in a manner she reasonably believes to be in Compco's best interest. She may be required to pay Compco the additional value of the stock.

Issuance to Carla

Since 100 shares were issued to Carla as a gift, adequate consideration has not been received for the shares and A is liable to Compco for their value, as is Carla. A will argue that she gave the shares to Carla in return for her marketing advice. However, many states prohibit issuance of stock in exchange for future services; in such a state, A remains liable for the value of the stock. In addition, even if Compco's state of incorporation permitted future services as consideration for stock, A did not obtain a sufficiently certain agreement from Carla to provide such services; in fact, it does not appear that any promise at all was obtained from Carla before the shares were issued to her. Thus, A's argument fails and she is liable to Compco.

As sole officer and director of Compco, A owes Compco a duty of loyalty; she must avoid self-dealing transactions. Her issuance of 200 shares to herself for less than their fair value (if that is the case) would be a self-dealing transaction, which must either be fair to

-34-

the company or disclosed to and approved by the shareholders. No such disclosure was made nor approval sought, and it is unlikely that obtaining company stock without paying fair value can be construed as fair to the company.

A also owes Compco a duty of care; she must act in a good faith, informed, and rational manner and as a prudent person in management of her own affairs. This duty was breached when A issued Compco shares to Carla for no consideration, and also if the court determines that A herself paid insufficient consideration.

Ben's Liability to Compco

Ben apparently received his shares in return for his agreement to loan Compco $1 million. This would seem to satisfy the requirement that stock be issued in return for consideration, since a loan is valuable property, particularly where other sources are unwilling to lend or are charging higher interest.

Note, however, that in return for his agreement to loan, Ben also received a promise of periodic repayment and 20% of Compco's net profits for 10 years. This tends to negate the argument that Ben's shares were issued for adequate consideration (i.e., it looks like the stock was a gift, on top of the loan repayment and 20% of profits).

If in fact Ben did receive stock without paying any value for it, Ben is liable to Compco for the value of the stock. This would be analogous to having received "watered stock," or stock issued for less than par value, for which a person is liable to the corporation. Since this is no-par stock, Ben's liability depends on a determination of whether A made a good faith determination that Ben provided adequate consideration for the stock under the loan agreement; if not, A and Ben are both liable to Compco.

Carla's Liability to Compco

As discussed above, Carla received her stock as a gift; the facts suggest that, despite A's hopes, Carla made no promise to give marketing advice, which might have served as consideration for the stock in those states which permit payment for stock with future services.

Like Ben, Carla is liable to Compco as if she had received watered stock. However, here there is no good faith argument that consideration was paid for the stock. Thus, Carla is liable to Compco for the value of the stock.

July 1999
Question 6

Sally is vice president for research at Chipco Corporation (Chipco), a microchip manufacturer. Chipco's stock is traded on a national stock exchange. During the course of her work for Chipco, Sally's research team developed technology that could reduce microchip production costs by 75%. However, Sally knew that additional testing was necessary to ensure commercial viability of the technology.

Chipco retained lawyer Laura to advise it on patenting the new technology. On March 12, 1998, Laura arranged a conference call with Sally and other Chipco personnel, who explained the new technology to Laura. This information was personally as well as professionally interesting to Laura because she already owned 12% of Chipco's outstanding stock as part of her personal investment portfolio. On March 16, 1998, Laura telephoned attorney Arnold, an opposing counsel in an unrelated matter, and mentioned that her client Chipco might soon become a major competitor in the microchip business because of new breakthrough technology. Shortly thereafter, Sally, Laura and Arnold each telephoned a broker and purchased shares of Chipco stock at $10.00 per share.

On April 10, 1998, a financial newspaper reported a rumor that Chipco had developed new breakthrough technology. Within the next 2 days, Chipco stock increased to $20.00 per share. Chipco had been purchasing large blocks of its own shares and it became fearful of continued price escalation of its shares. Therefore, Chipco promptly responded to questions from the press about the rumor by issuing a release which stated, "Chipco has not developed new commercially viable technology at this time." As soon as the statement was reported by the press, the price of Chipco shares fell to $11.00 per share.

On August 20, 1998, after successfully testing for commercial viability, Chipco publicly announced its new technology, and Chipco shares again rose to $20.00 per share. By September 5, 1998, Sally, Laura and Arnold had each sold all their shares of Chipco stock at the higher price.

Has there been any violation of federal securities laws by:

1. Sally? Discuss.
2. Laura? Discuss.
3. Arnold? Discuss.
4. Chipco? Discuss.

ANSWER A TO **QUESTION 6**

Question Six

1. Did the Court Correctly Decide W's Motion to Dismiss for Lack of Jurisdiction?

Here, the facts indicate that Park, a State X company, has sued wholesale, an Italian company, in federal district court in State X on a breach of contract claim, alleging $100,000 in damages, and Wholesale moved to dismiss for lack of jurisdiction. The motion could have been on one of two bases: subject matter jurisdiction, or personal jurisdiction. These will be discussed individually, below.

Subject Matter Jurisdiction

Contract cases such as this one not generally involving questions of federal law, diversity of citizenship jurisdiction should be the basis claimed, and should lie. Under 28 USC 1332, diversity jurisdiction exists over suits between citizens of different states or between citizens of one state and foreigners, provided a good faith allegation of damages exceeding $75,000 is pled.

Here, Park is a citizen of its state of incorporation and its state of principal operations, likely X. Wholesale is a citizen of Italy. Park alleged $100,000 in lost profits. Diversity of citizenship jurisdiction appears to exist, and the motion should not have been granted on this basis.

Personal Jurisdiction

Personal jurisdiction over Wholesale is required, and is the more likely basis for the motion made. The exercise of jurisdiction requires a showing of both a state statute authorizing jurisdiction, and sufficient minimum contacts by the defendant with the forum state.

Federal courts sitting **in** diversity only have jurisdiction to the same extent as the courts of the state in which the federal court is located. See F.R.C.P. 4. Here, the facts are silent as to the terms of the statute; if X's is like California's it permits exercision of jurisdiction to the fullest extent constitutional.

In 1945, in International Shoe v. Washington, the U.S. Supreme Court held that before personal jurisdiction may be exercised over a noncitizen of the forum state, it must be shown that the defendant had "sufficient minimum contacts with the forum state such that maintenance of the suit does not offend traditional notions of fair play and substantial justice."

Later, in Burger King v. Rudzeiwicz, the Court clarified that the test is two-fold: "contacts," and "fairness."

Contacts: The present facts indicate that Wholesale is an Italian corporation, which "before entering into this contract ... had never done business with Park" Further, the facts state that Wholesale "sells most of its goods to buyers in Spain." This suggests only very limited contacts with X, certainly not enough to rise to the level of pervasiveness for "general jurisdiction" to be shown. However, "specific jurisdiction" should be met: although the present contract was "negotiated entirely in Italy," Wholesale must have been aware that it was doing business with a State X company, considering the presence of the arbitration clause mandating non-binding arbitration in X. Because the present suit arises out of Wholesale's specific contact with State X; i.e., the contract with Park, contacts should be satisfied.

In Hanson v. Denckla, the Court clarified that contacts alone are insufficient: additionally, the defendant must have "purposefully availed" itself of the benefits and protections of the forum state. Here, the facts indicate that in 1996 Wholesale had sold three shipping containers of vases worth a total of $2.1 million to a state X company. This is probably sufficient purposeful availment by Wholesale, even though it was related to a different transaction: Here, Wholesale had recently and voluntarily entered as a supplier in the State X vase market.

In World-Wide Volkswagen v. Woodson, the Court further clarified that, for contacts to be sufficient, it must have been "foreseeable" to the defendant that it would be sued within the form state. Here, too, the element should be met: Wholesale knew it was dealing with a State X company, and had agreed, in its contract, to non-binding arbitration in State X in the event of a dispute. The very idea of "non-binding" arbitration suggests that a more formal proceeding may follow it - and thus a suit would be foreseeable. Since the arbitration was to be in X, the lawsuit would foreseeably be there as well: after all, the parties are already present in X.

Fairness Factors: in assessing the fairness factors, the court will consider the parties' competing interests, and the state interest in adjudicating the suit. Here, Wholesale is seeking redress in its own state, in its own country, under a judicial system it is familiar with. All the relevant Park employees are probably located in State X, and note that the allegedly defective vases are also presently in X. Should the trier of fact need to view the evidence, it's located here. Regarding the state's interest, State X has a valid desire to protect its citizens from wrongdoing by outsiders, and to provide an effective, low-cost, convenient forum for redress of their grievances. Particularly where, as here, the alternative forum (Italy) recognizes fewer theories for recovery than State X law, and imposes a limitation on recoverable damages which State X law does not, the state interest in exercision of personal jurisdiction over the outsider is particularly strong.

In conclusion, State X probably may validly exercise personal jurisdiction over Wholesale, and the motion was properly denied.

2. Did the Court Correctly Decide W's Motion for Dismissal on the Ground of Forum Non Conveniens? The doctrine of forum non conveniens allows a federal court, for the convenience of the parties and witnesses, in the interests of justice, to transfer a case to another federal district where it could have been originally brought, 28 USC 1404, or to outright dismiss it in contemplation of the case being refiled in a foreign jurisdiction, 28 USC 1406. Because the facts state that the federal court sitting in State X was asked by Wholesale to dismiss rather than transfer, what probably happened was Wholesale wished the case dismissed in contemplation of suit being filed in Italy instead.

In Piper Aircraft v. Reyno, an instructive case on discretion to dismiss under the doctrine of forum non conveniens, the Court considered whether a federal court sitting in Pennsylvania should have dismissed a suit under the doctrine which was based in tort on an airline disaster which had occurred in Scotland. In Reyno, the Court identified the relevant factors for consideration as (1) the convenience of the parties; (2) the convenience of the witnesses; (3)

the state interest in retaining the case; (4) the foreign court's interest, if any, in resolving the dispute, and (5) the relative ease or burden, which adjudicating the case would impose on the court entertaining the motion.

Regarding convenience of the parties, the facts suggest that Wholesale has no employees or officers in X, whereas Park has no employees or offices in Italy. If this is the case, the equities are reasonably split: one corporation is going to be inconvenienced here. While Park apparently had no difficulty negotiating the contract in Italy, Wholesale did agree to travel to X for non-binding arbitration in case of a dispute, and apparently was able to do so without trouble. Further, the evidence is located in X: for the suit to be brought in Italy, they might have to be returned. It's a close question, but Park probably is ahead on the convenience aspect.

Regarding the application of the law, Park almost inarguably wins: the facts indicate that while Italian law provides a remedy for this type of claim, it recognizes fewer theories of recovery, and imposes a limitation on damages that State X law does not. On this basis, a very strong factor exists in favor of den lug Wholesale's motion.

Regarding convenience of the witnesses, the facts clearly state "all of W's witnesses to its design and manufacturing processes are located in Italy." It is fairly clear that Wholesale wins on this factor, though Park's witnesses are probably in X.

Regarding the state interest, as noted earlier, State X has a valid and compelling interest in providing a remedy for its citizens; i.e., ready access to a friendly and efficient judicial process. This state interest is even stronger where, as here, the law of the alternative forum would not provide as much protection.

Regarding Italy's interest in adjudicating the suit, note that this is a simple action on a business contract, in which Italy is unlikely to have any compelling interest other than the protection of its own citizens (compare the facts of <u>Renyo:</u> compelling interest present because airline disaster occurred in Scotland, killing Scotch passengers and flight crew.

Regarding the interests of the court considering the motion, there does not appear to be any serious reason why the State X court would have difficulty, or be burdened, hearing this case. (Compare <u>Renyo:</u> the federal court, located in Penn., would have been required to interpret and apply Scotland's tort law).

In sum, the motion appears properly denied.

ANSWER B TO QUESTION 6

1) Sally - Rule 16 - Sally has violated the Federal Prohibition of short term trading by two corporate insiders (Rule 16e). Rule 16 applies anytime a stock is purchased at a lower price than it is sold by an officer, director or 10% shareholder within a six month window of time. Additionally, the stock must be traded on a national exchange or meet other requirements.

Here, Sally is an officer of ChipCo, whose stock is traded on a national stock exchange. She purchased stock on March 16, 1998 at $10,00 a share. She subsequently sold the stock on September 5 (within 6 months of the purchase) at $20.00 per share. She must therefore disgorge the profits therefrom.

Rule I0b-5 - Sally probably also violated Rule I0b-5. I0b-5 requires that in concession with the buying or selling of stock, corporate insiders have a duty to either refrain from trading or disclose relevant information. Additionally, an instrumentality of interstate commerce must have been used in connection with buying or selling the stock.

Here Sally knew about the development of the new technology and knew thus a reasonable investor would find that information material. She, therefore, had a duty to disclose the information or refrain from trading, and she breached that duty when she purchased the stock. Since she used the telephone to call her broker, she used an instrumentality of interstate commerce. Therefore she violated Federal Rule 10(b)5.

2) Laura - Like Sally, Laura's purchase and sale of stock within a six month period violated Rule 16. Laura was a 12% shareholder before she purchased the additional stock on March 16, so the rule applies to her. As mentioned above, ChipCo trades on two national stock exchanges. Because Laura bought stock at a lower price than for which she sold within a six month window, she violated Rule 16. Here, however, she is not required to disgorge the profits on the shares that she owned prior to March 16.

10b-5 - Laura is also probably liable for violation of Rule 10b-5 on two grounds.

First, like Sally, Laura owed a fiduciary duty to the corporation and was under a duty not to trade on inside information unless she disclosed it. Because she knew the information she learned in the conference call was material, she could not buy additional stock without disclosure. Since Laura used the instrumentality of commerce when she used the telephone call to her broker. Therefore, she violated Rule 10(b)5.

She may also have violated 10(b)5 in disclosing that ChipCo had developed new technology to Arnold. "Tippers" are liable under 10(b)5 when they have a fiduciary duty to a corporation that they breach by disclosing material information to a third party for an improper purpose.

Here, as an attorney for ChipCo, Laura had a fiduciary duty to the corporation. She breached that duty by disclosing material information (one a reasonable investor would deem important) to Arnold. It is unclear whether her purpose was improper; courts typically look to see if the "Tipper" received some benefit in making the tip. The benefit need must be pecuniary; here, it might be argued that Laura benefited by assuming the esteem of a fellow attorney or might have been seeking either reciprocal treatment, or else special consideration in the case in which she was dealing with Arnold. In any case Arnold relied on her tip and bought some of ChipCo's stock. Therefore, if the court thinks that Laura gave the tip for an improper purpose, she violated 1065 in this second respect as well.

3) <u>Arnold</u> - Rule 10(b)5 - Arnold might be subject to 10(b)5 liability as a "Tippee." Tippees violate Rule 10(b)5 when they receive a tip from a person who owes a fiduciary duty to the issuing corporation, knowing that the Tipper has breached the fiduciary duty, and subsequently buy or sell in reliance on the tip.

Here Arnold received the tip from Laura, who was in a fiduciary relationship with ChipCo. Arnold probably knew that the tip was a breach of fiduciary duty; he knew that Laura was ChipCo's attorney, and he is himself an attorney and must be familiar with what is required in the way of fiduciary duties. Finally, relying on the improper tip, he purchased some of ChipCo's stock. Again, he used the phone, an instrumentality of interstate commerce, to call his broker.

However, it is important to note that Arnold cannot be held to have violated Rule 10(b)5 unless Laura also did so; that is, there can be no tippee liability without a tipper, so all the elements of Laura's liability must be satisfied first.

4) <u>ChipCo</u> - Rule 10(b)5 - ChipCo may have violated Rule 10(b)5 by issuing the press release. Rule 10(b)5 prohibits fraudulent misrepresentations in connection with buying or selling stock using the instrumentality of interstate commerce. The misrepresentation must be

material as well.

Here the news release may or may not have been fraudulent. It merely says that "ChipCo has not developed commercially viable technology." In a strict sense, this is true, since the facts state that Sally knew it was not commercially viable. However, a court might find that ChipCo intended to mislead the general public in making the statement. Furthermore, ChipCo was actively acquiring its own stock, knowing that the technology would soon be released. Because it was buying and its statement led to stockholders selling ChipCo stock, that element has been satisfied as well.

The misrepresentation was obviously material and relied upon since after the announcement, the price of the stock plummeted.

Finally, since ChipCo is traded on a national exchange, an instrumentality of interstate commerce was involved. Therefore ChipCo has in all likelihood violated Rule 10(b)5.

July 1974
QUESTION NO. 3

Dinaco is a manufacturing company whose stock is traded on the New York Stock Exchange. Women on the March (WOM) is a non-profit corporation organized by women employees of Dinaco. On March 1, 1973, Dinaco's board of directors, by an 8 to I vote, rejected a request by WOM that Dinaco revise its personnel and promotion policies to comply with a recently enacted federal statute granting equal employment rights to women. X, the dissenting director, told the board that a carefully documented study prepared by WOM demonstrated that Dinaco was not complying with the statute and that the statute grants treble damages to employees who have been the victims of discrimination.

A suit was brought by WOM against Dinaco on behalf of all women employees of Dinaco to recover damages for violations of the equal employment rights statute. In January, 1974, a verdict for $2,000,000 was rendered in that suit against Dinaco and in favor of its women employees for violations of the statute after March 1, 1973. The verdict was trebled by the court and judgment entered against Dinaco for $6,000,000. The judgment has been paid by Dinaco.

In February, 1974, WOM made its first purchase of shares of Dinaco stock. WOM now consults you and wants to know:

(1) Can it bring an action on behalf of Dinaco against all Dinaco directors in office on March 1, 1973 and recover from them the damages paid by Dinaco, and

(2) Can it require Dinaco to insert in the proxy statement for the next annual meeting of shareholders the following proposals: "That the officers and directors of Dinaco be directed (a) to take affirmative action over and above that required by law to redress wrongs resulting from past discriminatory employment practices, and (b) not to pay any bonus to any director, officer or employee who was responsible for the adoption or administration of past discriminatory employment practices"?

What advice would you give WOM? Discuss.

Answer A to Question 3

I. Shareholder Derivative Suit

There are a variety of procedural problems standing in the way of a shareholder derivative suit by WOM, but if these problems are surmounted, recovery against the directors is possible.

The general rule on shareholder derivative suits requires that the action may only be brought by shareholders who were held stock at the time of the wrong as well as at the time suit is brought. The facts state that WOM acquired shares only after the recovery for discrimination. If this rule is strictly followed, then, the suit could not be brought.

It is possible that shareholders not holding stock at the time of the wrong may bring suit if they acquire stock from someone who dissented from the wrongful action. Usually such acquisition must be by operation of law, however, and at any rate no facts support this theory.

Another possibility is that the individual members of WOM each owned shares at the time of the wrong. Since all the members are employees this would not be unusual. If so, perhaps WOM could be seen as the representative of these shareholders and the head of a class action.

Although a court would probably award damages of the full $6,000,000 in a successful suit (actual and foreseeable harm caused by the directors) it might weigh against the claims of WOM, the fact that its members recovered all the money and thus aren't badly hurt.

If WOM were able to bring a derivative suit, it is likely that it would not be necessary to make a demand upon the directors first because such a demand would surely be futile. In some states it would be necessary to make a demand upon all the shareholders to give them a chance to ratify the action, but that is a minority rule.

If WOM surmounted its standing and procedural problems, arguably it could recover from the directors on behalf of the corporation. All necessary formalities for the rejection of the original WOM request appear to have been observed.

It could be argued that by failing to comply with the discrimination statute, the Board of Directors committed an ultra vires act and thus should be held liable. Ultra vires, however, does not refer to the breaking of the law by the corporation but to conducting activities outside the proper scope of corporate powers. Arguably, discrimination is outside proper corporate purposes and the directors are liable on this theory.

A better argument could be raised that the directors breached their duty of care to the corporation. Not only did they (negligently or purposefully) allow the corporation to violate the law and suffer a judgment on that account, but they were warned of the violation in a "carefully documented study," X could not be held liable because of his dissenting vote, but a case seems stated against the rest of the directors, at the very least for not reading the study and investigating further.

The directors might raise a defense of good faith "business judgment." The argument would be that they did consider the grounds of liability alleged and decided honestly that they were groundless. Although the law is sometimes far from clear, the facts given here seem to indicate that the directors should have taken the report more seriously and should thus be liable.

II. Proxy Statement

WOM now owns stock and thus is in a position to request that certain matters be included in the corporation's proxy statement. Dinaco is traded on the New York Stock Exchange and thus is subject to Section 14 of the Securities Act of 1934 which regulates proxy policies.

Section 14 requires the directors to include shareholder proposals in the proxy statement, subject to certain exceptions. Dinaco would probably not be able to successfully argue that the proposals are matters of general social policy not substantially related to the company. The proposal for affirmative action comes closest to this position but still seems directly related to Dinaco and its recent problems.

Dinaco would probably argue that the resolutions do not relate to a proper course of conduct. Here it would be suggested that shareholders may not tell the directors how to run the company and that it is fully within the Board's sole powers to determine hiring and salary policies. The proposal does request action beyond that required by law; moreover, past wrongs have presumably already been redressed by the award of damages. Also, the proposal to deny bonuses relates to a matter usually within the board's discretion and power. Bonuses usually can't be paid to directors for their services as such and the past discriminatory policies were probably the responsibility of the directors for the most part.

Perhaps the best advice for WOM would be to rephrase their proposals to be statements of company policy rather than directives about particular matters.

Dinaco could also argue against the proposals that they relate to the <u>day to day business operations</u> of the company and therefore need not appear on the proxy statement. This argument is closely related to the one above about matters which are proper for shareholder directive and should be treated the same way. Hiring practices and the payment of bonuses are on the borderline between general corporate policies and day to day operations.

<u>Conclusion</u>

WOM should be advised that in its present posture, the shareholder derivative suit probably cannot be maintained. Shareholders who owned stock at the time of the wrong should be sought out and suit brought in their name.. Recovery is fairly likely except against X.

It is uncertain whether or not the proposals as submitted would be required to be put on a proxy statement. A declaratory ruling from the SEC might be sought or the proposals might be rephrased. It is also possible that the proposals are unnecessary (the one contra bonuses) to some extent.

Answer B to Question 3

(1) Normally a shareholder's derivative suit may be brought only by a person holding shares at the time of the wrong to be sued on. WOM did not become a shareholder until nearly a year later. This is not an ironclad rule, however, and will not bar a derivative suit in types of situations where the corporation's failure to bring the suit itself is harming present shareholders regardless of when they assumed shareholder status. This case has elements pointing either way: the judgment was paid <u>before</u> WOM became a shareholder and so its payment did not harm WOM; yet present recovery of $6 million for Dinaco would clearly benefit all present shareholders, including WOM.

Before bringing a derivative action demand must be made on the directors to bring the suit unless such demand is futile. Here WOM apparently has not demanded that Dinaco sue on its own behalf, but it if many of the March 1, 1973 directors are still on the Board, and especially if they are still a majority, demand would meet the futility test.

A much more serious flaw in WOM's derivative suit is that a derivative suit asserts the rights of the <u>corporation,</u> not the <u>shareholders,</u> against the defendant. Here the Dynaco may not have a cause of action against the directors. The Directors clearly have a fiduciary duty, to the corporation, not to steal corporate opportunities or otherwise engage in self-dealing. What is involved here, however, if any breach at all, is <u>negligence.</u> Directors' negligence may be a breach of duty to the shareholders rather than the corporation, in which case WOM should bring another class action on behalf of shareholders, not on behalf of the corporation. (Such an action would again be problematical since WOM was not a shareholder at the time of the directors' tort. Yet the harm continues in the form of an unrecovered, potentially recoverable sum. Still, the damages would seem more appropriately recoverable by shareholders at the time the judgment was paid<u>.)</u>

If X told the directors before the vote about the employment discrimination documentation, it would seem they were negligent in voting against the proposal. Yet the directors' attorney might make an argument based on a cynical view of modern business morality that it is not negligent for a director to vote to violate the law when his best judgment is that the corporation can get away with it - immoral and illegal, perhaps, but not <u>negligent.</u>

Also, WOM would have to prove that the judgment would-have been avoided by adoption of the resolution - perhaps part of the judgment covered earlier discrimination.

X is not liable, because he dissented.

(2) These proposals probably need not be included in management's proxy statement because the wording <u>**directing**</u> the officers and directors to take certain steps may not be a proper subject of shareholder's authority. This argument against the proposal is much stronger for the second part than the first, because the payment of bonuses is rather firmly committed to the discretion
of management (officers and directors), not ownership (shareholders). (Parenthetically, directors are not salaried qua directors and query whether the corporation has power to pay them a

bonus.) While Dinaco might argue that the first part of the proposal may be excluded under the SEC's proxy rules because it is an expression of general social concern, I think this proposal is well tailored to the corporation's business activities and thus could not be excluded on that basis.

Of course WOM must meet the procedural requirements for proxy resolutions, including timeliness, number of shares held, etc.

The proposal would be more entitled to inclusion were it worded as a resolution recommending to the officers and directors that they take these actions. In particular, this would certainly solve the problem of the shareholders' role and power to direct these actions, since shareholders definitely have at least the power to recommend nearly anything to management.

July 1979

QUESTION NO. 9

Jax, Inc. was incorporated in 1969 with 2,500 shares of common stock at a par value of $100 per share authorized. 2,200 shares of Jax stock have been issued and are outstanding. From 1969 through 1974, Jax has incurred net operating losses totalling $80,000. At the end of 1975, the corporation had net earnings of $25,000 for that year. The Jax board of directors, consisting of A, B, and C, met on February 16, 1976, and unanimously voted to declare a cash dividend of $10 per share on outstanding stock.

Pursuant to a by-law authorizing the board to appoint officers and committees, at the February meeting A, B, and C also unanimously voted to create an Executive and Finance Committee composed of B, C, and W. W was not a director or officer of Jax, but was a shareholder. The by-law permitted and the board resolution provided that the Committee would have all the powers of the board of directors.

On June 15, 1976, the board authorized the purchase by Jax of 200 shares of Jax stock held by D, at a price of $95 per share. D had indicated he was ready to sell them at that price to a competitor of Jax.

On July 18, 1976, the Executive and Finance Committee directed Jax to issue 100 shares of previously unissued stock to E, as "fully paid" shares in return for E's promissory note to Jax in the sum of $7,500. Such stock was issued to E for his note as described.

On August 31, 1976, as president of Jax, A wrote to F, a shop superintendent employed by the company who was retiring on his 65th birthday, as follows:

"In light of your years of faithful service to this company since it was established, I have decided that upon your retirement today, Jax will pay you a monthly pension of $300 for the rest of your life, so long as our financial condition warrants it."

X, a Jax shareholder, asks you to advise him on the legality of:

1. The declaration of the cash dividend.
2. The appointment of the Executive and Finance Committee.
3. The purchase of shares from D.
4. The issuance of the 100 shares to E.
5. The promise to F to pay him a monthly pension.

Discuss.

Answer A to Question 9

1) Declaration of cash dividend -- Dividends may be paid out of accumulated earnings, or in jurisdiction allowing it, out of paid-in-surplus in excess of par value. At the end of 1975, Jax had no earned surplus, but had est an accumulated $55,000 (80,000 - 25,000) and had a deficit earned surplus of that amount. Normally, dividend cannot be paid if such a deficit exists unless adequate paid-in-surplus exists to not only pay the dividend, but also to "cover" the deficit.

However, a numble dividend in the amount proposed of $22,000 (2200 x $10) which does not exceed the net earnings during the proceeding fiscal period of 1975 of $25,000 may be allowable. This exception is allowed in an effort to not penalize the company for an inordinate period of time for start-up type losses, and based upon the idea that although creditors are deserving of protection from unwarranted depletion of corporate assets, they will not be injured by such a nimble dividend.

Such a dividend must also pass muster with the business judgement rule -where the Board of Directors has a good faith belief that such a dividend is possible and advisable, and that-The dividend must also not lead to or be declared during insolvency (where assets are greater than liabilities or cause the corporation to be unable to meet its obligations as they fall due).

(2) Executive and Finance Committee -- An executive committee may be established by the board to handle all ordinary business of the corporation in between scheduled Board of Directors meetings. Since the Board can delegate such responsibilities and they have the power over corporate finances, they may also obligate the power to a joint executive and finance committee.

However, a Board cannot delegate away all of its responsibility or authority. The shareholders here elected the Board and entrusted in them the operation and responsibility for the operation of the company. The Board cannot merely resolve the committee to have all of its power, but merely delegate the more usual types of operating decisions and powers. If the Board did so delegate, a small appointive group could make large decisions (liquidation, issuance of shares, mergers) which are reserved solely to the Board.

Further, since the executive committee is merely an extention of the Board in order to facilitate day-to-day operations, it is to be comprised of Board of Directors members. Although W as a shareholder surely has an interest in the function of the Board and the Executive Committee, he should be precluded from being on the executive committee itself.

(3) Purchase of D shares - A corporation may reacquire shares of its own outstanding stock held by its shareholders for whatever reasonable price in the business judgment of the corporate director is sound. Here, Jax acquisition of 200 shares, called treasury shares would normally be totally permissible. The reacquisition may even appear to be a good investment since the $95 price was less than par.

However, if the sole reason for reacquisition is to prevent transfer to a particular individual, the Board motive is suspect. If Jax is a close corporation such a move may be defensible in order to restrict the shareholders to a well defined group. But reacquisition of a minority block of stock in order to prevent a competitor from acquiring on interest may be a suspect motive. If a boards sole motive is to prevent a takeover, this is not a proper judgment unless accompanied by the belief that the purchaser is a "corporate raider" which may drain the corporation of its liquid assets or opportunities and usurp its opportunities.

The purchase of the shares for $19,000 (95 x 200) however appears to the be prohibited. Since treasury shares are construed to be acquired by the distribution of earnings to the shareholders, Jax must have adequate accumulated surplus to reacquire such shares. Jax has an accumulated deficit, and the nimble dividend exception has already used up current years earnings. Therefore unless adequate paid-in-surplus exists, Jax cannot reacquire the shares from D as it would violate corporate law.

(4) Issuance to E -- The corporation may issue stock for adequate consideration as authorized in its articles of incorporation. E is purchasing 100 shares of previously unissued stock. (Note: so preemptive rights apply to the other shareholders since the 100 shares are part of the originally authorized shares that remained unissued).

Consideration for shares issued must be quantitatively and qualitatively adequate. The issuance of 100 shares for $75 is less than the $100 par value and is presumptively inadequate. The discount of $25 per share normally creates a right of recovery for the discount amount since the share is construed as not being fully paid for, unless, in the Boards business judgment, the $75 is a fair price and more could not be obtained on the market. Such a discount creates a right in creditors to sue the holder of such discounted shares to the extent of the discount (sometimes called "water") under the creditor theory, or alternatively under the statutory obligation theory to entitle the corporation to recover the discount.

Here some discount appears to be present because of the disparity between the $95 6/15/76 reacquisition price and the $75 6/18/76 issuance price.

Further the quality of the considerations, being an unpaid note is generally regarded as inadequate consideration for the issuance of "fully paid" shares. The remedy to the corporation is to either demand the payment on the note or to cancel the shares.

(5) F's pension -- As president, A can hire and fire and set salaries and benefits of employees based upon his actual express and apparent authority. However, since there is no consideration given for F's pension because it is promised only in return for F's past service, the offer or pension promise is unsupported by consideration and is not enforceable. It amounts to nothing more than an offer to a future gift. A has not requested or made the pension contingent on the rendering of any future services, therefor it also exceeds his power.

X could advance the above argument in a stockholders derivative suit whereby after making a demand of the Board or Shareholders (which upon a showing that such a demand would be denied and therefor be meaningless) he may derivatively exert the corporations right against the above parties. Note, since X is only injured by the above actions incidentally as a result of his stockholder status he is likely limited to a derivative suit.

Answer B to Question 9 1. the cash dividend

The legality of the cash dividend depends upon the state's statute specifying the lawful sources of cash dividends, in order to protect creditors and senior shareholders.

All jurisdictions permit they payment of dividends from earned surplus, which is the corporation's total historical net profits, less any previous dividends. Jax, with a net loss of $80,000 through 1974 and 1975 earnings of $25,000, has no earned surplus from which dividends could be paid. The rule can also be phrased as no impairment of capital.

Some jurisdictions permit dividends out of reduction surplus, derived from a downward revaluation of par values. No such action was taken here. A few states permit payment out of re-evaluation (or upward re-valuing of assets) surplus. This is not evident here. Some states permit the use of paid-insurplus, also not apparent here.

The only possible lawful source would exist in a jurisdiction which permits dividends to be paid when there is a current year's profit, despite a negative earned-surplus account. This is the so-called nimble dividend. If the jurisdiction permits nimble dividends, the $10/share dividend (falling within the $25,000 total) would be lawful. Assuming -- that this is a majority jurisdiction -- nimble dividends would not be allowed and the cash dividend would be unlawful.

If so, the directors and any stockholders would be liable if the corporation becomes insolvent.

2. The Executive and Finance Committee

The general rule is that management and control functions are vested in the board of directors, with delegation of such functions narrowly circumscribed.

It is, however, generally permitted for a board to designate committees and Jax's by-laws allow this.

There are two objections to the instant arrangement, however. While a board may create committees for ad hoc purposes or to function between meetings of the board, it is an impermissibly broad delegation to give a committee "all of the powers of the board of directors."

Secondly, the appointment of an outsider -- whether or not a shareholder raises objections, at common law, outsiders could not be granted board powers Modernly, statutes may permit the granting of such authority for a limited period or for a limited purpose. Here, including W on a committee with broad and sweeping powers would be unlawful.

Conceptually, -- the board is adding a fourth, unelected "director" -clearly a violation.

3. The purchase of shares from D

In general, a corporation may are met.

First, there must be a lawful source of funds for the repurchase. The argument is similar to that involved in the declaration of dividends. Paying out funds -- here, to D -- puts corporate assets beyond the reach of creditors, preferred shareholders, if any, -- and other common shareholders, -- The rules are parallel to those for dividends.

Jax has no earned surplus nor any other lawful source of funds for the repurchase from D, unless the jurisdiction's statute would make the 1975 earnings available.

The parallel situation is easily seen if such a repurchase is viewed as a non-pro-rata dividend.

Second, the motive for were available. The repurchase possible to see either a motive desire to keep the stock out of
such a repurchase would be relevant assuming funds must serve a corporate purpose. Here, it is to benefit D (not a legitimate motive) or a the hands of the competitor of Jax.

The latter motive might support a finding of corporate purpose if it can be shown the competitor poses some threat -- e.g, is planning to take-over of Jax. Such a showing is not deducible from the facts of the problem. Indeed, the fact that fewer than 10% of the outstanding shares were involved makes corporate purpose unlikely.

The doubtful motive and probable lack of lawful funds make the purchase from D illegal.

4. The issuance of 100 shares to E

The general rule is that a corporation may not issue its shares for consideration which is inadequate in either quality or quantity.

As to quality of consideration -- cash, the cancellation of a debt, past services or a fully-secured promissory note would be of lawful quality. Here, there is mention only of "E's promissory note." If the note is unsecured, it is not lawful consideration for the 100 shares of stock.

As to quantity of consideration, the general rule is that par value stock may not be issued for less than par value (and no-par stock must be issued at least at stated value, if any). Here, the par value is $100 a share. The issuance to E at $75 a share would be unlawful discount stock.

However, if the board of directors concludes that a discounted price is the best that it can receive for its stock, it may be permitted to issue on these terms. The question is the standard by which its decision is to be judged.

A majority of states apply a good-faith test, so that the good faith judgment of the board would be acceptable. Some jurisdictions require a more strict test, similar to the true value test for valuing property acquired for stock. Here, the evidence that there is a market at $95 a share (based on D's possible deal with a competitor) would be relevant.

Quite apart from the amount, in any case, the inadequate quality would make the issuance to E unlawful.

Further, there is the question -- dealt with in #2 -- of the authority of the Committee to authorize the issuance of shares, which is normally the function of the board of directors.

5. The pension for F

Two objections would be raised: the authority of A to grant a pension and the retroactive compensation/gift nature of such a pension.

A, as Jax president, has whatever express authority the board grants him plus the authority of the presidential office to transact ordinary and routine business.

The argument would be that the granting of a pension would not fall within the limits of ordinary business, assuming this was not a standard company policy. Thus, A's acts would be beyond his authority and would not bind the company.

Second, <u>even</u> <u>if</u> the <u>board</u> were to grant such a pension, it could be objected to as <u>ultra vires</u> beyond the scope of its powers.

The board may not make a <u>gift</u> of corporate funds, unless it would clearly serve a corporate purpose. Pension plans, of course, serve a purpose in terms of retaining employees. However, a pension declared for the first time at the time of retirement would not serve any purpose relative to F. It might motivate other employees to stay with Jax; the connection is tenuous.

Compensation must bear some relation to the value of the services to the company. Retroactive compensation (which is what F's pension would really be) is especially subject to careful scrutiny.

The pension to F is probably illegal.

Fall 1978
QUESTION NO. 9

The following actions were taken pursuant to the unanimous vote of the directors of Ajax, a corporation:

I . In an effort to prevent a minority shareholder from acquiring control, Ajax purchased shares from three shareholders at their asking price of S80 per share. At the time, Ajax's shares had a book value of S92 and a market value of S75 per share.

2. After it was announced that Bob, the long-time treasurer for Ajax, was retiring. Ajax agreed to pay Bob S5.000 annually during his life-time.

3. Ajax agreed to pay the legal fees and costs of Curt, a vice-president, who was being sued in a shareholders' derivative action for making political contributions from corporate funds to foreign corporations with whom Ajax did business.

4. Ajax adopted a stock option plan for all officers and directors, and issued the first set of options.

Pat owns 100 Ajax shares which he acquired before the above events took place. He purchased 50 additional shares two months ago, but has been unable to have the shares transferred to his name because, according to the corporate secretary, the shares are subject to a restrictive shareholders' agreement preventing the transfer. No such restriction appears upon the Ajax stock certificates, including those in Pat's name representing his earlier shareholdings.

Pat feels that all the above described actions by Ajax and its directors have violated his rights as a shareholder and damaged him. He also wants to know if he is entitled to have the additional 50 shares of Ajax stock registered in his name.

(1) Does Pat have any claim for relief with respect to each of the above described actions taken by Ajax? Discuss.

(2) Does Pat have a right to have the 50 shares of Ajax stock registered in his name? Discuss.

Answer A to Question 9

Can P bring a derivative action?

Harms that are direct to the Corporation rather than the Shareholder must be brought as derivative actions.

Actions which allege breaches of fiduciary duties, waste, excessive compensation are harms to the corporation. P must seek to bring a derivative action against the Board of Directors.

Procedural requirements

Demand

A demand must be made on the directors to bring suit, unless such demand would be futile.

Here, the directors unanimously voted the actions subject of the suit, thus demand would be excused as being futile since it unlikely that the directors would vote to sue themselves after taking such concerted action.

In some jurisdictions, demand must be made on the shareholders. This usually occurs where the shareholders vest the right "ratify" the directors alleged wrong, e.g., waste of corporate assets.

Considering the allegations here, however, probably similarly excused.

Contemporaneous Ownership

P must usually own the stock at the time the wrong occurred (unless it is a continuing wrong) prior to bringing suit. P did own 100 shares at all times described in the facts, so P can now go to court.

Contract of Corporation

Generally, the Board (the corp) is prohibited from buying its own stock to maintain control. Unless a good faith, reasonable business judgment (described in detail infra) exist e.g. to prevent a looter from acquiring control, the corp cannot buy its own stock to assure control. P could claim that
demand on the shareholders is the corporation lost $5 a share to maintain control and that the directors are liable.

The directors, on the other hand, would retort that market value is only $75/share and $5 a share is a reasonable price to assure that the corp. isn't done harm by a looter. (There being no threat on the presumed facts, the
control attempt is improper).

Breach of duty of care & loyalty

Directors are not responsible for business losses flowing from good faith, _reasonable business decisions. This is the so-called business judgment rule.

P will allege that the directors breached their duty of care in actin unreasonably in spending Corporate funds above market price merely to maintain control. The directors will have a defense if they can show a reasonable business judgment as described supra.

Duty of loyalty

The directors owe a duty of good faith to act in the broad interests of the corporation and not in a self-serving manner.

If the sole purpose in buying the stock was to maintain control, in absence of a justification therefore, the directors will have breached their duty of loyalty since they were concerned only with their personal retention of their positions as directors.

Waste

The unnecessary expenditure of Corporate funds might arguably constitute a waste of corporate assets which will later be recoverable in damages from the directors.

Bob's Pension

Pensions raise the issues of waste, compensation, and duties of care. Normally, compensation must be for work done or to be done, must be reasonable vis a vis the job, and cannot be retroactive.

Here, P could attach the $5,000 pension plan as a waste of corporate assets since the corporation will receive nothing in return for their future payments.

Where there is no consideration for the corporation's agreement (e.g. future services, goodwill, etc.) the Act will probably constitute an ultravires act (beyond the power) of the corporation. Since Bob was not given the money in anticipation of future services (he announced he was retiring) the foregoing analysis would render the pension improper.

Loyalty & Care

The discussions in these regards are similar to those described previously. The directors are personally liable for breaches of their fiduciary duties, and unless they are covered by the business judgment rule (probably wouldn't be here for reasons described) they are liable for all proximately caused losses.

Legal fees

P will argue that the corporation paying fees for Curt is waste, in breach of fiduciary duties of care & loyalty and is improper.

Curt may be protected under the BJR if he can establish that the corporation benefited (albeit even illegally) from making foreign contributions.

The underlying analysis would have to determine whether the acts of C were improper. Chances are they were reasonable, tho shady, and no fiduciary duties were breached.

The reimbursement of costs to an officer for conduct on behalf of the corporation is permitted, since officers act as agents of the corp, and it is only fair that the corp bear the cost of official corp. policy.

Legal fees are slightly different since the corporation in C's suit was the nominal D but actual P, that is, the derivative suit was brought against C on behalf of the corp. It is illogical to expect the theoretical P-corp to pay the D's costs when the P wins (if he does).

Nevertheless, most jd's allow the officers and directors to recoup such costs and fees if they (the officers) are successful.

Some jd's even allow the losing directors and officers to reimbursement.
Stock Plan

The stock plan raises similar issues as to compensation since options are a form of compensation.

A stock option plan will be deemed proper and not considered a waste of assets, where the corp receives a benefit.

The continued employment of officers is such a benefit and would be approved.

For directors?

This presents a slightly different problem since directors generally serve without compensation.

When the directors voted unanimously to allow themselves stock options they created to problems P will want to argue.

(1) Interested directors?

An interested director is one who is dealing with his own corp. At common law the corp could avoid the transactions. This may be such a case since all the directors voted themselves a form of compensation. Modernly, such deals will be upheld where (1) disclosure and approval by the shareholders or (2) inherently fair. The directors bear the burden of proving the fairness of this transaction.

Loyalty?

Duty of loyalty may have been breached by self-serving directors not acting on behalf of broad interests of corp.

Restrictive Stock Agreements

Restrictions on stock agreements must be reasonable and notice given to the shareholder purchasing the same.

Reasonable restrictions such as right of first refusals are generally upheld.

No notice was given on the certificate as required in most jurisdictions, thus the restriction is probably void.

Name registered

Shareholders have the right to hold stocks in their names and be registered accordingly. Since no reason exists to prevent the transfer (see above) the name of P should be entered.

Equity will enforce this recording since there is no adequate remedy, at law and a property right protectable in equity exists.

Answer B to Question 9

(1) Pat's claims for relief, if any, should probably be brought in the form of a stockholder's derivative suit, naming Ajax as a nominal defendant. Here, given unanimous action by the board of directors, he need not request their bringing the suit since such request would be pointless. Also, he owned stock at the time of each event giving rise to a claim (under the first 4 paragraphs . His only concern might be with respect to the requirement of posting bond.

(1) Repurchase

The threshold issue is whether such repurchase was permitted by the terms of the stock authorization. (Unlike a redemption, which need be included in the articles of incorporation,) a repurchase authority derives from the terms of the issuance). There are no facts given; I assume such a provision was included.

The next issue, also quickly disposed of due to lack of facts, is whether the corporation had property which it could permissibly utilize in order to effect a repurchase. Such may never be made out of stated capital, may always be made out of earned surplus, may often (depending on the jurisdiction) be made out of capital (or paid-in) surplus and/or reduction surplus, and may rarely (only in a few states) be made out of revaluation surplus. Of course, it may never be made out of any account if its effect would be to render Ajax insolvent.

There are really only two clear issues raised by the repurchase: (1) impermissible purpose and (2) price paid (waste).

A repurchase may not be made in order to perpetuate control (prevent a minority or outsider from gaining control). However, often courts find a legitimate corporate purpose to fending off such a challenge, especially where the group seeking control are looters. We know nothing of such purpose here and it appears that the repurchase violated the director's fiduciary duties to the rest of the shareholders* and the corporation. * In some states the directors' fiduciary duty is said to extent only to the corporation, absent special circumstances.

Directors are permitted to sell stock for less than par where they have made a good faith valuation. Here they are purchasing. Assuming this is a public corporation with an active market in its shares, it is at least questionable whether the directors have not committed waste by paying a $5 premium per share for control. (a corporate asset) It is a close question and the $92 book value is a factor they may consider.

(2) Paying Bob (the retiring treasurer) $5,000 a year for life presents an issue of corporate waste, Bob presumably is not a director. If the board determines to pay what is in essence a modest retirement stipend to a long-time employee, it probably is within the board's discretion. While directors' compensation for ordinary services must be fixed in advance, here we are dealing with neither a director nor compensation for past services. (NOTE: An argument can be made that that is precisely what is involved - past services. The line between corporate waste and legitimate board action is often difficult to draw.)

(3) Agreeing to pay Curt's legal fees and costs presents a major problem. First, indemnification of directors, while permitted in most jurisdictions even if the director loses, typically awaits the outcome of the legal action (unless the corporation has properly purchased indemnification insurance which obliges the insurer to pay as fees accrue). Here, the facts are ambiguous - but one thing that is clear is that the board has committed itself to paying Curt's fees before knowing the outcome. Moreover, Curt is being sued by the stockholders, not some outsider. Thus, the issue of Curt's violation of duties owed the corporation is implicated in a way not usually involved where he is pressing the corporation's interests against the outsider.

However, here we have an additional factor: Curt is being sued for making political contributions to foreign corporation. Frankly, this fact doesn't make a lot of sense.

If such are illegal, then public policy may prohibit indemnification. Pat appears to have a good claim for relief on this point.

(4) The stock option plan almost certainly requires shareholder approval, at least as regards its applicability to the directors. One other concern here must be with Pre-emptive rights should this option require a new authorization (only accomplished by amendment of the articles). Also the problem here is that the board is not disinterested in the options it votes itself. To be sure, there is nothing inherently wrong with compensation in stock; however, options can create problems of discount or watered or even bonus **stock.** It is difficult to evaluate the option for fairness since its terms are not given.

(2) Pat wants the corporation to register his additional 50 shares. The corporation's refusal is based on the existence of a "restrictive shareholders' agreement." If Ajax is a large public corporation, such an agreement restricting transferability probably constitutes an unlawful restraint on alienation. If Ajax is a close corporation, on the other hand, if the restrictions are reasonable, they will be upheld in most jurisdictions.

The fact that the restriction does not appear on the stock certificates is relevant to Pat's status as a bona fide purchaser for value (i.e., without notice). If he qualifies, the corporation must register the shares in his name. The other signatories to the agreement may have an action against the seller, but not against Pat.

Spring 1978

QUESTION NO. 6

Hal owns 40% of the outstanding stock in Parco; the remaining 60% is owned by approximately 25 people, none of whom owns more than 6% of such stock. Hal has working control of Parco, and at each annual shareholders' meeting has been able to assure the election of himself, Art, and Bill, to the board of directors. For the past six years, Art and Bill have delegated their powers as directors to Hal through the annual execution of a "directors' agreement," which each year has been approved by the majority vote of Parco's shareholders.

A number of Parco's minority shareholders are concerned about Hal's domination of the corporation, and have made known their intention to attempt to gain control from Hal, at the next annual shareholders' meeting. Hal countered by causing the 5-man board of directors to (a) redeem 12% of the outstanding stock from Fred, the most vocal dissident shareholder, and (b) issue to Hal at the existing market price, sufficient previously-authorized but unissued shares to assure him of ownership of 51% of the authorized shares.

With control of Parco thus acquired, Hal subsequently entered into a contract to sell all of his stock in Parco to Curt, who owns no Parco stock, at a price approximately twice that of the market price at the time the contract was made with Curt.

Decide and discuss the following:

1. Is the "directors' agreement" between Hal, Art, and Bill, valid?
2. Was the redemption of 12% of Parco's stock from Fred a lawful act`?
3. Was the sale of additional Parco stock to Hal a lawful act?
4. May Hal retain the entire proceeds of the sale of his stock to Curt? If not, how should the proceeds be distributed?

Answer A to Question 6

Director's Agreement

At common law, directors' could not delegate away their duties to direct the corporation. This is still today the majority rule with the exception of close corporations. In the case of close corporations, directors are allowed to enter into certain limited agreements regarding how they will vote as directors.

However, this exception is not likely to be applied in the present circumstance. It is usually applied only in those instances when the board of directors own all of the stock of the corporation and the corporation does not perform all of the formalities of a corporation (e.g. holding shareholders meetings, notice, etc.). Here, the directors do not own all of the shares in the corporation nor is there any indication that all of the formalities of the corporate form of business are not being met. Therefore this agreement, which violates the directors duty of due care is likely to be found void, not simply voidable and the directors who have signed it remain liable for any breaches of duty that arise.

The fact that this agreement has been approved by the majority of shareholders has no bearing on this analysis. Even if such an agreement could be approved by the shareholders, it would have to be a unanimous vote not simply majority vote. Certainly those shareholders who did not approve the agreement are not bound by it, and if the agreement is void at its inception neither are those who approved of it.

Redemption of 12% of Parco's stock

As a general proposition, corporations are permitted to acquire and redeem outstanding shares in themselves, at least so long as the acquisition or redemption does not leave the corporation insolvent by either the equity or bankruptcy tests and the funds used for acquisition or redemption come from an appropriate capital source (e.g. retained earnings).

However, this general proposition is limited by the rule that such acquisitions or redemptions must be for a proper purpose. The proper purpose test is not met here. The facts make it evident that Hal caused the shares to be redeemed to retain control of the corporation and to attempt to prevent Fred from continuing his dissenting action. Redemption for this purpose is not for the benefit of the corporation, they are for the benefit of Hal and as such, are improper.

In addition when redemptions do take place, they cannot be for the benefit of a single shareholder. The modern trend is to redeem pro rata or by lottery but not for a single person as here.

The facts state that no one other than Hal owns more than 6% of the stock of the company and yet 12% is said to have been redeemed from Hal. The results reached here are the same regardless of whether this is a typographical error or if only 12% of Fred's holdings of the company, or any other such grouping is found. Improper purpose makes any redemption improper.

Sale of Additional Parco Stock

The general rule is that a corporation may issue previously authorized shares of itself at any time. Of course, the shares must be issued for a proper and adequate consideration, but these tests are met here. The sale of stock to Hal for cash (apparently) is a proper consideration -- cash being a proper consideration. Moreover the sale at the existing market price is most likely an adequate consideration although this might be below par value. Even if it is, the majority rule allows such issuance.

But as discussed before with regard to redemption, issuance of shares must be done with a proper purpose, such as financing the corporations needs. Here no such purpose is met: the issuance was made to assure Hal control of the corporation and this is an improper purpose.

At common law, shareholders had preemptive rights and the sale of this stock to Hal without offering the other shareholders a chance to purchase as well pro rata based on their ownership interest -- the company might have been improper. But preemptive rights have been abolished -- many jurisdictions and where they have not been corporate charters can abolish them.

Hal's Retention of the Proceeds of Sale

The general rule is that a person may sell his shares to another and keep any control premium associated with his shares. However, this rule is limited by the Perlmatter case. Here it was held that a majority holder could not pocket for himself the premium associated with the sale of a corporate asset. In that case, the sale of the majority holder of his interest gave the buyer not only control of the company but also control of the company's source of steel at a time when steel was scarce. No facts indicate here that Hal has sold a corporate asset, but if he has, he will likely have to share the premium with the other shareholders (but not the purchaser).

Similarly, a majority holder has a duty to investigate the person he sells to to ascertain that this buyer is not a corporate looter. Failure to investigate a sale to a looter is a breach of shareholder duty. Again no facts indicate if the purchaser is a looter. If he is, again the sale premium will have to be shared with the other shareholders (but not the purchaser).

Please note: the above two instances that the sale should not include the additional shares issued to Hal. Also, given that no facts indicate that Curt is a looter or has bought a corporate asset, the general rule should apply and Hal will likely keep the control premium.

If, however, the remaining shareholders can show any harm to themselves they may be able to rely on the Ahmensen case to bring a suit, but this would be an extension of the courts' holding.

Answer B to Question 6

1. Director's Agreement

The director's agreement is invalid.

The traditional view is that delegation of authority to "Committees" is permissible where there is a proper purpose, and a limited amount of authority delegated. Here Art and Bill have delegated all of their authority and thus the "director's agreement" appears not a mere delegation to a committee, but
an actual agreement by all directors on how they will vote and act as directors (i.e. Art & Bill are effectively agreeing to vote on all matters as Hal dictates).

Such director's agreements are traditionally invalid. There has been a recent trend to uphold stockholders agreements in close corporations which dictate how they will vote as directors. However, even such stockholder pooling agreements have been upheld only where there is a proper purpose and limited infringement on the discretionary powers of the directors.

Under the circumstances, whether the "directors agreement" is considered a delegation of duties to a committee or an agreement on how to vote, its purpose seems improper, and it is a vast infringement on Art and Bill's discretionary powers to act.

That is, the sole purpose seems to be to delegate all authority to Hal, without checks or balances by other directors, since it gives Hal an effective 3 to 2 majority.

Furthermore, it is such a vast delegation of Art & Bill's authority so as to be improper. A director cannot totally delegate all of his duties. Perhaps some major management functions may be delegated, but certainly not all.

It should be noted that the stockholder ratification is insufficient in most states to permit ratification of such a delegation, since it is a breach of Art and Bill's duty of due care, which requires unanimous approval for ratification in most jurisdictions.

2. Redemption of 12% of Parco's Stock

This action seems unlawful for several reasons. Assuming a valid capital source, and that the redemption will not result in insolvency, the redemption
is an unlawful "spot" redemption, and a redemption for an unlawful purpose (preventing a contrary vote) and a possible violation of Rule 10(b)(5) if no disclosure was made as to the pending sale.

First of all, redemption from a single stockholder, and not from a class of stockholders is clearly unlawful. The statutory enactments in most jurisdictions permit redemption of a specific class of stock only. Indeed, even where redemption is permitted, if the redemption condition is not specifically indicated on the stock, such stock cannot be redeemed without a vote of the majority of the shareholders of that class. Thus, the redemption was clearly in violation of the state law of many jurisdictions.

Furthermore, the redemption is for an illegitimate purpose. Many states will permit the repurchase of stock to prevent a pending takeover, where matters of policy are concerned. However, here the directors are redeeming stock to prevent a shareholder election. Such an act (in addition to being a clear breach of director's duty of due care, and controlling shareholders duty of fairness) is probably unlawful under most state law.

Finally, such redemption will be in violation of Security and Exchange Rule 10 (b)(5) if there was knowledge of the pending sale which was not disclosed to Fred.

10 (b)(5) creates liability where, in connection with the sale of stock, there is a material misstatement or omission knowingly made by one of the parties.

Under these facts, if Hal knew of the pending sale to Curt, his failure to disclose it would probably result in 10(b) (5) liability since such knowledge would certainly be "material" (the knowledge of a pending sale twice market value). Since Fred is a "seller" (Albeit by force) 10(b)(5) liability is likely present in this instance.

3. Sale of Additional Parco Stock

Again, Rule 10(b)(5) may impose liability for this act. If there was no disclosure by Hal. In the recent Santa Fe Case, the U.S. Supreme Court held that 10(b)(5) liability will attach on or primary stock sales only if there is a material non-disclosure by one of the parties. Since Hal was both a director and a purchaser, there is a good argument that there was no 10(b)(5) liability since full "disclosure" was made to the corporation (of which Hal is a director) of any pending sale. However this argument is tenuous since the other directors may not have had knowledge of such a pending sale.

The sale is probably also "unlawful" for two additional reasons.
First of all, it is a "spot" release of authorized but unissued shares.

It is doubtful that applicable state law permits a release of unissued shares except through a general release to the public.

Furthermore, in many states there is a question of pre-emptive rights. Although pre-emptive rights normally apply only to newly authorized shares, the doctrine will be applied where authorized but unissued shares have been in existence forlong period of time,' or where there' are' changed circumstances, Thus, if the authorized but unissued stock which was sold to Hal has been authorized for several years, or if new circumstances have raised its value, there may have been pre-emptive rights in other stockholders, which were violated by the sale to Hal.

It should be noted, however, that many modern jurisdictions do not require pre-emptive rights by statute but leave such rights to the charter of the corporation.

4. Sale to Curt of Controlling Interest in Parco

Hal cannot retain all of the proceeds of Parco for a myriad of reasons.

First of all, since Hal is a controlling stockholder he is under a duty to investigate to see if Curt is a "looter". If the facts reveal Curt is such a looter, Hal may be liable to the other stockholders or the corporation for all of the proceeds.

Additionally, judging by the tremendous increase price, there is a possibility that the sale was not one of mere corporate control, but of a corporate asset. That is, a controlling stockholder is free to obtain a premium for his controlling interest in the corporation. However, where that premium is actually a disguised sale of assets, he is liable to the other stockholders (and possibly the corporation) for such excess profit. A closer examination of facts not given may reveal that Parco supplied some great need of Curt, and that the sale was really one of an asset, rather than stock.

Finally, Hal's actions in obtaining the additional stock and forcing the redemption was a clear breach of his fiduciary duty as a majority shareholder to deal fairly with other shareholders. That is, since he had a controlling interest, most jurisdiction would impose a fiduciary duty to deal fairly with other stockholders. Since Hal obtained his 51% controlling interest by breach of this duty (forcing Fred's redemption, unlawful sale of unissued shares) he should not be entitled to retain the "premium" received under any circumstances.

That is, even if he did not breach his duty by selling a disguised corporate asset, or sale to a looter, since the premium was obtained on the basis of his overwhelming 51% controlling interest, and since such interest was obtained in violation of his fiduciary duties to deal fairly, he should not be entitled to the premium.

How Distributed

The proceeds should be distributed prorata to all shareholders at the time of the sale. That is Hal, and all other stockholders should equally share in the premium.

Curt should not share since he was not a stock holder at the time of the sale, and indeed may have been fraudulent, or at least knowledgeable if he was a looter or if it was a disguised asset.

Spring 1978
QUESTION NO. 15

The directors of Motive, a corporation, mailed a notice of the annual shareholders' meeting specifying the order of business as "(1) Election of directors, and (2) such further business as may come before the meeting" together with proxy materials soliciting authorization for Scripps, the corporation's Secretary, to act as proxy at the meeting.

Motive manufactures combustion engines for power equipment. Its stock is not listed on any stock exchange. Its 2 million outstanding shares are held by about 300 shareholders. A quorum of shareholders consists of a majority of the outstanding shares, present by proxy or in person.

Only Char, the chairperson of the board of directors, owning 10,000 shares, Scripps owning 5,000 shares, Mr. Gad owning 1,000 shares and Mrs. Gad owning 1 share, were present in person at the meeting. Scripps held sufficient proxies, however, to establish a quorum. Gad had signed and mailed a proxy to Scripps covering his 1,000 shares; however, he announced at the meeting that he intended to vote his 1,000 shares in person.

At the meeting, after the election of directors was completed, Char, the duly elected chairperson of the meeting, asked if there was any further business to come before the meeting. Gad then made the following motion, duly seconded by Mrs. Gad:

"Resolved, that one-half of the firm's profits for the next year be devoted to research and development of pollution-free engines."

After the motion was made and seconded, and before any vote upon it, Scripps left the meeting. Immediately after Scripps left, Char unilaterally adjourned the meeting and left. Nevertheless, Mr. and Mrs. Gad remained, and both voted in favor of the motion.

Applicable state statutes allow the voting of shares by proxy and provide that at annual meetings directors may be elected and "any other business may be transacted which is within the powers of the shareholders." There are no other relevant statutory, charter or bylaw provisions.

Is the board of directors required to follow the Gad resolution. What result?

Discuss.

Answer A to Question 15 Proxy -

Revocable

A signed proxy gives the right to vote the shares to the proxy holder.

However, any time prior to the shareholders meeting that proxy may be revoked and voted by the shareholder unless the proxy is coupled with an interest or it is part of a pool or trust-arrangement. Since Gad showed up at the meeting and announced his intention to vote his shares and his proxy was not coupled with an interest or part of a pool or trust he could effectively revoke his proxy and vote his shares.

Resolution

Proper subject for shareholder action?

In resolving to use 1/2 the firms profits for research and development of pollution free engines, it could be argued this is not a proper subject for shareholder action. This is an environmental or social concern.

However, the action in this case should be proper in that motive is in the business of producing combustion engines for power equipment and since government regulations are getting more stringent on pollution they could gain a decided advantage **in** the market by having pollution free engines as well as meeting gov't standards.

On the other hand the decision as to what to do with the profits -whether to declare a dividend or to invest them in research and development is usually a board of directors decision. The shareholders cannot mandate the management of the business. The shareholders can elect the board of directors who in turn determine the business management o#' the company, The shareholders can amend the by-laws or vote on fundamental changes. While a resolution to devote money to research and development may be proper they
cannot restrict and mandate how much,

Absence of the quorum

Valid shareholder meetings need only have a quorum present to hold the meeting, However to pass the resolution would only require a majority of the quorum. When Scripps left the meeting he took the majority of the' quorum with him. However if a shareholder deliberately absents himself from a meeting to prevent the requisite votes he cannot deny the action.

In this case it doesn't establish deliberate action. His absence would merely be an abstention.

Adjournment

When Char adjourned unilaterally without a vote the meeting was not legally over.

Since the motion was made and seconded and Char's adjournment was not valid it seems a vote was proper.

Since a quorum is only necessary to convene the meeting and the meeting was still validly continuing Mr. & Mrs. Gad's vote in favor could carry the resolution. Most states require valid shareholder action by a majority of a quorum. Since the quorum was convened and there are no statutory provisions
as to vote requirements of the quorum and the meeting was not validly adjourned the vote of Mr. & Mrs. G was valid.

However I conclude that restricting the use of the profits and requiring the profits to be used for research and development is within the province of the board of directors and not the shareholders.

Notice

The notice of the annual shareholders meeting seems a little nebulous. Although it is an annual meeting and the notice states that directors will be elected it does not indicate what further business is expected. Since there may be none anticipated and this is not a Special meeting the directors need not write an agenda with specificity.

Proxy Solicitation

Since this corp, is not listed on a national exchange and does not have more than 500 shareholders it is not within the jurisdiction of the Security and exchange Act which requires specificity and no material omissions when management solicits proxies.

Answer B to Question 15

Whether the directors of Motive will be bound by Gad's resolution will depend upon whether it was validly adopted and, if it was, whether their discretion over affairs of management is thereby limited.

Was the meeting properly noticed?

Ordinarily, a general notice of a shareholders' meeting requires only a statement of time and place and, unlike a special meeting, the agenda need not delineate the specific matters to be considered for action. Therefore, assuming the time and place of the meeting were properly noted, the notice sent to the shareholders was sufficient.

Proxy Solicitation

Whether the solicitation is within the jurisdiction of Section 14 of the Securities Act of 1934 depends upon whether jurisdictional requirements are met. Motive is not traded on an exchange, but may still be governed by the section if involved in interstate trade and having at least 500 shareholders. Since fewer than the minimum number of shareholders exits; motive is not within the jurisdiction of that section.

However, general common law provides that, when management uses corporate funds to solicit proxies, it may do so only to vindicate or further concepts or programs of management, and not merely to maintain control. Thus, if the proxies were solicited to maintain control by Char and the other directors, all proxies so obtained would be invalid to constitute a quorum at the meeting.

Assuming, however, that a valid purpose existed for the solicitation, the proxies obtained would be valid.

May Gad Revoke His Proxy?

May a proxy validly solicited and given be later revoked? The general rule is that proxies are revocable by the shareholder, unless the proxy is coupled with an interest. Thus, G's proxy may have become irrevocable if, for instance, he was indebted to Scripps on the purchase of the shares. In such a case, his vote would have been ineffective unless cost under proxy by Scripps. No indication is given of such an interest, however, in which case the proxies could be validly pevoked, allowing G to vote his own shares.

The Quorum at the meeting

Motive's bylaws provide for the presence of a majority of shares either in person or by proxy. Since Scripps held sufficient proxies, there was a valid quorum to conduct business.

Once the commencement of business with a valid quorum, may shareholders or proxy holders destroy that quorum by walking out of the meeting? Such conduct is not effective to vitiate the quorum, since to allow shareholders to do so would be to enable them to control the order of business by the timing of their departure. Therefore, Scripp's leaving did not destroy the quorum. Moreover, the adjournment by Char was improper, since a quorum existed and a motion was before the floor, and the action was taken unilaterally without vote.

Was the Resolution a valid subject of Shareholder Action?

Shareholders have a very limited role in the management of a corporation. Their interest is an ownership interest, not a management interest. The latter is within the realm of the directors, whom the shareholders elect to serve their interests.

Some types of recommendations, in the form of resolutions, may still be properly considered. Other types are proscribed.

Resolutions dealing primarily with social concerns are normally not proper subjects of shareholder resolutions, since they are beyond the normal purposes of the corporation. Since this resolution calls for pollution free engines, it may be based on a social goal of limiting pollution. So characterized, it is an improper subject for resolution.

Was the Resolution Adopted?

Assuming, arguendo, that the topic of the resolution was proper, it still did not pass by a majority of the shares' votes that constituted a quorum.

However, in such cases where a party such as Scripps voluntarily leaves a meeting, as noted the quorum is not destroyed and the number of votes required to pass is a majority of these remaining. Since G held all votes that remained, the resolution would be validly adopted.

Are the Directors Required to Follow the Resolution

Assuming the resolution was validly adopted, it still must be viewed in the framework of corporate organization. The management of the corporation is vested in its directors, each of whom has a duty to exercise his discretion in the management decisions required. This duty is non-delegable, and may not be usurped by the shareholders.

Should the directors elect not to follow the resolution, even assuming its valid adoption, they would be protected by the business judgment rule if their decision was exercised with due care and in good faith with regard to the business interests of the corporation.

Therefore, due to their non-delegable duty to utilize their own discretion, and the protection they enjoy in their business decisions, the directors are not required to follow the resolution.

Spring 1982

QUESTION NO. 3

In January 1979, Able and Baker decided to establish Zeeco to manufacture electronic devices. They signed articles of incorporation and established themselves as a two-man board of directors. Each paid $10,000 in cash for 100 shares of the $100 par value common stock of the corporation.

In mid-June 1979, Able and Baker met Charlie, a business consultant who advised them on Zeeco business matters. In July 1979, Charlie filed Zeeco's articles of incorporation with the Secretary of State. Immediately thereafter, Charlie was issued 100 shares of Zeeco common stock: 10 shares in return for services rendered, 40 shares in return for services to be rendered in the future, and 50 shares in return for his personal note for $5,000. Charlie became the third member of the board of directors and was elected treasurer.

In August 1979, Charlie discharged his $5,000 note obligation by transferring to Zeeco office equipment appraised at $6,500 by an independent appraiser, but which Charlie had purchased at auction in May 1979 for $1,000.

In March 1980, Zeeco received $10,000 in cash from each of two investors, David, a local banker, and Edwards. Zeeco issued to each investor 100 shares of common stock.

By late 1981, Zeeco was in financial difficulty. When Charlie heard of a developmental opportunity in a field directly related to Zeeco operations, he did not advise the other directors because Zeeco did not have sufficient assets to exploit the opportunity. Instead, Charlie, David, and several of David's banker friends formed a partnership which invested in and made considerable profit on the new business opportunity.

Early in 1982, Zeeco's assets were insufficient to discharge its liabilities. Its creditors, many with claims dating back to the beginning of 1979, commenced an action against Zeeco and all five shareholders. Edwards cross-complained against the other four shareholders.

1. What are the liabilities of Able, Baker, Charlie, David, and Edwards to Zeeco's creditors? Discuss.
2. What are the liabilities of Able, Baker, Charlie, and David to Edwards? Discuss.

Answer A to Question 3

1. Liabilities to Creditors

Those creditors whose claims go back to early 1979 may be able to sue the corporation for their claims, or may be able to go beyond the corporation and hold Able and Baker directly liable for those claims. Although Able and Baker signed their incorporation papers, they were far from having created a corporation. Creditors may sue directors and shareholders directly when it appears that there was no corporation at the time the debts were incurred. Here, there was clearly no de jure corporation. Where a corporation fails to qualify as a de jure corporation, shareholders and directors will still be protected if it is a de facto corporation, where the corporation has made at least a colorable attempt to comply with incorporating requirements. Here, there was not even colorable compliance, as the articles of incorporation were never filed, nor did Able and Baker actually follow formal corporate practices, in that they set up a two-man board, which would be in violation of most corporate statutes, as a two man board could not give rise to a majority vote in decision making.

Able and Baker may argue that the creditors should be estopped to seek their claims directly from them, as they did business during the January to June period with the corporation as a corporation. If Able and Baker can in fact show that this was so, they may be protected against direct action by creditors under the estoppel theory.

By June, 1979, Zeeco has finally become a corporation. Upon the filing of articles of incorporation, the corporation's existence is presumed to exist. Able and Baker apparently cured their two man board defect by electing Charlie to the Board. However, problems arise with respect to the shares of stock distributed to Charlies. Shares of stock may only be distributed for consideration, and they may never be distributed without sufficient consideration. The 10 shares distributed to Charlie in return for his services rendered were validly distributed, if Able and Baker can show that the value of Charlie's services equalled the value of the shares. A good faith valuation of Charlies services by the rest of the board, assuming Charlie's election to the board was concurrent with the distribution of the shares, would be protected by the business judgment rule from any losses flowing from that good faith reasonable decision. However, the 40 shares distributed for future services was not properly distributed, in that shares may never be distributed upon the expectation of future services to the corporation. The 50 shares issued on Charlies personal note may also be subject to a failure of consideration. While shares may be issued on promissory notes, it is unlikely that they may be issued on an unsecured personal note. This would be sufficient consideration to a risk of default which would leave it with nothing.

Shares of stock which are issued for overvalued consideration are watered stock. The shareholder who receives the stock is liable to the corporation for the water. Creditors who extended credit to the corporation may seek their money from the shareholder or from the corporation, depending on which creditor theory is followed. Under the reliance theory, any creditor who can show that he relied on the corporation's balance sheet, reflecting the distribution of the overvalued shares, can sue the shareholder/owner of the watered stock for the difference in value between what the stock was worth, and shareholder paid. In these cases, the creditor must show reliance on the balance sheet, therefore, it must be a creditor who extended credit after the stock distribution was made. In other jurisdictions, under the statutory theory, any creditor must look to the corporation first for repayment, and seek the shareholder secondarily. The creditors who extended credit between January and June, may be unable to look to Charlie for repayment, as they would not be able to show reliance on the value paid for his shares. However, under the statutory theory, they may look to Charlie, after looking first to the corporation.

Charlie's discharge of his note is also questionable. As a director of a corporation, Charlies has a duty to the corporation to deal with it openly and honestly, and not to make a secret profit from dealings with the corporation. In giving the corporation $6,500 worth of equipment, Charlie may say that he is fulfilling his obligation to the corporation to the corporation's benefit, in that they are receiving $1,500 more than the original promise. However, Charlie's knowledge that he only paid $1,000 for the furniture taints the transaction, as the result of the deal gives Charlie a $4,000 secret profit. A director may not make secret profits at the expense of the corporation. If Charlie had disclosed to the other directors that he had paid only $1,000, the taint of the deal might have been purged by the independent appraisal of the equipment at $6,500 and the acceptance of that value by the remaining directors. Such a decision, if made in good good and if reasonable, would be protected by the business judgment rule, as the corporation is actually sustaining no loss from the transaction. However, the secretiveness of the profits made from Charlies, may require him to disgorge those profits to the corporation to be used in repayment of creditors.

The partnership between Charlie and David constituted a violation of Charlie's duty of loyalty to the corporation. The duty of loyalty prevents a director from profiting from his position to the detriment of the corporation. Here, there was a usurpation by Charlie of a corporate opportunity. A Director usurps a corporate opportunity when assumes for himself an opportunity in which his corporation has an interest or expectancy. Corporate interests will be shown when the opportunity involves a field related to the corporation's field, as is given here. Furthermore, there is evidence that Charlie may have discovered the opportunity while acting in his corporate capacity, as he would likely to hear of new business while he is doing business. Corporate opportunities will not be deemed to have been usurped if the director can show that he presented the opportunity to the corporation and the corporation decided not to take advantage of it. There is no showing here that Charlie presented the opportunity to the corporation, nor is there any showing of any other reason for the corporation not to have been interested in the opportunity. Charlie may say that the fact that Zeeco was in difficulty financially indicated that the new business was not a corporate opportunity on Zeeco's part. However, financial difficulty of a corporate is rarely a reason for a finding that the corporation was not interested in opportunity. Where a finding is made that a director usurped a corporate opportunity, the opportunity itself, i.e., the other business or property, will be deemed to be held in trust by the director for the benefit of the corporation. Often, the director's actual costs in gaining the opportunity will be reimbursed. However, the success of the new business and its profits will be available to creditors.

2. Liabilities to Edwards

The liabilities of Able, Baker and Charlie appear to be largely liabilities owed to the corporation for violations of fiduciary duties. In this respect, should Edwards wish to take any action, he would have to sue derivatively on behalf of the corporation, to enable the corporation to gather all its proper assets for payment to creditors. It does not appear that there are direct liabilities flowing from the directors to the shareholder. David may be liable to Edwards for profits which he made in his deal with Charlie. While David may not be a controlling shareholder, his holding is significant. Controlling shareholders are held to a fiduciary duty not to use their resources to benefit themselves to the detriment of the other shareholders. Here, it arguable that David used his resources to profit himself. However, as a non-controlling shareholder, it is probably that he would not be held to such a fiduciary duty.

It would appear Able, Baker, Charlie and David are liable to Edwards on the basis of their liabilities to the corporation for breaches of duty.

Answer B to Question 3

1. Liabilities of A, B, C, D, & E to Z's creditors.

A. Liability of A & B for creditor's claims from Jan. 1979 to July 1979.

One of the advantages of corporate form is that it insulates shareholders and directors from claims of the corporation's creditors. This protection extends to de facto corporations as well as de jure corporations. A de jure corp. is one which has complied with the statutory prerequisites of incorporation. A de facto corporation is one whereby the incorporators have made colorable compliance with applicable law and have exercise corp. functions and powers. Here A and B signed articles of incorporation and elected themselves directors. Although establishing themselves as directors is an exercise of corp. function as is issuing stock, merely signing the articles of incorp., w/o more, would not constitute colorable compliance. Thus Z would be neither a de facto or de jure corp. and A & B would be personally liable to Z's creditor for the period from Jan. 1979 to July 1979.

(If, however, creditors dealt w/A & B as corp. agents, the creditors may be estopped from asserting the invalid corporate form.)

B. Liability of C for C's watered stock.

The issuance of 10 shares of z stock in return for services rendered was valid. However, the issuance of 40 shares for future services and 50 shares for C's personal note was not valid, since stock may only be issued for presently valuable consideration. The subsequent discharge of the note removed the water from 50 shares, but liability for the remaining 40 shares persists.

Creditors may proceed under two theories:

1) Statutory obligation theory: the unpaid consideration for the issued stock is an asset of the corp.; the creditors must first get judgment against the corp. and may then proceed against the recipient of the watered stock (C).

2) Misrepresentation theory: if creditors relied on the corp.'s financial statements in extending credit, they may proceed directly against the shareholder (C).

C. A's and B's liability subsequent to July 1979.

In July 1979, C filed Z's articles of incorp. w/ the Sec'y of State, thereby insulating A & B from personal liability for Z's creditors' claims.

There does not appear to be any justification for invoking the Deep Rock doctrine since there were no shareholder loans to the corp. Nor does the alter ego doctrine appear applicable since the corp. form was not a sham.

D. Liability of D & E.

As shareholders D & E are not liable to Z's creditors. They are not controlling shareholders nor are they active in the operation of the corp. There is no justification for extending liability to them.

E. Liability of A, B, & C to E.

A & B are liable to E for the issuance of shares for invalid consideration under the majority rule which states that liability for such transactions attaches if additional stockholders are envisioned in the future.

F. Liability of C to E.

C, by transferring the furniture has made a secret profit and thereby breached his duty of loyalty to the corp. The duty of loyalty requires that the director act for the benefit of the corp. and not for his personal benefit. C must disgorge the profit made
to the corp.

C is further liable for usurping a corp. opportunity. Bankruptcy of the corp. is a defense, but lack of sufficient assets is not. Remedy is a constructive trust place on the asset.

G. D is not liable to E for his participation in the partnership w/C. Shareholders of a controlling interest have a fiduciary duty to the corp. and may breach that duty by usurping an opp'y. but, here D only owned 20% of Z's stock and the fact indicate no
indicia of his...

=

Spring 1983

QUESTION 8.

In 1978, Paul bought 10,000 shares of the common stock of Deco Corporation. In 1980, Deco purchased four retail stores from Savco for $4 million, which was a fair price. Tom, president and a director of Deco, was also a director of Savco. He was absent from the meeting of the Deco board of directors where the agreement for Deco's purchase of the Savco stores was considered. In Tom's absence, the proposed purchase was unanimously approved by the remaining four Deco directors, who constituted a quorum of the board.

In early 1981, the Deco directors resolved to offer 25,000 shares of authorized but unissued Deco common stock to Smith, in exchange for Greenacre, a store site owned by Smith. The directors did not offer any of the 25,000 shares for acquisition by Deco shareholders before consummating the deal with Smith.

At a meeting of the Deco board on March 15, 1982, Tom advised the board that an audit had established that Deco had incurred a $25 million loss during the preceding fiscal year, which would be publicly announced at the annual Deco shareholders' meeting on April Ist. Tom then tendered his resignation both as president and a director of Deco, effective immediately, which the board accepted.

Beginning on March 19 and continuing through March 27, 1982, Tom sold his 20,000 shares of Deco common stock for an average price of $25 per share. After the annual shareholders' meeting on April 1, 1982, the market price of Deco common stock dropped to $10 per share.

In May, 1982, Paul died. His daughter, Emma, inherited all his shares of Deco stock. Emma made three demands upon the Deco board of directors, stating that if each of the demands was not met, she, as a shareholder, would bring appropriate legal action. The demands are:

a. That the purchase of the four stores from Savco be set aside.

b. That she be permitted to purchase a number of Deco shares in the same proportion as Paul's 10,000 shares bore to all Deco shares issued and outstanding at the time of the share transfer to Smith.

c. That Deco bring suit against Tom to recover $300,000 based upon the sale of his Deco stock. How should the Deco directors respond to each of the demands by Emma?

Discuss.

<u>ANSWER A TO QUESTION 8</u>

A. Purchase of four stores

The sale of the four Savco stores raises the question of whether Tom breached his duty of loyalty and whether the board breached its duty of care. Since we are told that the sale price was fair, it does not appear that the Board breached its duty of care.
Under this duty, directors oust behave in prudent fashion, reaching their decisions non-negligently, for the good of the corporation and in good faith. There is no evidence here that the board members violated their duty of care.

A more substantial question concerns a possible breach by Tom of his duty of loyalty. Since Tom was also a director of Savco, he was in the position of an interested director. He did not own Savco, yet his position there creates a conflict of loyalty. In transactions involving interested directors, a breach of the duty of loyalty will be found unless the transaction was: (1) fair, or (2) disclosure was made to disinterested directors, they approve the transaction, and the transaction was fair, or (3) disclosure of the conflict of interest is made to shareholders and they approve the transaction. If shareholder ratification is unanimous, these may not be a fairness requirement in some jurisdictions.

Here the transaction was fair and in some jurisdictions that alone may be sufficient to defeat any breach of loyalty attack. Moreover, a majority of the disinterested directors approved the transaction. Four of the five directors approved the deal -- a unanimous vote by disinterested directors and a proper quorum of the board. The only question raised by the facts is whether Tom's absence from the meeting indicates less than full disclosure on his part of his conflict of interest and perhaps of any further negative *information* concerning the transaction, although such information might breach Tom's duty of loyalty to Deco.

In short, Tom's possible breach of his duty of loyalty appears to have been cured by the fairness of the transaction, coupled with the approval of a quorum of disinterested directors.

Finally, even if there were a breach of the duty, it is unclear that the remedy Emma seeks -- setting aside the transaction -- is the appropriate relief. Emma and the corporation might have an action for damages against Tom or might be able to recapture any benefit Tom received from the transaction. Yet, since the transaction was fair, there does not seem to have been any damage. Nor is it clear that Tom was enriched by the deal.

In addition, such an action against Tom by Emma would presumably be brought as a derivative suit on behalf of the corporation. In general, derivative actions may be brought only by a shareholder who was a shareholder of record at the time the putative breach occurred and who continues as a shareholder throughout the litigation. Since Emma inherited her shares, and was not a shareholder in 1980, it is unclear that she is a proper person to bring a derivative suit. She may argue that she is merely standing in Paul's shoes and acting on behalf of his estate.

B. <u>Sale of shares to Smith</u>

This sale of shares raises the question of whether Paul's preemptive rights were violated by the sale of shares to Smith in exchange for Greenacre. For about half the states, preemptive rights do exist unless the Articles of Incorporation provide otherwise. In the other half of the states, preemptive rights do not exist unless the Articles of Incorporation so provide.

A shareholder's preemptive rights -- where they exist -- permit the shareholder to purchase a percentage of a newly authorized issue of stock, sold for cash, so as to pressure his percentage of ownership in the corporation. The right applies only to newly authorized issues. It does not apply to stock that has been authorized but unsold. Nor does it apply to stock sales authorized in exchange for property or services. Finally, although not relevant here, the right does not apply to sale of Treasury stock -- stock the corporation has redeemed or repurchased.

On the facts of this case, and assuming that the Deco Corporation's articles provide for preemptive rights, Paul's preemptive rights were not triggered by the 25,000 shares transferred to Smith. The transfer was not for cash, but for property. Moreover, the transfer was of previously authorized but unissued stock, whereas preemptive rights attach only to newly authorized shares. In some jurisdictions, preemptive rights may be triggered if there is a long time lag between the authorization and issuance of shares. Yet there is no evidence of such a time lag here and, in any event, the shares were exchanged for property, not cash.

On the facts of this case, and assuming that the Deco Corporation's articles provide for preemptive rights, Paul's preemptive rights were not triggered by the 25,000 shares transferred

to Smith. The transfer was not for cash, but for property. Moreover, the transfer was of previously authorized but unissued stock, whereas preemptive rights attach only to newly authorized shares. In some jurisdictions, preemptive rights may be triggered if there is a long time lag between the authorization and issuance of shares. Yet there is no evidence of such a time lag here and, in any event, the shares were exchanged for property, not cash.

C. Tom's $300,000

Finally, Emma seeks to recover Tom's $300,000 "profit" on the sale of his shares. The application of federal law is in doubt in this case. To begin with, it is unclear that Deco is a §16(b) corporation -- listed on a national exchange or having over $3 million in assets and 500 shareholders. Assuming that the corporation is within the ambit of §16(b), it yet does not appear when Tom purchased the shares that he sold. If they were purchased when Tom was a director and within six months of the March 27, 1982 sale, then the corporation may have an action against Tom for the difference. The fact that Tom had resigned when he sold the shares is irrelevant. One need only be an insider at one end of the purchase or sale to fall afoul of §16(b).

Section IOb-5 would be available to purchasers of Tom's stock since he failed to disclose a material fact. But Emma was not a purchaser-seller, nor was the corporation. Thus, neither is entitled to a damages action under §IOb-5.

More promising is the corporate opportunity doctrine. Under this common law theory -- sometimes referred to as the Diamond doctrine -- the insider's knowledge is a corporate asset. Possibly, since Tom was no longer a director when he sold the shares, he might no longer be an insider for purposes of this doctrine. Yet a court might well conclude that a former director, trading on recent material, and still private information is trading on a corporate asset (information). Under this theory, the corporation may have an action against Tom.

Again, however, it is unclear that Emma can pursue the cause of action on behalf of the corporation in a derivative suit, should the directors reject her demands. As discussed above, since Emma was not a stockholder when the cause of action arose in March, it is unlikely that she could bring a derivative action under 516(b) or under the Diamond doctrine.

In sum, the directors should reject Emma's claim with respect to the Savco transaction and Paul's purported preemptive rights. If the corporation is §16(b) corporation and if Tom purchased his shares as a director within six months of the sale, the directors should commence suit to recover Tom's profit. Alternatively, the corporation should seek recovery under the Diamond doctrine. If the directors decline to take action, it is unclear that Emma may bring the derivative suit.

ANSWER B TO

QUESTION 8

Standing to sue

Emma's threatened legal action would have to be a direct suit on her *behalf* for injuries direct to her or a derivative suit in her own name on *behalf* of the corporation. If a loss or a breach of fiduciary duty can be traced directly to Emma than her action would be a direct action. Emma's other option would be a derivative suit. This latter action would present problems for Emma as discussed below.

A derivative suit is a suit brought by a shareholder in her own name on *behalf* of the corporation for injuries done to the corporation. It usually is permitted where there has been a breach of fiduciary duties, or excessive compensation. In order to bring a derivative action, a shareholder must first made a demand upon the directors that such an action be brought by them. If such a demand is refused by them, or it would be futile to make it, then the shareholder can proceed with the action if she was a shareholder at the time that the wrong took place and when the derivative suit was brought.

Here no problem exists with respect to the demand. Emma has not brought the action, yet and she has clearly asked the directors to do something about what she perceives to be wrongs. The difficulty with her suit stems from the fact that she was not a shareholder at the alleged wrongs took place -- Paul was. Emma could possibly argue that since she did not purchase the shares, but rather since she inherited them, she in effect took Paul's place with respect to any rights flowing from ownership of those shares. A court would probably look favorably upon such an argument, in my judgment.

(A) <u>Purchase of</u> <u>stores.</u>

The purchase of the stores involves Tom, an interested director. Tom was interested because he was a director of both Deco and Savco. When a transaction involves an interested director, there arises the possible question of breach of fiduciary duty by the interested director. Under the present facts, however, there was no such breach.

The rule is that a majority of disinterested directors may approve the transaction, provided it can also be established that the transaction was independently fair.

C. <u>Tom's</u> <u>$300,000</u>

Finally, Emma seeks to recover Tom's $300,000 "profit" on the sale of his shares. The application of federal law is in doubt in this case. To begin with, it is unclear that Deco is a §16(b) corporation -- listed on a national exchange or having over $3 million in assets and 500 shareholders. Assuming that the corporation is within the ambit of §16(b), it yet does not appear when Tom purchased the shares that he sold. If they were purchased when Tom was a director and within six months of the March 27, 1982 sale, then the corporation may have an action against Tom for the difference. The fact that Tom had resigned when he sold the shares is irrelevant. One need only be an insider at one end of the purchase or sale to fall afoul of §16(b).

Section lOb-5 would be available to purchasers of Tom's stock since he failed to disclose a material fact. But Emma was not a purchaser-seller, nor was the corporation. Thus, neither is entitled to a damages action under §lOb-5.

More promising is the corporate opportunity doctrine. Under this common law theory -- sometimes referred to as the Diamond doctrine -- the insider's knowledge is a corporate asset. Possibly, since Tom was no longer a director when he sold the shares, he might no longer be an insider for purposes of this doctrine. Yet a court might well conclude that a former director, trading on recent material, and still private information is trading on a corporate asset (information). Under this theory, the corporation may have an action against Tom.

Again, however, it is unclear that Emma can pursue the cause of action on behalf of the corporation in a derivative suit, should the directors reject her demands. As discussed above, since Emma was not a stockholder when the cause of action arose in March, it is unlikely that she could bring a derivative action under 516(b) or under the Diamond doctrine.

In sum, the directors should reject Emma's claim with respect to the Savco transaction and Paul's purported preemptive rights. If the corporation is §16(b) corporation and if Tom C. <u>Tom's</u> <u>$300,000</u>

Finally, Emma seeks to recover Tom's $300,000 "profit" on the sale of his shares. The application of federal law is in doubt in this case. To begin with, it is unclear that Deco is a §16(b) corporation -- listed on a national exchange or having over $3 million in assets and 500 shareholders. Assuming that the corporation is within the ambit of §16(b), it yet does not appear when Tom purchased the shares that he sold. If they were purchased when Tom was a director and within six months of the March 27, 1982 sale, then the corporation may have an action against Tom for the difference. The fact that Tom had resigned when he sold the shares is irrelevant. One need only be an insider at one end of the purchase or sale to fall afoul of §16(b).

Section lOb-5 would be available to purchasers of Tom's stock since he failed to disclose a material fact. But Emma was not a purchaser-seller, nor was the corporation. Thus, neither is entitled to a damages action under §lOb-5.

More promising is the corporate opportunity doctrine. Under this common law theory -- sometimes referred to as the Diamond doctrine -- the insider's knowledge is a corporate asset. Possibly, since Tom was no longer a director when he sold the shares, he might no longer be an insider for purposes of this doctrine. Yet a court might well conclude that a former director, trading on recent material, and still private information is trading on a corporate asset (information). Under this theory, the corporation may have an action against Tom.

Again, however, it is unclear that Emma can pursue the cause of action on behalf of the corporation in a derivative suit, should the directors reject her demands. As discussed

above, since Emma was not a stockholder when the cause of action arose in March, it is unlikely that she could bring a derivative action under 516(b) or under the Diamond doctrine.

In sum, the directors should reject Emma's claim with respect to the Savco transaction and Paul's purported preemptive rights. If the corporation is §16(b) corporation and if Tom purchased his shares as a director within six months of the sale, the directors should commence suit to recover Tom's profit. Alternatively, the corporation should seek recovery under the Diamond doctrine. If the directors decline to take action, it is unclear that Emma may bring the derivative suit.

ANSWER B TO

QUESTION 8

Standing to sue

Emma's threatened legal action would have to be a direct suit on her *behalf* for injuries direct to her or a derivative suit in her own name on *behalf* of the corporation. If a loss or a breach of fiduciary duty can be traced directly to Emma than her action would be a direct action. Emma's other option would be a derivative suit. This latter action would present problems for Emma as discussed below.

A derivative suit is a suit brought by a shareholder in her own name on *behalf* of the corporation for injuries done to the corporation. It usually is permitted where there has been a breach of fiduciary duties, or excessive compensation. In order to bring a derivative action, a shareholder must first made a demand upon the directors that such an action be brought by them. If such a demand is refused by them, or it would be futile to make it, then the shareholder can proceed with the action if she was a shareholder at the time that the wrong took place and when the derivative suit was brought.

Here no problem exists with respect to the demand. Emma has not brought the action, yet and she has clearly asked the directors to do something about what she perceives to be wrongs. The difficulty with her suit stems from the fact that she was not a shareholder at the alleged wrongs took place -- Paul was. Emma could possibly argue that since she did not purchase the shares, but rather since she inherited them, she in effect took Paul's place with respect to any rights flowing from ownership of those shares. A court would probably look favorably upon such an argument, in my judgment.

(A) Purchase of stores.

The purchase of the stores involves Tom, an interested director. Tom was interested because he was a director of both Deco and Savco. When a transaction involves an interested director, there arises the possible question of breach of fiduciary duty by the interested director. Under the present facts, however, there was no such breach.

The rule is that a majority of disinterested directors may approve the transaction, provided it can also be established that the transaction was independently fair.

purchased his shares as a director within six months of the sale, the directors should commence suit to recover Tom's profit. Alternatively, the corporation should seek recovery under the Diamond doctrine. If the directors decline to take action, it is unclear that Emma may bring the derivative suit.

ANSWER B TO

QUESTION 8

Standing to sue

Emma's threatened legal action would have to be a direct suit on her *behalf* for injuries direct to her or a derivative suit in her own name on *behalf* of the corporation. If a loss or a breach of fiduciary duty can be traced directly to Emma than her action would be a direct action. Emma's other option would be a derivative suit. This latter action would present problems for Emma as discussed below.

A derivative suit is a suit brought by a shareholder in her own name on *behalf* of

the corporation for injuries done to the corporation. It usually is permitted where there has been a breach of fiduciary duties, or excessive compensation. In order to bring a derivative action, a shareholder must first made a demand upon the directors that such an action be brought by them. If such a demand is refused by them, or it would be futile to make it, then the shareholder can proceed with the action if she was a shareholder at the time that the wrong took place and when the derivative suit was brought.

Here no problem exists with respect to the demand. Emma has not brought the action, yet and she has clearly asked the directors to do something about what she perceives to be wrongs. The difficulty with her suit stems from the fact that she was not a shareholder at the alleged wrongs took place -- Paul was. Emma could possibly argue that since she did not purchase the shares, but rather since she inherited them, she in effect took Paul's place with respect to any rights flowing from ownership of those shares. A court would probably look favorably upon such an argument, in my judgment.

(A) Purchase of stores.

The purchase of the stores involves Tom, an interested director. Tom was interested because he was a director of both Deco and Savco. When a transaction involves an interested director, there arises the possible question of breach of fiduciary duty by the interested director. Under the present facts, however, there was no such breach.

The rule is that a majority of disinterested directors may approve the transaction, provided it can also be established that the transaction was independently fair.

First, Tom was absent when the vote was taken regarding other purchase of the stores for $4 million. Was there also full disclosure? The facts do not state whether Tom disclosed his interest in the deal as a director of Savco. Nevertheless, the transaction was approved by a unanimous vote of the remaining Deco directors, who constituted a quorum of the board. The transaction was also a fair one since the price was right. Under these circumstances, the directors should respond to Emma that the transaction was a proper exercise of their business judgment, and that they will simply refuse to do anything about it.

(B) Preemption rights.

At common law, and in many jurisdictions today, the concept of preemptive rights was applied to assure that an existing shareholder maintained his proportionate interest in the corporation whenever newly authorized shares of stock were issued for cash. Emma's argument is that she was not offered the opportunity to purchase sufficient shares so as to allow her to maintain the same proportionate interest in the corporation. This contention is not valid for a number of reasons. First, newly authorized shares were not issued. The facts state that the shares had been previously authorized, and that they were only issued to Smith. Second, the shares were not issued for cash, but rather they were issued in exchange for real property. Under these conditions, Emma is not entitled to exercise any preemptive rights. The directors should explain this to her, and a court of law would uphold the directors.

Further, some modern jurisdictions have, by statute, made it possible to eliminate preemptive rights. In these jurisdictions the directors can include a provision in the articles of incorporation stating that no preemptive rights exist.

(C) Tom.

Tom's actions involve secondary stock sales. Under various rules he may be held accountable for the profit that he made in the sale. At common law three approaches existed when an existing shareholder sold his or her shares. Under the original common law approach, a shareholder owed no duty to existing shareholders in the sale of his shares. Under this view, he did not have to disclose any facts which were known only to him and which motivated his sale. To prevent the harshness of this approach, the special facts doctrine was developed. Under the special facts doctrine, an officer or other shareholder of the corporation owed a special duty to the remaining shareholders to disclose any "special facts" which were known only to him and which motivated his sale. Clearly, Tom was under a duty to disclose his knowledge of the $25 million loss before he made the sales of his shares. Since he did not make such a disclosure, the persons he sold to may sue him and recover the profit that Tom made or rescind the purchase and sale.

Another common law view would hold the shareholder, Tom, always responsible for making a disclosure of special facts known to him only. The facts do not state whether existing shareholders or other persons purchased the shares sold by Tom. The court would need to ascertain these facts.

Finally, another common law view announced by Diamond v. Eramulo holds that the shareholder owes a duty to the corporation if he makes a sale of shares based on inside information. Under this view, the directors can sue Tom and recover the profit made by him. Thus, even though it is not possible to determine who purchased Tom's shares, Deco can sue and recover the profit from him. This would be the difference between $25 per share and $10 per share.

An attempt could be made to hold Tom responsible for the profits under rule 16(b), but such an attempt would probably fail. Rule 16(b) of the Securities Exchange Act of 1934 states that if an officer, director, or more than 10% shareholder is involved in the sale and a purchase of shares within six months of each other, and such sale or purchase involves the making of a profit, such person is strictly liable for the profit. Rule 16(b) is applicable only to certain corporations. The corporation must have one million dollars in assets and at least 500 shareholders, or its stock must be traded on a national stock exchange.

Tom also qualifies as an officer and a director. The problem has to do with whether there was a purchase and a sale within the stated six months. There is no indication that Tom purchased the shares within six months of the sales. Unless this is determined, 16(h) would not be applicable.

Is rule IOb-5 applicable? Rule IOb-5 of the Securities exchange Act of 1934 is applicable to any security transaction that involves the purchase or sale of shares and which purchase or sale involves fraud or misleading. Here, Tom failed to state material inside information at the time of the sale. Any prudent purchaser would be extremely

interested in knowing of the upcoming announcement of the $25 million loss. This was material information, and it was not disclosed by Tom.

But in order for IOb-5 to apply, the person suing must be a purchaser or a seller. Here we are not told who those persons are. Assuming that they will come forth, they can bring the IOb-5 action. Another requirement is that an instrumentality of interstate commerce must have been involved in the purchase of sale. Here too we are not sure whether this is the case. If a telephone was used, or the mails, or some other instrumentality of interstate commerce, then this requirement would be satisfied.
Lastly, the requirement of scienter would also need to be proven. This is established by the fact that Tom knew of the loss and based his sales upon this knowledge.

July 1983
QUESTION 3

Paul owns 250 of the 1,000 issued and authorized shares of Durco, a State X close corporation. The Durco directors are Al, who owns 650 shares, and Baker and Carr, each of whom owns 50 shares of Durco stock. Al has offered to buy the shares of Durco stock owned by Paul at a price substantially less than that paid by Paul to acquire the stock. Paul has refused Al's offer, claiming the offered price was "unfair."

Paul has brought an action in State X court against Durco and its three directors. His complaint alleges:

(A) The directors have acted unreasonably in failing to have Durco distribute as cash dividends approximately $5 million of accumulated earnings;

(B) The distribution is being arbitrarily withheld for the benefit of Al;

(C) There is an "invalid" agreement between the individual defendants as Durco shareholders, the purpose of which is to maintain Al in office as "managing director" to "supervise and direct the operations and management" of all of Durco's business;

(D) Paul has been consistently denied the right to inspect Durco's corporate records during regular working hours or at any other time.

By way of relief, the complaint asks that: (1) Al be removed as a director for misconduct; (2) the shareholders' agreement be found invalid; (3) the directors declare and pay a substantial cash dividend; and (4) Paul be permitted to inspect Durco's records during normal business hours.

In their answer, the defendants allege that Paul's action should be considered a derivative action, and admit the existence and terms of the shareholders' agreement, the withholding of accumulated earnings of approximately $5 million, and the denial of access by Paul to Durco's records. They then allege by way of affirmative defense that: (1) the discretion of the directors to declare dividends has been properly exercised; (2) the shareholders' agreement is valid and therefore Al cannot be removed as director, even for cause; and (3) the requested inspection should be denied because Paul only wants to inspect the corporate records for the "improper purpose" of bringing a "strike suit."

The defendants have moved for an order requiring Paul to post security for costs in the pending action.

State X law grants an unqualified right to shareholders of State X corporations to inspect corporate books and records, and requires plaintiffs in shareholder derivative actions to provide security for costs.

1. How should the court rule on defendants' motion for security for costs? Discuss.

2. How should the court rule on each of Paul's requests for relief? Discuss.

ANSWER A TO QUESTION 3

1. Motion for security for costs.

A derivative action exists when the corporation has a cause of action that the shareholder is stepping in to enforce for the corporation. A derivative suit can be brought against a third party who has dealings with the corporation or against the directors for hurting the corporation in some way, e.g., insider trading and the Diamond doctrine.

A shareholder has a separate cause of action, however, if they are hurt personally by either the directors or by other shareholders. The harm is therefore done to the shareholder, not the corporation.

Paul has a valid argument that this is an individual suit, not a derivative suit, as he has not received his "entitled" dividend, that other shareholders have "illegally" banded together to hurt his interests, and that he is not being allowed his shareholder's right of inspection of the corporate records. Further, Al is breaching his fiduciary duty as a controlling shareholder to force Paul from the corporation. All of these harms are direct to Paul. While it can also be argued that the corporation could be hurt and could maintain a suit against Al, Baker & Carr, the fact that Paul decided to go a separate suit is permissible and Paul thereby can avoid State X's requirements of security for costs in a derivative action.

Additionally, this requirement may be invalid as it could totally bar a person from instituting a derivative suit. A better view is to require costs security unless demand on the directors is futile, as they are interested. This would allow some flexibility for shareholders in situations where the board is controlled by a group that is not caring for the corporation, but their own interests.

2. Paul's requests for relief.

a. Removal of Al for misconduct.

The courts are hesitant to remove directors that have been chosen by the shareholders. This is true especially when the complaint is misconduct. What courts prefer to do in these situations is to impose financial repercussions on the directors for their misconduct. As a major shareholder, Al is under a fiduciary duty to provide fair deals for the minority shareholders. This would include the duty to refrain from attempting to force them out. As a director, Al had a duty of care to make business judgments for business reasons. While the standard for viewing a director's interest is usually the flexible business judgment rule, if Paul can prove that decisions are being made by Al for personal reasons, he will lose the protection of the business judgment rifle. Further, if Al is using his office for the purpose of benefiting himself personally, he could also be liable for breach of his fiduciary duty and therefore questionable as a director.

But, as stated before, the courts are reluctant to remove directors from office and, at most, the court might be willing to order a new election and forced cumulative voting which would allow Paul to place a representative on the board of directors.

The only time that directors will be removed is when shareholders vote to. If the court were to order a new election and not allow Al to vote in the election, due to his interest, the same result would be achieved.

Courts will also aid the shareholders in removing a director for cause when he is a major shareholder and therefore impossible to remove. The court would need a clear indication of self-dealing, which seems to be clear in this case, as Al appears to be trying to force Paul out and take over his stock.

b. The shareholders' agreement.

Shareholder agreements are upheld in most states as long as they are not illegal, do not unduly restrain alienation and they do not usurp the director's duties. This agreement is a mixture of the two. It is permissible for shareholders to get together and decide to pool their votes for one person as a director. In this case, the shareholders have gone even further and stated that he will be managing director and he will supervise and direct the operation and management. This is clearly the board of directors' role, to elect a "managing" director and to supervise and direct the operation and management of the corporation. (Directing the operation of the corporation is the officer's normal duties. If this is what is meant, this agreement is further violative as it is agreeing on the board's actions and the officers' actions.)

In a close corporation, the shareholders can all agree to dispense with a board of directors and run the corporation on agreement but this is only in some jurisdictions and only if all shareholders agree.

As this is not the case here and the agreement is delegating the director's duties to Al, this agreement should be held invalid.

A rationale note, this will do no good if some form of appointing directors that ensures Paul's rights is used, like cumulative voting because even if the agreement is taken away, the directors can still totally defer to Al.

Declaring a dividend is clearly within the control of the board of directors. It is one of their main functions. They are the ones that are aware of the corporation's condition, the corporation's anticipated needs and the corporation's financial needs. Courts are therefore reluctant for directors to distribute dividends.

Courts are amenable to this only if it can be shown that the corporation is capable of paying a dividend, the dividend is being held up for illegal uses, e.g., to force a shareholder out, and the board of directors are interested directors. An aid to this would be if the corporation was forced to or close to needing to pay the accumulated interest tax. If this occurred, the plaintiff could use this to show that there was no valid purpose for withholding the money (distribution) and the directors may be forced to distribute the money and even replace the accumulated earnings tax the corporation was forced to pay.

d. Inspecting the records.

Under the law of the state, Paul can unqualifiedly inspect the corporate books and records. This would mean that all he would have to do is ask and he should be permitted, during working hours, to inspect the books. This statute may, however, be overbroad and onerous to the corporation. Most states require a mere proper purpose (that is liberally interpreted) in order to examine the books as a shareholder.

c. Declaring a dividend.

.

As Paul is a shareholder and is being deprived of a dividend, it would be permissible for him to see the records to see if the corporation is able to pay a dividend. If not, he would not need to go further in that action.

Paul, therefore, should be permitted to inspect the books.

ANSWER B TO QUESTION 3

I. Security for Costs

A. Nature of Lawsuit

Whether Paul can be required to post security for costs turns on whether the action is properly a derivative suit. Derivative actions are designed to prevent injury to the corporation. In essence, a shareholder stands in the shoes of the corporation to adjudicate if--, rights when a corporation's directors/managers refuse to do so. Derivative suits are improper to adjudicate rights personal to shareholders. Such actions are to be brought by the shareholder against the corporation.

Paul's complaint seems to seek adjudication of rights personal to him, and hence should not be brought as a derivative suit. Actions for dividends are shareholders' rights, hence subject to personal action. Likewise, inspection of records is a right of Paul as shareholder, and hence not subject to derivative action. Misconduct of Al also seems to be a personal action to the extent that Paul is complaining about his actions in withholding dividend money as a director. The action arguably implies a breach of the control's fiduciary duty -- a duty to Paul, not the corporation. (See, infra.) If, on the other hand, Paul alleged that Al's actions were harming the corporation, there could be a basis for a derivative action. The complaint does not seem to allege that. Finally, the action as to the pooling arrangement/voting trust goes to the validity of the agreement. Again, the complaint does not allege a right of the corporation which the directors have failed to vindicate. Hence, it too is properly personal.

If Paul's action were construed to be properly derivative, in whole or in part, then the corporation could be awarded security for costs, since the law seems to require it. Presumably, the court has a certain amount of discretion in weighing likelihood of success by Paul, etc.

II. Paul's Requests for Relief

A. Removal of Al

(1) Breach of Fiduciary Duty

Al is both a director and a controlling stockholder. In both positions he owes shareholders a fiduciary duty. As a director, Al must run the corporation using good business judgment. As a control, Al has a special duty to deal fairly with minority shareholders like Paul. This is particularly true in closed corporations, with limited markets for securities, and also as to repurchase by control. In some jurisdictions, under the equal opportunity rule, a control person cannot attempt to freeze out the minority, or force them to sell shares at loss. It is unclear whether Paul has sufficiently alleged such a breach by Al. The facts say only that the offer was "unfair". The key is whether there was no other market available. If so, then Al's acts may have constituted breach.

Al also has breached his fiduciary duty as a control if he is withholding dividends for his own benefit. Again, as both a director and as a control, Al must act in the corporation's best interest. Al maintains that the corporate directors have acted in the corporation's best interest. Aside from Paul's allegation, the facts suggest nothing to the contrary.

(2) Relief

Paul seeks removal of Al. This is a drastic step. A court would order it only when a clear violation of corporate articles or state law. The facts do not indicate whether either is present. It is unclear whether a court would order removal for fiduciary breach. However, if other directors failed to remove after a breach by Al was proved, then they would probably be liable to Paul. Hence, the court would probably wait and let Baker and Carr remove Al. Failing that, and facing a violation of articles/state law the court could remove. The effect of shareholders' agreement on removal of Al turns, first, on the validity of the agreement (see II-B, infra) and, second, if improper actions on Al's part, the agreement shouldn't prevent removal (e.g., if Al acted contrary to state law or corporate articles) .

Paul's better course would be to receive damages resulting from Al's breach of fiduciary duty/misconduct. This would probably exist under state corporate law, since federal securities law (10b-5) appears inapplicable because of the Blue Chip Stamps standing problem: there was a mere offer, no sale/purchase.

B. Shareholders' Agreement

Most jurisdictions allow shareholders' agreements, whether pooling agreements or voting trusts. In either case, the shares are voted a certain way, either by contract or by a trustee. Such agreements are only valid for proper purposes. Courts generally hold trust agreements which govern who is a director and how a director votes are invalid, as having an improper purpose.

Assuming that the agreement here complies with applicable state law formalities, the key is whether it is for a proper purpose. The fact that Al, Baker, and Carr have agreed to elect Al as director and further to give him broad control over the corporation may be an invalid purpose since it requires directors to give up control to Al. Hence, shareholders, by requiring that Al be the managing director, have taken from the Board of Directors a measure of control over the operation of the corporation. Such intrusions into the sphere of the power of directors are allowed only when all shareholders in a closed corporation have signed the agreement, and all shareholders are directors. Under the facts, that does not seem to be the case. If the agreement does have an improper purpose, a court should declare it invalid.

Al and Baker and Carr may argue that the voting agreement has a proper purpose; it only requires election of Al as a managing director and does not require the directors to vote any particular way. Indeed, it is arguable that the directors could strip the managing director of some authority. If "a court accepted this argument, the voting agreement would be valid. The argument is disingenuous, however, and a court is more likely to examine the actual effect of the agreement.

C. Payment of Dividends

A shareholder has no right to dividends -- payment of dividends is within the discretion of the Board of Directors and is limited only by the amount of earned surplus and whether the payment of dividends will impair the firm's capital. If the acts of the Board of Directors in not paying dividends was a good faith exercise of the director's business judgment, then Paul probably has no recourse.

If, however, failure to pay dividends was made in bad faith, and was a breach of Al's fiduciary duty as a control (see, II-A, supra), then Paul probably may properly bring action against the Board, on behalf of the stockholders, to require payment of dividends. Paul must meet a heavy burden here. Payment of dividends is within the province of the authority of the directors. The facts suggest possible bad faith by Al (too low offer, voting agreement) , but to force payment Paul will have to provide stronger evidence of a breach by the directors.

D. Right to Inspect Records

Inspection of corporate records is a common law right of shareholders. Some jurisdictions limit inspection to particular purposes. The law of State X appears to give an unqualified right. If the right is unqualified, then the court should order the corporation to provide access to records, and if the corporation fails to cooperate, then the court can supervise.

It is likely that there is at least an implicit requirement of good faith in the corporate records' inspection law. If there is, the burden should be on the corporation to show bad faith. Most jurisdictions place the burden on the corporation to safeguard shareholders' rights to inspection. If Paul seeks inspection for improper purposes, and if the law has this implicit good faith requirement, then a court could deny :inspection. This is speculative, however, and the law -on its face -- gives unlimited access.

FEBRUARY 1985
QUESTION 5

The by-laws of Dixie, a publicly held corporation, provide, "The number of directors of the corporation shall be five." Insofar as pertinent, Dixie's articles of incorporation state that the number "constituting the initial board of directors" is five and provide for annual election of directors.

Since its incorporation five years ago, Dixie has been very profitable. Anticipating a hostile takeover attempt, the board voted to increase its size to nine and to stagger the terms of directors so that only three would stand for election each year.

, Stan, owner of 29% of Dixie's voting stock, demanded that the board call a special meeting of shareholders to disapprove the board's action and to remove the president from office. The board refused to call a meeting for those purposes. It filled the newly created board positions with persons who were experienced in business and were close friends of the original board members. The new board entered into transactions that harmed Dixie financially but which made the corporation a less attractive target for takeover.

When Stan filed a derivative suit against Dixie and the directors challenging the board's conduct, the board appointed the new members as a "special litigation committee." Thereafter, the board moved to dismiss the suit because "based upon the recommendation of the special litigation committee, the board has concluded the suit is not in the best interests of Dixie."

1. Did the board act lawfully:

   A. In increasing its size to nine members without a shareholder vote? Discuss.

   B. In staggering the terms of board members without a shareholder vote? Discuss.

   C. In refusing to call a special meeting of shareholders? Discuss.

   D. In filling the newly created board positions without a shareholder vote? Discuss.

2. Should the court grant the board's motion to dismiss? Discuss. Do not discuss federal securities law issues.

ANSWER A TO QUESTION 5

1. A. Increasing Board Size:

Since the number of Directors is stated in the articles as 5 "initial" members but is clarified in the by-laws as "shall be five", it is unlikely that one could successfully argue that the articles are ambiguous.

The issue, then, is whether the Directors (Ds) have the authority to change the by-laws without shareholder approval. Absent a statute, article or by-law here, the general rule is that the ultimate power with regard to amending by-laws rests with the Directors unless shareholder approval is also required in general or as to that subject. Given the ultimate power of the Shareholders (Sh) to select and remove Ds, it is likely that Sh approval is also required for changing the number of Ds. Finally, if change in number of Ds is considered a fundamental change, Sh approval is required.

Was the Board decision proper if the anticipated hostile takeover constituted an emergency? Given the fact that an emergency Sh meeting could have been called, the fact of an impending takeover should not alter the result.

B. Staggered Term:

The express language in the articles provides for annual election and thus the decision regarding 3 year staggered terms directly violates the articles. Moreover, the 3 year staggered board can affect Sh voting rights, particularly if there is cumulative voting.

Although some of the arguments made in (A) above may apply, the staggered board directly conflicts with the articles and is improper absent Sh approval. Moreover, whereas the election of additional directors in response to the imminent takeover attempt may be justified as an emergency measure, the same cannot be said of the staggered term.

In the majority of states, the Shs are entitled to call a special meeting and their right to do so will be judged by the purpose of the meeting.

As stated above, the selection of directors is ultimately within the purview of Shs. Moreover, state statute, the by-laws, or even the situation may mandate Sh approval of the Board actions discussed above. Moreover, the hostile takeover is a threat to the Shs as well and there may be issues in this regard which would justify the meeting and relate to the Board action.

The same is not true, however, of the decision to remove the President. Although the selection and removal of Ds is a matter of Sh concern, the selection and removal of officers and agents is a matter of everyday business management and is within the purview of the Board.

Thus, refusal regarding by-law amendment was improper. Refusal regarding removal of president was proper.

C.

Refusal to Call Special Meeting:

D. Filling New Positions:

As stated above, the selection of Ds is ultimately a power of the Shs. Nevertheless, the

Board is usually empowered to fill vacancies on the Board pending ratification and election at the next Sh meeting. Here, of course, given the Board decision to stagger terms, the impropriety of that action becomes even more apparent.

The issue, then, is whether by increasing the size of the Board, the Ds have created a vacancy or if a vacancy refers only to a position which was once occupied and is now vacant. There is a split of authority on this issue, but assuming the Board could fill the vacancy, the issue is whether it did so properly.

As Ds, the Board must act so as to conform to two standards: 1) duty of loyalty and 2) duty due care. The first requires placing one's own interests behind those of the corporation's and choosing one's friends as Ds could be a breach of loyalty if done for self-interest at corporation's expense.

Here, however, we know the Ds were experienced in business. The decision to select them will survive the business judgment rule if arrived at with the care and prudence of a reasonable director, despite the friendship.

2. A derivative action is proper when a Sh's actions derive from the rights granted in articles, bylaws or the Shs are alleging breach of fiduciary duty, all of which are met here.

A. Contemporaneous Ownership:

In order to bring a derivative action, a Sh must be an owner at the time of the wrong, which Stan apparently was, and through judgment. Thus, if Stan still owns stock, the action is proper.

Note that if Stan bought his stock after the decision to increase the board, he may allege the "continuing wrong" exception to the rule.

B. Demand on Board:

Required unless would be clearly futile. A special litigation committee can in theory exercise its judgment and be regarded as an independent body for these purposes. (I.e., the special litigation committee decision won't be invalid merely because subject Ds are being sued for less than full Board acts.)

However, the refusal of a demand must survive the business judgment rule to preclude right to bring derivative action. Here, it arguably does not. First, there is every indication these new members are not independent and disinterested. Second, they may well be too new to the company to form as well reasoned judgment.

Result: Motion to dismiss denied.

ANSWER B TO QUESTION 5

1A. <u>Lawfulness of Board's Action - Increasing Size to 9</u>

The bylaws and articles of a corporation provide the structure for its lawful operation. In this case, the board's actions fly in the face of the bylaws and possibly articles.

The bylaws state unequivocally that the "number of directors shall be five". Without more, any change in corporate bylaws must be accomplished by the majority of votes cast by the shareholders attending the annual or special meeting.

A strict reading of the articles, however, is not as clear. The language could be interpreted as allowing the directors to expand the board's size: "the number 'constituting the initial board of directors' is five". Dixie has been in operation 5 years--they may be allowed to increase the size by their own actions, following a determination that the corporation has passed the "initial" stage.

However, even if this were true, it would only allow the directors to decide (by vote) to increase the board's size--the articles require that the shareholders elect the directors annually. As such, the directors actions were in direct violation of the bylaws and articles--an ultra-vires act. The shareholders are entitled to vote on changes in the articles (majority of all outstanding shares) and bylaws.

1B. Staggering Terms

We are not told if Dixie has direct or cumulative voting. In cumulative voting jurisdictions, such an act would require shareholder approval--this is because the rights and powers of the minority shareholders would be infringed and their ability to elect representatives to the board impaired.

In addition, the articles call for "annual election". Again, it appears that the directors have acted to contradict the articles. Such behavior may make them personally liable for any damage resulting to the corporation. The shareholders must approve changes in the articles.

The action of the directors must be measured against their duty of care to the corporation. If their action was motivated only to protect their jobs, and not protect Dixie from a corporate looter, they may be again personally liable for any resulting damage to Dixie because they breached their duty of fiduciary responsibility to the corporation.

1C. Special Meeting

The shareholders have the right to call special meetings. They also have the right to have the corporation disseminate notice of the special proposal in mailings to the shareholders, if the special meeting is for a proper purpose.

Stan has two reasons for desiring a special meeting: to disapprove the board's action, and to remove the president from office.

A proper purpose is to disapprove the corporation's board's actions--it appears that Stan has a good faith interest in the corporation, and is not motivated by a desire to harm the corporation. Case law has held that similar situations do not constitute an improper purpose.

However, it is not a proper purpose for the shareholders to call a special meeting in order to fire the president--a corporate officer. The officers, in public corporations, are hired and fired by the directors. Given the absence of any article or bylaw to the the contrary, this is an improper purpose to call a special meeting.

The fact that one reason for calling the meeting is proper and one is improper does not justify the directors refusal to call the special meeting-there was a valid purpose for the meeting.

1D. Newly Created Board Positions

The board is empowered to fill all vacancies as they arise, subject to the right of the shareholders to replace the temporary appointees at the annual meeting. If the expansion of the board was proper, the board has acted properly, if all appointments were made in good faith after a reasonable determination that the replacement was a good business person (i.e., qualified) .

Of course, the term of these directors is only until the next properly held shareholder meeting; then the vote of the shareholders will control.
This is because of the expensive and cumbersome process of notification of all shareholders in a large, publicly held corporation like Dixie. The courts view such temporary replacements as appropriate measures.

2. The Board's Motion to Dismiss

In a derivative action, the shareholders must make a demand on the board to bring suit on behalf of the corporation. If the board makes a good faith determination that the suit is improper and/or is not in the best interests of the corporation, the suit is barred.

The directors must exercise their two major duties in evaluating the suit: the duties of care and loyalty. The first requires a reasonable, good faith determination that the financial status of the corporation will not suffer from the effect of their actions; the latter requires the directors to place the interests of the corporation above and before their own.

Was the demand futile? Given the number of directors who stand to lose their position if the suit is successful, it may be. However, the demand having been made, the only question is whether it was valid (the board's dismissal, that is).

It has become acceptable modern practice to appoint special litigation committees to evaluate the merits of derivative suits. Here the committee is comprised solely of directors--there is no delegation problem. The only real issue is whether the directors acted on behalf of Dixie's best interests or on their own.

There are few facts to determine if the suit would have a negative impact in Dixie's financial interests. However, it is reasonable to assume that since Dixie's only losses have come recently, since the addition of the directors the suit seeks to disqualify, the suit could actually restore public confidence in Dixie and be of benefit to the corporation.

Because of the relative ease of defending a business decision on the grounds of the business judgment rule (directors simply show they were reasonable in their decision making process) the courts would probably validate the refusal on this ground.

However, the duty of loyalty to Dixie may have been breached. The directors on the committee all stood to lose their jobs if the suit was successful. If they acted in their own interest--to protect their jobs--the dismissal was improper. The equities of the problem would seem to justify this finding.

February 1986
QUESTION 5

Corp, Inc., (Corp) has 200,000 authorized shares of $1 par value stock. Andy, Ben, Carl, and Dave each purchased at par and continue to hold 50,000 shares of Corp. Corp's articles prohibit incurring any single debt in excess of $75,000 and require a vote representing 80% of outstanding shares to amend the articles. The articles also provide for preemptive rights, cumulative voting, and a board of four directors. Each of the four shareholders has elected himself director at annual shareholder meetings during each year of corporate existence.

Corp's board unanimously decided to borrow $100,000 from Lender. Lender took Corp's ten-year note, bearing interest at 20% per annum, payable in monthly interest installments. Corp has the option to pay off the note at any time, without penalty. Later, Lender needed funds and approached Andy, who serves as Corp's treasurer. Lender offered to sell the note for $90,000 and Andy, without consulting with Ben, Carl, or Dave, purchased the note on his own account.

The week following the purchase of the note by Andy, Rich asked to subscribe to 100,000 shares of Corp stock at $1 per share. Ben, Carl, and Dave approved Rich's proposal, but at the annual shareholders' meeting, Andy voted against and thus defeated a proposed amendment of the articles authorizing additional shares free from preemptive rights. Because of the note's high interest, Andy did not want it paid off. The other directors, hoping to use Rich's investment to pay the note and now aware of Andy's acquisition of it, were angered and caused Corp to cease paying the monthly interest installments.

Rich then caused the incorporation of Endrun, Inc., and subscribed to 100,000 of its shares for $100,000. Rich proposes that Corp be merged into Endrun, that each Corp share be converted into an Endrun share, and that Endrun pay the Lender note now held by Andy. Corp's board has approved the merger three to one, Andy dissenting.

Assume that the interest rate is not usurious.

1. Did Andy breach any duty to Corp or to fellow shareholders in voting against the proposal to issue 100,000 shares to Rich? Discuss.

2. Can Andy obtain an injunction to prevent the Corp-Endrun merger? Discuss.

3. Can Andy collect interest payments on Corp's note? Discuss.

ANSWER A TO QUESTION 5

(1) Andy (A) may be alleged by Corp [and Ben (B), Carl (C) and Dave (D) as directors of Corp] to have breached his duties of loyalty and care to Corp.

It is a well established rule that the director of a corporation owes to it a double duty of loyalty and care. The former duty is usually analyzed in subjective terms ("was the director's vote inspired by the corporation's interest or his own?"), whereas the duty of care is put in more objective terms ("would a reasonable person placed under the same circumstances have acted as the director did?")

A is Corp's director. His relevant vote here is his vote as director against the merger -- not his vote as shareholder against the amendment to the Articles (discussed infra).

A's vote against the merger was most probably inspired by the same fact as his shareholder vote against the amendment. As the new holder of the note, A does not want it to be paid by Corp (which has an option to repay it at any time without penalty) as such payment would deprive A of the high yield of the note. The proposed merger would put enough funds at Corp's disposal to repay the note. Such merger and repayment would be in Corp's interest as it would save Corp the cost of borrowing without depriving Corp of the cash supply, provided by Rich and Endrun, Inc. instead of by the note.

As the facts do not point to any other possible reason for A's vote against the merger, this vote was clearly inspired by A's giving pre-eminence to his own interests as note holder over those of Corp. ' This is a breach of A's duty of loyalty to Corp.

As to A's duty of care, Corp would have some more difficulty in showing A's breach.

A, under the objective test described above, could argue that a reasonable person would also have voted against the merger under the same conditions. A therefore would have to gather possible alternative reasons for his vote against the merger -- other than his noteholder's conflicting interests. A could try to argue that his vote was inspired by a desire to maintain the current capital structure of Corp, to avoid the dilution of the current capital repartition which would follow from the merger, as Rich would become a controlling and majority holder in the new corporation.

In the duty of care context, a court frequently resorts to the so-called "business judgment rule": notwithstanding the losses to a corporation resulting from a director's vote: if this vote was based on his best business judgment, he incurs no liability to the corporation.

The loss that would result to Corp from the absence of merger is obvious: the 20% interest on the note. However, A's possible arguments listed above would probably not suffice to show his exercise of good business judgment: first, because his conflicting noteholder's interest would cast much doubt as to the authenticity of these "alternative reasons"; secondly, these reasons again would amount to promoting A's interests as shareholder and director against Corp's interests. It is well established case law that a director's decision solely inspired to save his seat is not protected by the business judgment rule.

In conclusion, therefore, A's disloyal attitude to Corp and the absence of plausible legitimate reasons to vote against the merger make it likely that he also breached his duty of care.

A's duties as shareholder in his vote against the amendment. A shareholder's duties to his corporation and fellow shareholders are traditionally lesser than those of a director.

Here, however, Corp's case is somewhat different from a general situation. Although few statutes have recognized a special status to "closely held corporations," case law has tended to carve out special rules for those.

Corp is a close corporation. It has few shareholders, all of whom participate in its management as directors and even officers (A is a treasurer). The preemptive rights and the 80% vote required for amendments tend to preserve this close corporation quality.

"Traditional" courts would probably hold that this special quality of Corp is irrelevant and that a shareholder's duty of loyalty (and care) to his corporation is very weak. In that context, A's vote against the proposed issue of 100,000 shares would not appear as a breach of his duties to Corp.

Courts with a more "modern" jurisprudence would hold A liable for a breach of his duty of loyalty to Corp and even to B, C, and D possibly, on the basis of Corp's closely held status.

Such courts would impose on' A a duty of loyalty close to that of a director -- and this would be even more understandable as A is also Corp's director. What was said above on A's duty of loyalty would apply here. By making his own interest prevail over that of his close corporation, A probably breached a duty of loyalty toward it.

These "modern" courts also tend to assimilate to a certain extent the duties of a close corporation's shareholder to that of a partner in a partnership. A partner is not supposed to act against the interest of the partnership or those of his co-partners. In such context, there is an implied fiduciary relation among the co-partners and by extension the close corporation shareholders.

Before such a court, A's voting against a measure which would have saved his corporation and co-shareholders a very high interest paid to himself may be held to an improper breach of his duty of loyalty. Even more so as A probably obtained the note in violation of his director's duty of loyalty (infra).

(2) On a very technical point, A might be able to enjoin the merger: the merger was approved by the Corp board only, not by the shareholders.

However, such a victory would be pyrrhic as as B, C, and D would vote (75% majority) for the merger in a special meeting of the shareholders.

Here A could raise another argument. If A could prove that the merger amounts to an amendment of the articles, A could block the merger as B, C, and D would not be able to gather the required 80% of outstanding shares.

However, A would have difficulty with such a position. First, a merger is traditionally considered by case law as a "fundamental change" of the corporation, different from a mere amendment of the articles. In that respect, A might be able to block the merger if the applicable law required the New York type of 2/3 of voting shares majority for substantial changes. Other jurisdictions require a majority of all outstanding shares for such changes: A then would lose.

Secondly, it is possible that Corp's articles or bylaws provide for a lower majority for merger approvals.

Finally, if A could find some colorable claim to an injunction (like oppression of a minority shareholder), he would have to overcome two major obstacles:

(a) An appropriate remedy at law already exists: A is entitled to appraisal, i.e., to the redemption of his shares at an agreed price (or otherwise at a fair market value) as a dissenting shareholder against the merger. A meets the requirements for such a right: he has constantly opposed the merger and has not voted for it either as a director or as a shareholder. In addition, A would, of course, have to deliver his stock certificates to Corp. The choice for A would be between losing his shareholder and noteholder interests or only his noteholder interests.

An equity court would not have to give him a third alternative and might even have to deny it.

(b) A, to obtain an injunction, would have to come to equity "with clean hands." Under this doctrine, a plaintiff in equity must have had a proper conduct with respect to the transaction involved in his action.

A probably violated his duty of loyalty to Corp when he obtained the note. This note is his main reason to want to avoid the merger. Therefore, A would probably be denied an injunction.

(3) A's collection of interests would encounter two obstacles.

(a) A probably acquired the note in violation of his duty of loyalty. As a consequence to this duty, a corporation's director is not supposed to obtain a "corporate opportunity" without first offering it to the corporation.

The offer to buy the note fits the definition of "corporate opportunity": buying the note was in Corp's best interest as it would have saved the 20% interest and the debt burden.

In addition, it is apparently as Corp's director and treasurer that A obtained the offer to buy the note.

Finally, as was seen above, the note and A's interest therein are in direct conflict with Corp's interests.

A therefore should have communicated Lender's offer to the whole board and waited until their rejection of the offer before acquiring the note.

The remedy for not having done so is the establishment of a constructive trust on behalf of Corp: Corp is entitled to receiving the note interests.

However, a court would probably not allow Corp simply not to pay the interests. Corp would have to pay them to A as trustee for Corp.

Also, and this would be A's only argument, the law presumes that the corporation would have had the funds to acquire the "corporate opportunity." Here A might rebut such presumption: Corp, if it had the funds, would not have had to borrow or to look for a merger partner. On the other hand, Corp had borrowed $100,000 and the note was sold for $90,000. Corp, if the 100,000 were still liquid, could have got the note and made a profit of $10,000.

A therefore is probably a constructive trustee for Corp.

(b) Authority and ultra vires question. Corp and B, C, and D may argue that the $75,000 single debt ceiling in Corp's articles rendered the note avoidable by Corp under the ultra vires doctrine.

Under this doctrine, Corp exceeded its powers by borrowing more than the ceiling.

B, C, and D would probably not be successful:

Courts today are reluctant vis-a-vis applying ultra vires to excuse corporation from its liabilities.

Estoppel. B, C, and D as sole shareholders and directors (with A) of Corp first agreed to the note, knowing (or should have known) the ceiling; they cannot now use ceiling as excuse. However, this estoppel notion plays also against A -holder of the note. It would not have played against Lender (good faith, no notice of ceiling).

ANSWER B TO QUESTION For

ease of explication, **I** will answer question 3 first.

3. Can Andy collect interest payments on Corp's note?

By purchasing Corp's note, Andy has breached both his fiduciary duty of loyalty and his duty of care to the corporation and to this fellow shareholders. Andy owes the duties as a result of his position as **director** and treasurer (officer) of the corporation. **He** also arguably owes these duties as a controlling shareholder, since his vote can block certain fundamental corporate actions as amending the articles of incorporation or approving a merger. The purchase of a debt owed by a corporation by one of its officers, directors **or** controlling shareholders represents a potential conflict of interest with the interests and needs of the corporation and may constitute a breach of the duty of loyalty owed by persons in these positions to the corporation, its shareholders and possibly **its** other directors. When such a conflict arises, the officer or director must fully disclose all material facts concerning the transaction to the other directors and the shareholders, even where a fair profit may be involved. **In** addition, the transaction must **be** authorized by the directors or shareholders and it must be fair.

Andy made no such disclosure to **the** corporation and did not receive the board's authorization **or** shareholder authorization prior **to** purchasing the note. In addition, the transaction is not at all fair to the corporation. Ordinarily, a debt purchased by an officer that is unmatured, liquidated, and undisputed may be purchased by an officer or director without raising a conflict of interest problem. Here, however, Andy purchased a note that the corporation wishes to pay off early **so** as to avoid the additional interest payments which will accrue on the note. It could also **be** argued that Andy usurped a corporate opportunity by buying the note at a discount when the corporation itself may have wished to do that and was searching for a means to pay it off. Clearly, if the corporation was willing to find a way to pay off the note at face value, it would **be** willing to save $10,000 by paying it off at a discount. Andy didn't reveal the availability of the discounted note before the purchase in order to let the corporation decide. Accordingly, he breached his duty of loyalty to the corporation by taking this opportunity himself. Further, the corporation has been seeking a means of paying off the note. The reason Andy wants to hold on to it is clearly in conflict with the needs of the corporation and is injurious to it, because it means that the corporation will pay a substantial amount of interest on the note during the time in which it is still outstanding and they cannot retire it.

Andy has also possibly breached his duty of care and loyalty as a director by refusing to authorize a transaction that might stand to benefit the corporation through an influx of needed capital. The added cash from Rich if used by the corporation to pay off the note may stand to benefit the corporation in the long run by saving it substantial interest payments. The problem, however, is that we do not know what other assets the corporation has besides the $50,000 contributed by Andy, Ben, Carl, and Dave. If the corporation has no other assets, then the issuance of 100,000 shares to Rich, which would add $100,000 to the stated capital account might not be the proper means of paying off the note since the stated capital (based on the number of shares authorized and outstanding) would appear to indicate that the corporation had at least $150,000 in assets, when in reality its assets would be only $50,000. On the other hand, since the outstanding liability of the $100,000 note would be cancelled, arguably there may be no impairment of capital by virtue of the issuance of shares to Rich and the simultaneous use of the money acquired to retire the debt. Thus, there does not seem to be a valid basis for Andy to argue that he had been acting out of concern for the corporation by refusing to authorize the issuance of additional shares free from preemptive rights to Rich.

It might be noted that the acquisition of the $100,000 note was an ultra vires act of the board of directors to begin with, since the articles prohibit incurring any single debt in excess of $75,000. However, since the shareholders (A, B, C, and D) impliedly ratified or adopted that action, Andy cannot argue that since the debt was not validly incurred, he is not required to act fairly in connection with it. This would be a fallacious argument anyway; there are no grounds for a director to suggest that because an act was initially ultra vires, he is someone relieved of his duties of loyalty and care in connection with it if it continues to impact on the corporation.

Based on the breaches of loyalty which Andy committed with regard to the loan transaction, he should not be able to collect interest payments on the note. Some courts hold that in a situation such as this, Andy would have to turn over only any unfair profit (which would include the interest payments). Other courts would require him to turn over his entire profit from the note which would be the difference between his purchase price of it and its face value plus any interest paid to him by the corporation. Since they stopped paying the interest, he would only be required to return the interest paid over and above the difference between face value and- purchase price.

1. Did Andy breach any duty to corporation or to fellow shareholders in voting against the proposal to issue 100,000 shares to Rick?

As mentioned above, since Andy was motivated purely by self-interest and was not fulfilling his duty of due care (to act as an ordinarily prudent person in the conduct of his or her own affairs) in connection with the corporation nor to avoid self-dealing (his duty of loyalty), he did indeed breach these duties by voting against a transaction which stood to benefit the corporation.

As mentioned, he entered into a transaction that represented a clear conflict of interest and usurped a corporate opportunity and thereby breached his duty of loyalty. In addition, he was not exercising his business judgment when he voted against the issuance of additional shares (or the authorization that the currently authorized shares be sold without preemptive rights -- it is not clear which was proposed) but was acting in bad faith and with obvious self-interest. He is also a controlling shareholder, and owed the same duty of loyalty to his fellow shareholders as he did to the corporation as one of its directors.

Therefore, he breached his duty of loyalty to his fellow shareholders as well (this is the Massachusetts rule where close corporations are concerned and may be applicable to the facts here).

2. Can Andy obtain an injunction?

The Corp-Endrun merger may not have been properly authorized by the corporation if the 80% necessary to amend the articles is also necessary to approve the merger. However, the merger was authorized by a majority of a quorum of the board, and that may be satisfactory approval, and of a majority of the shareholders. Since the merger has not been proposed to freeze Andy out, he can't argue that it is unfair to him in that way. It would dilute his stock interest in Endrun and this might be arguably unfair to him. However, he is entitled to his appraisal rights if he doesn't approve of the merger. Many courts hold that only appraisal rights are available to a dissenting shareholder, and he would receive them. If he seeks an injunction, which in some instances the courts might approve if the merger was totally unfair or if there was a fraudulent representation or omission involved (under 101 .5 or common law) -- which is not present here -- he would be going into an equity court with "unclean hands" which he cannot do. His reasons for opposing the merger reflect his self-interest only and he has already breached numerous duties to the corporation. He should not, therefore, be afforded injunctive relief.

February 2001
QUESTION 2

Adam owns 100% of the stock of Sellco, a corporation that sells houses. Sellco's board of directors consists of Adam and his wife Betty.

Sellco owns 90% of the stock of Buildco, another corporation. Pat owns the remaining 10% of Buildco's stock. Buildco's business is home construction. Buildco's board of directors consists of Adam, Betty and Evan. Betty is the president of Buildco and, as such, is a salaried employee. Neither Adam nor Evan is an officer or employee of Buildco.

Adam urged Buildco's other directors (Betty and Evan) to approve an arrangement whereby Buildco would build houses and sell them to Sellco at cost. Sellco, in turn, would sell the homes for a profit. Based solely upon Adam's representation that the arrangement "made sense," Buildco's board unanimously approved this arrangement. Buildco thereafter commenced constructing homes exclusively for the purpose of selling them to Sellco. Buildco sold the houses at cost to Sellco, and Sellco sold the houses for a considerable profit.

Pat objects to this arrangement because it deprives Buildco of the only source of money with which to pay dividends.

What personal and/or derivative claims can Pat reasonably assert against Sellco, Adam, Betty and/or Evan, and is he likely to succeed on each claim? Discuss.

ANSWER **A** TO **ESSAY QUESTION 2**

Shareholder Derivative Suits

To bring a shareholder's derivative suit, the plaintiff must be a shareholder at the time the claim arose and throughout the course of the litigation. The shareholder must be asserting a claim for which the corporation could sue. He must make a demand on the Board of Directors to rectify the situation unless he can show that it would be futile, and may be required to make a demand on the shareholders to rectify unless the majority of the shareholders are also wrongdoers. He must then file a verified complaint with the corporation as a nominal defendant and post a bond.

Here, Pat, is seeking to rescind this agreement as it deprives Buildco any ability to pay shareholders' dividends. The company is not making a profit so not only is Pat as a shareholder injured but so is Buildco. Since Buildco's Board of Directors already approved the Buildco-Sellco arrangement it would be futile to demand of them to rescind it. Also, Sellco is the majority shareholder, which in turn is owned by Adam, who is on the Board of Directors of Buildco; thus, to ask Sellco to rescind this profitable agreement would also be futile.

Pat v. Sellco

Pat can sue Sellco in his individual capacity as a shareholder or under a shareholder's derivative suit if Sellco's actions as a majority shareholder injure the corporation. Traditionally a majority shareholder had no duty to minority shareholder; however, there is a trend to impose such a duty, particularly in close corporations. Close corporations are those that have a few number of shareholders and are not traded on national exchange. Here, Sellco and Pat are the only shareholders of Buildco. Nothing in the facts indicate whether Buildco is traded on national exchange.

Duty of Sellco

The trend is to impose a duty on the majority shareholder, not to act to the detriment of a minority shareholder. The court will look to the Entire Fairness Test, i.e., 1) fair price and 2) fair dealing.

Sellco as the maiority shareholder of Buildco

Sellco as a company is reaping great profits at the expense of Buildco making no profits. Buildco cannot issue dividends to its shareholders, who are Sellco and Pat. Since Sellco is already making money, it is only Pat who suffers. Thus, Sellco by making this agreement has breached its duty of fairness to Pat and its duty of fairness to the corporation.

Pat should be able to disgorge the profit made by Sellco, but he will want the recovery personally rather than to Buildco; otherwise, Sellco would benefit as the majority shareholder.

Pat v. Adam

Adam, as a member of the Board of Directors of Buildco, owes the fiduciary duties of care and loyalty to the corporation.

Duty of Care

The duty of care is the standard a reasonably prudent person would use in the course of his own business affairs. The plaintiff bears the burden of proof to show this fiduciary duty has been breached. Adam urged the other directors to vote for the agreement with Sellco saying that it "made sense." He made no further statements.

Adam may argue the Business Judgment Rule as a defense. The Business Judgment Rule excludes a director from liability where 1) he acted in good faith, 2) the decision was reasonable, and 3) it was supported by a rational basis. To be reasonable, a decision must be made after the directors investigate, analyze and deliberate over a corporate action.

Other than the statement that the agreement "made sense," there is no indication that Adam, Betty or Evan further discussed or questioned the agreement. Thus none of them abided by their duties of care. Thus, Adam may be liable for lost profits to Buildco as a result of the Buildco-Sellco Agreement.

Duty of Loyalty

The duty of loyalty is such that a director must act in good faith belief that his actions or decisions are in the best interest of the company. The duty of loyalty prohibits directors from self dealing, i.e, profiting at the expense of the company.

Company

The Interested Director's Rule forbids a director from any transactions with his company unless he fully discloses the arrangement in which he has an interest and the deal is approved by a majority of the disinterested directors or shareholders. Some jurisdictions count the involved directors for purposes of a quorum; others do not.

The problem here is that Buildco's board consists of Adam and his wife Betty, both of whom are interested in the transactions. Evan, the only disinterested director, was not made aware of Betty and Pat's involvement with Sellco. Thus there was no disclosure of the appropriate involvement of Adam and Betty with Sellco, and 2 of 3 board members were interested persons. Adam, as owner of Sellco, and therefore 90% owner of Buildco, could've submitted the agreement to Pat, but Pat's dissent would not have mattered.

Since Adam violated his duty of loyalty to Buildco, any loss suffered by Buildco he will be held liable for. However, if the corporation receives the profits, Adam will benefit as a company shareholder, so Pat may want to sue personally to recover.

Pat v. Betty

Betty, as a director and officer of Buildco, owes the fiduciary duties of care and loyalty to Buildco discussed above. She is in violation of both duties for the same reason as her husband, Adam, and will be held liable to Buildco and Pat for damages.

Pat v. Evan

Evan also owes the fiduciary duties of care and loyalty to Buildco as discussed above. However, as he had no personal interest in the Sellco-Buildco arrangement he will not be liable for breach of the duty of loyalty. However, Pat will be able to show that Evan breached the duty of care.

A reasonably prudent person would have further inquired of Adam and Betty about the proposed transaction, particularly where he knows Sellco is the majority shareholder in Buildco. Evan also knew Buildco would not be making any profit. Evan failed to act with the care a reasonably prudent person would in his own business affairs and, thus, is liable for any damages to Buildco.

ANSWER B TO **ESSAY QUESTION 2**

Pat v. Sellco

Pat will bring both a derivative shareholder action and a personal action against Sellco on behalf of Buildco.

In a personal action against Sellco, Pat will claim that Sellco, as a majority and controlling shareholder of Buildco, breached its fiduciary duty to him, a minority shareholder. A controlling shareholder has a general duty to deal fairly with the other shareholders and to not take any action that will affect their interest. Here, Sellco entered into a deal with Buildco that was unfair to Buildco and deprived Buildco of the only source of money with which to pay dividends. Thus, this will not only cause Pat as a minority shareholder to receive no dividends, but it will greatly decrease the value of his stock.

Action to Declare a Dividend

Pat may also attempt to bring an action against the company demanding that it pay a dividend. The facts tell us that the company has not been able to pay dividends because of the arrangement between Sellco and Buildco.

A shareholder is generally not entitled to a dividend until it is declared. Furthermore, a dividend can only properly be paid out of net earnings or, in some states, excess capital. Here, there were no net earnings because the company was not making any money. Thus, payment of a dividend was not warranted.

Nonetheless, some courts may entertain an action demanding a dividend where a shareholder can show Board misconduct. For the reasons discussed below, Pat can show that the Board acted improperly. Thus, the Court may require the corporation to declare a dividend. More likely, however, the court will order a buyout of Pat's shares at a reasonable price.

Pat (on behalf of Buildco) v. Sellco - Shareholder Derivative Suit

Pat will also bring a shareholder's derivative action against Sellco on behalf of Buildco. A shareholder can bring a derivative action on behalf of the corporation if he was an owner of stock both at the time of the action complained of (here, the entering in the contract with Buildco) and throughout the course of the lawsuit. Before bringing such a suit, a shareholder must generally either make a demand on the Board of Directors to bring the suit themselves or, in some states, make a demand to the shareholders to bring a suit. A shareholder is excused from this requirement where the making of such a demand would be futile. Here, the making of the demand would be futile since a majority of the Board (both Adam and Betty) have an interest in the deal. Adam is the 100% owner of Sellco and thus would not likely approve an action to sue the company. Betty is Adam's wife and is thus indirectly interested in Sellco. Pat will have to file a complaint alleging that the demand was futile with specificity and then he will have to likely post a bond. If Pat is successful in his suit, he will be entitled to an award of attorney's fees and the company will receive any damages.

Pat's suit will allege that Sellco, as a majority shareholder, breached its duty of loyalty and care to Buildco. A majority shareholder such as Sellco stands in a fiduciary relationship with Buildco, since it in essence has control of the Board. Here, Sellco breached its duty of loyalty to Buildco by entering into a deal that was entirely unfair to Buildco and which will cause Buildco to lose a lot of money.

Unjust Enrichment

Pat will also sue Sellco derivatively alleging that the contract between Sellco and Buildco is unenforceable because it was unconscionable when made. He will bring an action against Sellco in equity to rescind the contract and for restitution in the amount that Sellco was unjustly enriched at Buildco's expenses. This would include any and all profit which Sellco made on the sale of Buildco homes, which, according to the facts, was a considerable profit. Pat may also seek a constructive trust on the profits made off of Sellco's sale of Buildco-built homes. Because the deal was unfair to Buildco, Pat is likely to succeed on these claims.

Pat (on behalf of Buildco) v. Adam

Pat will bring a shareholder derivative action against Adam on behalf of Buildco. Again, he will be able to show that a demand on the Board is futile because Adam is a Board Member.

Adam is a member of the Board of Directors of Buildco, and as such owes certain fiduciary duties to the corporation. A board member owes the corporation a duty of care, which requires that he act with respect to the corporation as a reasonable person would with respect to their own business affairs. He also owes a duty of loyalty which requires that he act in good faith, and with the reasonable belief that he is acting in the best interest of the company.

Breach of the Duty of Loyalty

Adam engaged in self-dealing when he urged the other Buildco directors to approve an arrangement whereby Buildco would build houses and sell them to Sellco at cost. The facts indicate that Adam made a representation that the arrangement "made sense" and thus the Board unanimously approved the arrangement. Adam clearly had much to gain from the transaction as he was the 100% shareholder of Sellco. A transaction benefiting a Board member is a breach of the duty of loyalty unless: (1) it is fair to the corporation; or (2) the interested Board member makes a full disclosure of his interest to the Board and a majority of uninterested Board members or shareholders approve the deal. Here, it is not clear that Adam disclosed his interest in Sellco to Evan (presumably Betty knew of his interest since she was his wife). Furthermore, this deal was not fair to Sellco as it took away all of its profits.

Breach of the Duty of Care

Adam also breached his duty of care to Buildco because, as discussed above, the deal was not fair to the corporation. As a result of his breaches of care and loyalty, Pat is likely to succeed on his claims and Adam will be liable to Buildco for the losses it sustained as a result of the bad deal with Sellco.

Pat v. Adam (directly) - Piercing the Corporate Veil

Adam is also a 100% owner of Sellco. Pat will sue Adam directly, arguing that the corporate veil should be pierced and that Adam should be directly liable for the same causes of action Buildco has against Sellco discussed above. A court will hold a shareholder directly liable where there is evidence that the corporation was a mere shell for the shareholder. The court will consider factors such as the amount of control of the shareholder and the amount of capital the company maintains. Here, Sellco's Board of Directors consists of Adam and his wife, Betty. Thus, it is clear that Adam controls Sellco. It also appears that Sellco is merely a holding company, as the facts do not indicate that Sellco has any purpose other than holding Buildco stock and reselling Buildco homes. Thus, the interests of justice would allow Pat to pierce the corporation veil and bring a direct cause of action against Adam.

Pat (on Behalf of Buildco) v. Betty

Pat will also bring a shareholder derivative suit on behalf of Buildco against Betty. Again, because Betty and her husband are on the Board, Pat will be able to show that a demand on the Board would be futile.

Betty is both a President and Board Member of Buildco. In both roles, she also owes duties of care and loyalty to the corporation. Betty, as Adam's wife, also engaged in selfdealing, because she stands to benefit from any profit made by Adam. Thus, for the reasons discussed above with respect to Adam's breach of the duty of loyalty, Betty also breached this duty.

Betty breached a duty of good faith [to] the company also. The facts indicate that the Board approved the action "based solely on Adam's representation that the agreement made sense."

Business Judgment Rule

Under the Business Judgment Rule, a Board member will not be held to breach the duty of good faith if the facts show that the judgment was made in good faith, reasonably informed, and rationally based. Here, the decision was not reasonably informed or rationally based. Furthermore, Betty cannot claim that she relied in good faith upon the representations of another Board member, because this was not reasonable under the circumstances, particularly since Betty knew that Adam (and she) had an interest in the deal.

Pat may also be able to bring an action against Betty based upon the theory of piercing the corporate veil if she has an ownership interest in the stock (e.g., based on her community property interest).

Pat (on behalf of Buildco) v. Evan

Finally, Pat will bring a shareholder derivative suit against Evan. Pat will again argue that a demand on the board would be futile since Evan is on the Board and the deal he complains of involves both Adam and Betty.

Evan was a Board member and thus owed Buildco duties of care and loyalty. For the same reasons discussed above with respect to Betty, Evan acted in an uninformed and unreasonable manner in approving the deal with Sellco. Thus, he is liable to Buildco for any losses it incurred.

Conclusion

As a result of the above actions, Pat will successfully bring shareholder derivative suits on behalf of the company and will be able to seek damages against all of the defendants jointly. A court will rescind the Sellco-Buildco contract. In addition, the company will be entitled to unjust enrichment against Sellco and damages from the Board Members, which represents the damage caused to the company as a result of the contract.

February 2002

Question 3

Acme Corporation was a publicly traded corporation that operated shopping malls. Because of an economic slowdown, many of Acme's malls contained unrented commercial space. Additionally, the existence of surplus retail space located near many of Acme's malls prevented Acme from raising rents despite increasing costs incurred by Acme.

In June 2001, Sally, president and sole owner of Bigco, approached Paul, Acme's president. She proposed a cash-out merger, in which Bigco would purchase for cash all shares of Acme, and Acme would merge into Bigco. Sally offered $100 for each outstanding share of Acme's stock even though Acme's stock was then currently trading at $50 per share and historically had never traded higher than $60 per share.

Paul, concerned about Acme's future, decided in good faith to pursue the merger. In July 2001, before discussing the deal with anyone, Paul telephoned his broker and purchased 5000 shares of Acme at $50 per share. Paul then presented the proposed merger to Acme's board of directors and urged them to approve it. The board met, discussed the difference between the current market share price and the offered price, and, without commissioning a corporate valuation study, voted to submit the proposed deal to a shareholder vote. The shareholders overwhelmingly approved the deal because of the immediate profit they would realize on their shares. Based solely on shareholder approval, the board unanimously approved the merger, and all shareholders received cash for their shares.

In December 2001, shortly after completing the merger, Bigco closed most of the Acme malls and sold the properties at a substantial profit to a developer who intended to develop it for light industrial use.

1. Did Paul violate any federal securities laws? Discuss.
2. Did Paul breach any duties to Acme, and/<u>or</u> its shareholders? Discuss.

3. Did the board breach any duties to Acme and/or its shareholders? Discuss.

<u>ANSWER A TO QUESTION 3</u>

PAUL'S VIOLATION OF FEDERAL SECURITIES LAW

The issue here is whether Paul violated any federal securities laws by purchasing 5000 shares of Acme stock prior to the merger with Bigco. The two main federal securities laws that Paul could be liable under are Rule 10b-5, which prohibits insider trading, and Section 16(b), which imposes strict liability on officers, directors, and 10% shareholders for trading the stock of their company within 6 months of each other. Each will be discussed below:

Rule 10b-5

The issue is whether Paul violated rule 10b-5 of the SEC. Rule 10b-5 prevents insider trading by making it illegal for one who owes a fiduciary duty to a corporation and possesses "inside information" to use an instrumentality of interstate commerce to buy or sell the corporation's stock. Additionally, the rule contains a scienter requirement. The "insider" must either disclose the information or abstain from trading.

A person who owes a fiduciary duty is one who is an officer, director, attorney, employee, etc. who owes some duty (duty of care, loyalty, confidentiality, etc.) to the corporation. As the president of Acme, Paul is an officer and is clearly within the class of persons owing Acme a fiduciary duty.

Inside information is that information that a reasonable trader would want to know before buying or selling the corporation's stock. Here, the information was that Bigco had proposed a merger and buyout of Acme's stock at twice its current selling price and $40 higher than it had ever traded before. This information would be crucial to any person who was trading Acme's stock.

Using an instrumentality of interstate commerce is easily satisfied. Here, Paul used the telephone to place the order to his broker. The telephone lines cross state lines and are used to conduct business across state lines. Therefore, this requirement is satisfied as well.

Paul did purchase 5000 shares of Acme's stock. And, he did so with improper intentions. This is what is required in "scienter" -- it is knowledge that what one is doing is wrong. In short, Rule 10b-5 requires that the insider to something "slimy" and repugnant to an ordinary person. Purchasing 5000 shares of his company's stock on the basis of inside information is just what Rule 10b-5 was enacted to prevent.

The "abstain or disclose" rule is also part of 10b-5. Here Paul did eventually disclose the Bigco offer to the Board of Directors, and then to the shareholders, he traded on the information prior to disclosing. The announcement could have increased the current trading price of Acme, and Paul took advantage of the low price of Acme stock by purchasing before the disclosure.

In short, Paul has violated Rule 10b-5 and will be forced to disgorge his profits to the corporation.

<u>Section 16(b)</u>

The issue here is whether Paul violated Section 16(b). Section 16(b) imposes strict liability on any officer, director, or shareholder owning 10% or more of the outstanding stock from buying and selling or selling and buying stock of the company within 6 months of each transaction. There is no "guilty mind" requirement as in 10b-5 because the idea is that it is simply bad policy and bad for the market to have these persons trading. In order for Section 16(b) to apply, the corporation has to either be publicly traded or be of sufficient size to meet the guidelines. Here, Acme is a publicly traded corporation, and Paul, as president is an officer; therefore, the rule applies.

Here, Paul bought 5000 shares in July of 2001. If he sold those shares within 6 months, he is strictly liable to the corporation. The facts do not indicate when Bigco purchased the shares, but it had to be prior to December of 2001, when Bigco closed the malls. This is 6 months or less from the purchase. Paul therefore is strictly liable for profits.

Profits under 16(b) are tricky -- the calculation is the difference between the lowest price in the six month period and the highest price in the six month period. Paul's profits were at least the same as they would be under 10b-5. However, if the price fluctuated under $50 or sold for more than $100, P would be liable for that additional amount as well.

Conclusion

Paul has violated both Rule 10b-5 and Section 16(b).

PAUL'S BREACHES OF DUTY TO ACME/SHAREHOLDERS

The issue is whether Paul breached any duty to Acme or the shareholders. Paul owes two overarching duties to the corporation and hence the shareholders: the duty of care and the duty of loyalty. Each are discussed below.

Duty of Care

As an officer, Paul owes a duty of care to Acme. Paul must act as a reasonably prudent person would in this situation. He must act in good faith and in what he honestly believes is the corporation's best interest.

Paul, in good faith, decided to pursue the Bigco merger. A reasonably prudent person would most likely do the same thing. A merger would be good for the shareholders because the company was suffering from financial hard times. However, Paul apparently did not do any checking on Bigco's intentions after the merger. Had Paul done some investigating, he might have been able to discover that the reason Bigco was offering so much for the Acme stock was because it had a developer waiting to purchase the property and make a substantial profit.

Business Judgment Rule

Paul will assert that his actions did not violate the duty of care he owes the corporation because he acted under the protection of the business judgment rule. The business judgment rule provides that when an officer or director acts in a way motivated by a good faith belief that he is acting on behalf of the corporation's best interests and that judgment turns out in hindsight to be wrong, the court will not step in [and] hold the officer or director liable.

However, the corporation or the shareholders will be able to argue that a reasonable person would have made the further inquiries, that the high asking price should have tipped Paul off that something else was happening here. This was a substantially high price for stock here -- Acme had never traded higher than $60/share, and Sally offered $100/share while the market was depressed and Acme was suffering financial hardship. This would have tipped off any reasonable person that something was motivating her.

Therefore, the business judgment rule will probably not protect Paul's decision in the end. While pursuing the merger might have been a wise choice, the failure to inquire into the basis of the merger was a violation of the duty of care.

Duty of Loyalty

As an officer, Paul owes a duty of loyalty to the corporation as well. This means that Paul must put the corporate interest ahead of his own, or those close to him, at all times. There are many ways to violate the duty of loyalty; of particular relevance here is the duty not to engage in interested transactions.

Normally, an interested transaction is one where the officer has an interest such as an ownership in another corporation that this corporation is considering doing business with. Here, however, the interest came in the $250,000 Paul spent on Acme's stock before he went to the Board with the merger proposal. A quarter of a million dollars -- there was no way that Paul would be able to act in an impartial manner in this transaction. By purchasing the stock before he even went to the meeting and informed the board of the merger proposal, he had indicated that he had decided it was going to happen. Otherwise, he risked losing that money.

As such, Paul violated his duty of loyalty to the corporation.

Conclusion

Paul has violated both the duty of loyalty and the duty of care he owed to the corporation.

THE BOARD'S BREACHES OF DUTY TO ACME/SHAREHOLDERS

The issue is whether the Board breached any duty to Acme or the Shareholders. Directors owe two overarching duties to the corporation and hence the shareholders: the duty of care and the duty of loyalty. Each are discussed below. Duty of Care

The board of directors owes the same duty of care that Paul, as an officer, owes. The Board will, like Paul, argue that the Business Judgment Rule protects their decision to take the merger to the shareholders. However, like Paul, the argument will fail.

One of the fundamentals of the duty of care is that the directors need to investigate. Here, all the directors saw was dollar signs. They did not take the time to get a corporate valuation study, which in all likelihood would have revealed the developer that Bigco was dealing with, or some other similar venture. Directors are allowed to base decisions on the recommendations of employees or other people who have relevant information. However, there has to be some basis for this reliance. Here, the directors only relied on Paul's recommendation. Paul had done nothing to indicate that he had substantially investigated the deal. All the board based its decision on was the price. While price is important, it is not the only concern of the board. The board should have investigated further.

Therefore, the board breached its duty of care to the corporation and is not protected by the business judgment rule.

Duty of Loyalty

The board owes the same duty of loyalty that Paul, as an officer, owes. There is no evidence here of any interest on the part of the directors. If the directors were also large shareholders in Acme, that might provide the basis for the breach of the duty of loyalty, but absent such or similar evidence, there is no indication that the board breached any duty of loyalty to the corporation.

Conclusion

The board has violated its duty of care owed to Acme, but no facts indicate that a suit for violation of the duty of loyalty could be maintained.

POSSIBLE DEFENSES BY PAUL AND THE BOARD

Shareholder Approval

Paul and the board both could attempt to defend any liability based on the fact that the shareholders approved the merger. The merger constituted a fundamental corporate change, and as such, required shareholder approval. Therefore, the board acted properly in submitting it to them. However, the shareholders are permitted to rely on the board's recommendation, as they did here.

Therefore, the shareholder approval will not protect either Paul or the Board.

ANSWER B TO QUESTION 3

1 Did Paul violate any federal securities laws? Rule

10b-5

Rule 10b-5 is a federal law that makes it illegal for any person to use any means or instrumentality of interstate commerce to engage in a scheme to defraud, make an untrue statement of material fact (or omit a material fact) or engage in any practice that operates a fraud, in connection with the purchase or sale of a security. The elements of a violation of Rule 10b-5 therefore include an instrumentality of interstate commerce, scienter, an act or misstatement and the purchase or sale of a security.

Here, Paul telephoned his broker, which satisfies the element of interstate commerce. The "means or instrumentality" requirement is broadly defined to include anything that affects interstate commerce, and the use of the telephone is included. (Also, the facts state that Acme

Corporation is publicly traded. If it is traded on a national exchange, Paul would satisfy this element even without using the telephone.)

Paul purchased 5000 shares of Acme while in possession of insider information, which is insider trading. Paul is an insider of Acme Corporation because, as its president, he is in a position of trust and confidence to the corporation. He knew about the merger proposal when he purchased the shares, even though not even the Board, much less the public, knew about it. Inside information is material nonpublic information, which includes any information about which there is a substantial likelihood a person would be interested (or that a person would find persuasive) in deciding whether to buy or sell the security. A potential $50 per share profit in a month or two is certainly material. Because Paul is an insider and he possessed inside information, he had an obligation to either disclose the information or abstain from trading on it. He violated this duty when he purchased the shares without disclosing the offer.

Paul's knowing disregard of his duty to disclose or abstain fulfills the scienter element of a Rule 10b-5 violation. His purchase of the shares is the requisite act and also satisfies the purchase or sale requirement.

Paul has violated Rule 10b-5.

<u>Section 16b</u>

Section 16b makes it illegal for any director, officer or 10% shareholder of a company to profit from the purchase and sale, or sale and purchase of shares of that company's equity securities within a time frame of 6 months; if the company has 500 shareholders and $10,000,000 in assets or is traded on a national exchange.

Here, Paul purchased 5000 shares of Acme stock at $50 per share in June of 2001. Because he

was a shareholder of Acme when the merger was approved, he received $100 per share. The merger was completed prior to 2001, so Paul's profit was
sustained within 6 months. Acme Corporation is publicly traded. If it has 500 shareholders and $10M in assets or is traded on a national exchange, Paul has violated Section 16b. His profit of $50 per share times 5000 shares must be disgorged to the company. Therefore, Paul owes Acme (now Bigco) $250,000, assuming someone pursues this claim against him. He will have to defend a claim by any shareholder who held shares of Acme in June 2001 when Paul purchased the 5000 shares, and remained a shareholder through the merger and the suit.

2. <u>Has Paul breached any duties to Acme and/or its shareholders?</u>
As Acme Corporation's President, Paul owes Acme and its shareholders the duties of care and loyalty. He is therefore required to act in good faith as a reasonably prudent person would and in the best interests of Acme and its shareholders.

Paul's decision to pursue the merger was in good faith and supported by his concern about Acme's future. Therefore, this decision did not breach his duties.

However, Paul's purchase of 5000 shares of Acme stock based upon material inside information breached his duty of loyalty. An officer or director may not profit at the expense of the company or its shareholders. Paul purchased his shares from either Acme or another shareholder, so he profited at their expense when he reaped the $50 profit per share associated with the merger.

Paul may also have breached his duty of care when he submitted the merger proposal to the Board and urged them to approve it. Other than Paul's good faith concern about Acme's future, there is nothing in the facts to suggest that Paul did any research regarding the offer or the other possible ways Acme could make a profit. Since the facts indicate that Bigco sold Acme's properties at a substantial profit shortly after the merger, it appears that there were options Paul failed to look into or convey to the Board.

3. Did the Board breach any duties to Acme and/or its shareholders?

As with Paul, the Board as directors have duties of care and loyalty they owe to the corporation. This means that they must act as reasonably prudent persons would, and in good faith, in the best interests of the corporation and its shareholders.

The business judgment rule prevents the directors from being liable for any action taken in good faith that they reasonably believed to be prudent in their business judgment. The directors are also allowed to rely on the recommendations of officers in good faith.

Here, the Board was unaware of Paul's breach of duty when it relied on his recommendation, so the reliance was probably justified. However, a closer question arises regarding the Board's decision to submit the merger proposal to shareholders without commissioning a corporate valuation study or, as with Paul (above), considering alternative sources of profit. If a reasonably prudent person in conducting his or her
own business affairs would have taken such actions then the Board's failure to do so breached their duty of care owed to both the corporation and its shareholders.

As with Paul, the Board likely should have considered other possibilities or commissioning a valuation study. A reasonably prudent person, when offered double what that person previously believed to be the fair value of his or her property, would probably look into whether there was value to the property of which he or she was

unaware.

On the other hand, the fact that the shareholders overwhelmingly approved the deal undermines this argument and could be used as evidence that the Board acted prudently.

The Board also breached its duties by failing to vote on the merger proposal until after the shareholders had already approved it. The Board may not shirk its responsibility to make decisions for the corporation and leave the decisions to the shareholders. The shareholders must see the Board's decision in the proposal.

July 2003

Question 1

Corp is a publicly held corporation whose stock is registered under Section 12 of the Securities Exchange Act of 1934. The following sequence of events occurred in 2003:

January 2: Corp publicly announced that it expected a 25% revenue increase this year.

March 1: A Corp director ("Director") sold 1,000 Corp shares for $25 each.

June 15: Corp learned that, because of unforeseen expenses, its revenues would decrease by 50% this year, contrary to its January 2 announcement.

June 16: A Corp officer ("Officer") consulted his lawyer ("Lawyer") for personal tax advice. Officer mentioned, among other things, the probable devaluation of his Corp stock.

June 17: Lawyer telephoned his stockbroker and bought a put option for $1,000 from OptionCo. The put option entitled Lawyer to require OptionCo to buy 1,000 Corp shares from Lawyer for $20 per share.

June 18: Corp publicly announced that its revenues would decrease by 50% this year. Its stock price fell from $30 to $5 per share.

June 19: Lawyer bought 1,000 Corp shares at $5 per share and required OptionCo to buy the shares for $20,000 pursuant to the put option.

July 1: Director bought 1,000 Corp shares for $5 per share.

1. In each of the foregoing events, which of the actions by Director, Officer, and Lawyer constituted a violation of federal securities laws and which did not? Discuss.

2. Did Lawyer violate any rules of professional responsibility? Discuss.

Answer A to Question I

Publicly Held Corporation

Corp is a publicly held corporation and is thus subject to federal securities laws. The two laws at issue in this question are Rule 10(b)5 and Rule 16(b).

Director Liability for violating Rule 16(b)

Rule 16(b) prohibits a director, officer or 10% shareholder of a publicly traded corporation on a national stock exchange or with assets of over $10,000,000 and 500 shareholders from purchasing and selling or selling and purchasing stock of the corporation in less than 6 months. This is deemed short swing trading. The policy behind prohibiting short swing trading is that short swing trading is against the interests of the corporation.

Corp is entitled to recover the maximum difference between a sale and purchase during this 6 month period.

On these facts, Director sold 1,000 corp shares for $25 each on March 1. Less than 6 months later on July 1, director purchased corp shares for $5 per share.

The corp is entitled to recover $25-$5=$20 multiplied by 1,000 shares or $20,000 dollars from this violation of Rule 16(b).

Officer Not Likely Liable for violating Rule 10(b)(5)

Rule 10(b)(5) prohibits the use of an instrumentalityof inter-state commerce in any scheme to defraud, make material misrepresentations or omissions or in any other way use fraud in the purchase or sale of securities. An insider must either disclose inside information or not trade in the securities. An insider may also be liable for tipping information regarding the company for an improper purpose.

On these facts, officer had a fiduciary duty to Corp. That duty included not disclosing private information regarding Corp. Officer violated his fiduciary duty to Corp when he improperly mentioned the probable devaluation of Corp stock on June 16"' prior to public disclosure of this information on June 18`h

However, Officer is only liable for a 10(b)(5) violation if he tipped this information to his lawyer for an improper purpose. An improper purpose would be personal gain of Officer either by pecuniary gain or by gifting to Lawyer. It is unclear whether Officer used a telephone to speak with Lawyer or whether he met him in person. Thus, the instrumentality of inter-state commerce requirement may be lacking as well. The facts tell us that Officer was seeking tax advice, then he mentioned the devaluation. There is no other indication of personal gain by Officer resulting from telling Lawyer about the devaluation.

Officer is not likely liable for tipping for an improper purpose and thus did not violate Rule 10(b)(5).

Lawyer Not Liable under Rule 10(b)(2) but is Liable for Misappropriation

A tippee is only liable if the tippee knew that the tipper was giving them non-public information for an improper purpose. As detailed above, it is unlikely that Officer will be liable for tipping for an improper purpose. Thus, Lawyer is not liable under this section.

Note that if Officer had an improper purpose, it would be easier to find Lawyer satisfied the other tippee requirements because Lawyer should have known that the information from Officer was private information regarding Corp. Lawyer knew that Officer had a duty not to disclose such information. Nonetheless, Lawyer traded on such information.

Misappropriation Liability

Some courts would find that Lawyer is liable for misappropriation of non-public (insider) information in the purchase or sale of securities.

Lawyer used the insider information to purchase a put option from Option Co. prior to the public announcement on June 18`h. This bound Option Co. to purchase 1,000 Corp shares from Lawyer at $20 per share. Lawyer then purchased Corp shares at the discounted rate of $5 per share after the public announcement (June 19th). Lawyer profited at $15 per share multiplied by 1,000 shares=$15,000. This $15,000 was ill gotten gain from misappropriating non-public information about Corp's revenue decline.

<u>**2. Lawyer's Violations of Rules of Professional Responsibility**</u>

Lawyer violated the duty of loyalty to Officer, the duty of confidentiality, the duty of care, and engaged in deceitful, dishonest/fraudulent conduct that both negatively reflects on Lawyer's ability to practice law and that harms the dignity of the profession.

Duty of Care

A lawyer has a duty to act as a reasonable lawyer of ordinary skill, judgment and preparation. Here, Lawyer's actions were patently unreasonable. Use of a client's corporation information fell below the standard of care of a reasonable attorney.

Duty of Loyalty

A lawyer has a duty to act in the best interests of the client and not to personally benefit at the client's expense. This includes a duty not to self-deal. Lawyer took advantage of a breach of Officer's fiduciary duty to keep Corp's information private for personal gain. Lawyer benefited from the insider trading. Lawyer may also have created professional and legal liability for his client by using this information. Lawyer breached the duty of loyalty to Officer.

Duty of Confidentiality/Confidential Communications

A lawyer has a duty to keep all communications from his client related to his representation of the client confidential. Courts interpret "related to the representation" quite broadly. Officer consulted Lawyer about personal tax advice. The equity value of Corp may have been related to this representation. This includes using any of such confidential communication. As discussed above, Lawyer used such confidential communication to do insider trading. Lawyer violated his duty to keep Officer's information confidential.

Attorney-Client Privilege

The attorney-client privilege is a more narrow evidentiary exception that prevents a court from obtaining information told to a lawyer by his client related to the litigation at issue. Here, there is no pending litigation discussed. Under the ABA rules, an attorney may disclose confidential communication to prevent a future crime involving death or serious bodily injury. California does not have a clear exception for death. On these facts, Officer's statement regarding Corp's shares would not likely fall under the attorney-client privilege.

Duty Not to Engage in Deceit, Fraud in Personal Dealings

A lawyer has a duty not to use deceit or fraud in private dealings. Here, the facts show that Lawyer deceitfully misappropriated insider information and used fraud to obtain a lucrative option from Option Co. Lawyer should be subject to discipline for these private acts as well.

Duty to Maintain Dignity of Profession

A lawyer also has a duty to maintain the dignity of the profession. For all of the reasons mentioned above, Lawyer violated this duty. A lawyer who acts with deceit and fraud in his private dealings stemming from improperly used information from a client lowers the reputation of the entire profession.

Answer B to Question I

Director's Actions

The Director ("D") may be liable for violations of federal securities law based on his sale and purchase of 1,000 Corp stocks during 2003. The Corp stock is an equity security, and therefore, is subject to federal securities laws. There are two bases for D's liability under federal securities law: violation of Rule 10B-5 and violation of Section 16B. Please note that D may also be liable for common law violations of his duty of loyalty as a corporate director, but that issue is not to be addressed here.

Rule 10B-5 Liability

Rule 10B-5 makes it illegal to use deceit or any fra[u]dulent scheme in connection with the purchase or sale of a security. Here, the issue is whether D used deceit and/or fraud when he sold Corp stock on March 1, and when he bought it at a lower price on July 1.

Rule 10B-5 Elements

The elements of Rule 10B-5 are as follows: (1) use of the instrumentalities of interstate commerce (which gives the federal government jurisdiction over the transaction); (2) a fraudulent scheme or device, which includes (a) misrepresentation of a material fact and (b) insider trading; that is, trading on the basis of material inside information; (3) in connection with the purchase or sale of a security; (4) with scienter, which must be at least recklessness; and (5) reliance by the person on the other side of the transaction, which is presumed in cases of misrepresentation and insider trading. Any person may be liable for insider trading, and plaintiffs include both private persons on the other side of the transaction and the SEC. In addition, "materiality" means that which a reasonable investor would want to know in making his investment decision.

With these elements in mind, I shall assess D's liability under Rule 10b-5

March 1 Sale

D sold 1,000 Corp shares for $25 on March 1. This transaction will fall under the jurisdiction if D used the instrumentalities of interstate commerce, which includes the telephone, US mails or internet. Here, I will assume that he did so. Note that if D had not used interstate commerce, he could still be liable under state securities laws. In addition, since D actually sold his shares, the transaction is "in connection with a purchase or sale" and, thus, D will be liable if he used fraud or deceit in this sale with necessary scienter.

Misrepresentation of a Material Fact. The main issue is whether the Corp's public announcement that it expected a 25% increase in 2003 constituted a misrepresentation of a material fact for which D maybe liable. Surely, an investor would consider it material that the revenue increase would not happen, and would instead decline.

If the corporation recklessly made that announcement in order to pump up its stock price, then D, as a corporate director, would be liable. However, the facts indicate that D sold his stock on March 1, many months before the Corp learned that its revenues would actually decrease by 50% during 2003. In addition, the facts also indicate that the revenue decrease was due to "unforeseen expenses". If anything, Corp was negligent in making a bold revenue prediction that was reversed six months later. Therefore, Corp, and hence, D, did not have the necessary scienter to be liable under Rule 108-5.

Insider Trading. For D to be liable for insider trading, he would have to had traded on material inside information. Since D is a corporate director, he is considered an "insider". Therefore, he may not trade on material inside information. The critical issue is whether D possessed any material inside information when he sold his shares on March 1. If D, in fact, knew on March 1 that Corp would not have a 25% revenue increase, and that revenues would drastically decline, then he may not trade based on that information.

Again, the facts indicate that D sold his shares 3'/2 months before the Corp learned that it would suffer a serious revenue decline, and, thus, probably did not trade on the basis of inside information. However, if he did suspect that the Corp would not reach its revenue target of 25% in his capacity as a corporate insider, then he would be liable under Rule 10B-5.

<u>July 1 Purchase</u>

On July 1, D purchased 1,000 Corp shares for $5. Since the revenue decrease of 50% had been publicly and accurately disclosed a few weeks earlier, D is not liable under Rule 10B5.

<u>Rule 10B-5 Conclusion</u>

Because the revenue decline was due [to] "unforeseen expenses", D probably did not have material inside information, nor possess the necessary scienter to be found liable under Rule 10B-5. However, if the court did find him liable, he would have to disgorge his profits made or losses averted.

<u>Section 16B</u>

D may be liable under Section 16B of the `34 Act, which holds "insiders": directors, officers and 10% shareholders, strictly liable, if they make a "profit" on the purchase and sale of their corporation's stock within a 6 month period. Section 16B applies to public companies, that is, ones that are traded on a public exchange and/or meet the number of stockholders/asset test. Here, Corp is a public company, registered under Section 12 of the `34 Act, and thus, Section 16B applies to D's actions.

<u>March 1 Sale</u> D was an "insider" when he sold his 1,000 shares of Corp stock for $25/share on March 1, and, thus, must comply with Section 16B. The facts do not indicate that D bought or sold any Corp shares before this date, so I will focus on the subsequent transaction. If D bought shares within 6 months following this sale for a lower price, then he is strictly liable under Rule 16B.

<u>July 1 Purchase</u> On July 1, 4 months following his sale of Corp stock, D purchased 1,000 shares for $5 per share. Since this occurred within 6 months of his sale, D is strictly liable and must disgorge his "profit." Here, D's profit is calculated by the difference between the sale price and purchase price multiplied by the number of shares, which totals $20,000 (1,000*(25-5)).

<u>Officer Liability</u>

The Officer's ("0") only action was consulting his Lawyer ("L") for personal tax advice on June 16, and mentioning that the value of Corp stock would probably go down, since the Corp had just learned that its revenues would decrease the day before.

<u>Rule 10B-5 - Tipping</u>

The elements of Rule 10B-5 are discussed above. As indicated, 0 did not purchase or sell any securities. Instead, the only basis for his liability would be "tipping". A corporate insider is liable for "tipping" if he has a fiduciary relationship with the corporation and discloses material insider information, at least recklessly, to a "tippee", who trades on the basis of that information. Here, 0 would be the "tipper" and Lawyer would be the "tippee." A tipper can be liable even if he discloses only to make a gift to the tippee or to enhance his reputation. A tippee will not be liable unless the tipper is first found liable

0 did disclose material insider information to Lawyer, but it does not appear that he did so recklessly, that he intended to make a gift to Lawyer, or wanted to enhance his reputation. Instead, 0 consulted L for personal tax reasons. As a client, 0 had every reason to expect that L would keep this information confidential. If, however, 0 disclosed this information to L to make a gift, use it to pay for legal services, or to enhance his reputation; or if he was reckless in disclosing this info (by shouting it in a public place), he would be liable. However, the facts indicate that 0 was careful and confidential in disclosing this info.

Therefore, since 0 was not reckless in disclosing the inside information to L, and [sic] therefore, is not liable under Rule 10B-5.

<u>Section 16B</u>

Although 0 is an "insider" of a"public company" for Section 16B purchases, since 0 did not purchase or sell any securities, he has no liability here.

<u>Lawyer Liability</u>

Unbeknownst to 0, L traded on the basis of the material inside information about Corp's unexpected revenue decline that had not been made public as of June 17. On June 17, L bought a "put" option that entitled him to sell Corp shares for $20 per share. He presumably did so fraudulently in order to personally benefit from the inside information. The issue, is however, whether he is liable under Rule 10B-5 or Section 16B.

<u>Rule 10B-5</u> L's liability would be based on his status as 'tippee", since the facts do not indicate that he is an insider of Corp. As discussed above, a tippee is not liable if the tipper is not liable. Since 0 was not liable as a tipper, L is not prevented from trading on the basis of inside information.

<u>Misappropriation theory.</u> The Supreme Court had found non-insiders liable under a misappropriation theory, where the person uses and trades on inside information that he knows or should know is inside info. Here, L clearly knew that it was inside information since Corp did not publicly disclose its revised revenue forecast until June 18. Therefore, he could be found liable for the misappropriation theory, and be subject to sanctions by the SEC. He would have to disgorge his profits of $15,000 from the put option, which he made on June 19, when he purchased shares for $5,000 in toto and sold them for $20,000.

The misappropriation theory does not apply to individual actions under rule 10B-5. **2. L's**

Professional Responsibility

L violated several rules of professional responsibility when he traded on the inside information, including the duty of confidentiality, duty of loyalty, duty of fairness and duty to uphold the law.

Duty of confidentiality

A lawyer may not use or reveal anything learned in the course of representing his client without the client's consent. Here, 0 was L's client, who revealed confidential information to L about the possible devaluation of Corp stock. 0 did not consent for L to use this information or reveal it to anyone. Although it does not appear that L revealed this information, he certainly used it and therefore, violated the duty of confidentiality. He should not have traded on this information.

Duty of loyalty

A lawyer also owes a duty of loyalty to his client, and may not let personal interests, or the 3rd party or other client interfere with his representation of his client. Here, there is a conflict of interest between 0 and L. L may not use O's confidential information for his own benefit, which L did so when he purchased the put option.

Duty of Fairness/Candor

A lawyer also owes a duty of fairness and candor to the public and 3`d parties. Here, L violated that duty by "misappropriating" the inside information and trading on it to his own advantage. By using this info, he acted unfairly to OptionCo, forcing it into a bad deal.

Duty to Uphold the Law

A lawyer also has a duty to uphold the law. Here, L violated the laws of securities trading and committed several breaches of his ethical duties when he used inside information. If he were in California, he would be required to "self-report" this fraudulent activity.

February 2005
Question 3

Molly and Ruth were partners in the operation of a dry cleaning store. Recent government environmental regulations relating to dangers posed *by dry* cleaning fluids increased their exposure to liability and caused a decline in their business. Molly and Ruth decided to convert their partnership into Dryco, Inc. ("Dryco"), a corporation, to limit their potential personal liability.

Molly and Ruth each contributed $20,000 in cash to Dryco. In return, each received a $15,000 promissory note from Dryco and 5,000 shares of stock with a value of $1 per share.

Prior to incorporation, Molly entered into a contract on behalf of Dryco with Equipment Company ("EC") for the unsecured credit purchase of an environmentally safe dryer for $100,000. EC was aware that Dryco had not yet been formed. EC delivered the dryer one week after the incorporation, and Dryco used it thereafter and made monthly installment payments.

Dryco had been incorporated in compliance with all statutory requirements, and Molly and Ruth observed all corporate formalities during the period of Dryco's existence. One year after incorporation, however, Dryco became insolvent and dissolved. At the time of the dissolution, Dryco's assets were valued at $50,000. Its debts totaled $120,000, consisting of the two $15,000 notes held by Molly and Ruth and a $90,000 balance due EC for the dryer.

1. As among EC, Molly, and Ruth, how should Dryco's $50,000 in assets be distributed? Discuss.

2. On what theory or theories, if any, can Molly and/or Ruth be held liable for the balance owed to EC? Discuss.

Answer A to Question 3

1. Distribution of Dryco's $50,000 in Assets Valid

De Jure Corporation

A corporation is conclusively formed when the articles of incorporation are filed with the state. Here, the facts indicate that Dryco had been incorporated in compliance with all statutory compliances. Therefore, Dryco will be treated as a de jure corporation.

The Equipment Company Contract (EC)

Whether EC will have a claim to Dryco's assets on dissolution depends on whether EC's pre[-]incorporation contract with Molly as a promoter was adopted by Dryco.

A corporation is not liable for pre-incorporation contracts unless the corporation adopts the contract. Since Dryco did not exist at the time the contract was made, it can have liability unless: i) the corporation expressly adopts the contract (i[.]e[.,] through board resolutions or ii) the corporation accepts or retains benefits from the contract and therefore impliedly adopts the contract.

On these facts, Dryco accepted the dryer, used it, and made monthly payments on it. Even though EC was aware that Dryco had not yet been formed, Molly entered the contract on Dryco's behalf. Further the dryer was delivered after incorporation. EC will argue that Dryco's acceptance and use of the dryer constitutes implied adoption, and will likely prevail.

Therefore, EC has a valued unsecured claim against Dryco's assets.

Promissory Note

Promissory Notes are debt securities of a corporation. The holders of these notes have a creditor/debtor relationship with the corporation, and are on equal grounds with other unsecured creditors of the corporation.

Shareholders' Claims

Shareholders own an equity interest in a corporation. Shareholders are not entitled to distribution of a dissolved corporation's assets until all debts of the corporation have been satisfied.

Distribution

EC and Molly and Ruth stand on equal footing as unsecured creditors. As shareholders, Molly and Ruth will receive no part of the $50K, as explained above.

As between unsecured creditors, however, there is a possibility that Molly/Ruth's claim will be subordinated by a court to EC's claim, based on corporate veil piercing principals [sic] due to inadequate capitalization at the outset of the corporation.

Piercing the Corporate Veil

A corporation is a separate legal entity designed to insulate its officers, directors, and shareholders from personal liability. However, the corporate form will be ignored in some circumstances, including when i) the corporation is acting as the alter ego of the shareholders or ii) when there was inadequate capitalization of the corporation at the outset.

Inadequate capitalization is determined by looking at if the corporation had adequate funds to meet its prospective liabilities. The time between incorporation and dissolution is also considered.

Here, Dryco was funded with $40,000, and dissolved within one year. The short time in existence may be an indication that the corporation was not adequately funded. However, it is unclear from these facts what caused Dryco's dissolution. If Molly/Ruth were aware of increasing environmental costs and liability, $40,000 may not have been sufficient. If this is so the corporate veil will be pierced. (Desire to shield from personal liability from environmental regulation is not enough to pierce the veil in and of itself.)

When shareholders use the corporation[']s assets as their own or otherwise ignore corporate formalities, the corporate form may be ignored to hold the SHs personally liable for the corp's debts[.] Here, there is no indication that Ruth/Mary used Dryco's assets as their own, and they did observe all corporate formalities. Therefore, the veil will not be pierced on this theory.

Since the veil can be pierced due to inadequate capitalization, however, Ruth/Mary's claim on the unsecured notes will be subordinated to EC's claim. EC will receive the entire $50,000.

In the event the claims are not subordinated, EC, Mary and Ruth will equally divide the $50,000.

2. Molly and[/] or Ruth's liability

A corporation is a separate legal entity that insulates its SHs from personal liability. As discussed above, Dryco was a de jure corporation. Unless circumstances exist to pierce the corporate veil, Ruth/Mary will not be liable to EC for the excess debt.

Piercing the Veil

As explained above, the corporate veil may be pierced for inadequate capitalization at the outset. Also as explained above, if the veil is pierced, Ruth/Mary will be liable to EC for the $40,000 of unpaid debt.

Promoter Liability

When a promoter raises capital or enters contracts on behalf of a [sic] unformed corporation, the promoter is personally liable on those contracts. Absent novation, this liability remains even if the corporation has adopted the contract.

Here, Molly entered the contract with EC on behalf of Dryco. Therefore, absent novation, she is personally liable. There is no indication of a novation here, so Molly will be liable for the 40K even though Dryco adopted the K.

Ruth maybe liable based on vicarious liability. Ruth and Molly were joint venturers, co-promoters, so EC may try to reach Ruth on this theory, or at minimum, Molly may seek contribution from Ruth. Since Ruth did not sign the contract[,] however, this theory will likely fail.

Answer B to Question 3

3)

1. Distribution of $50,000 of Dryco's assets

Dryco has [sic] $120,000 in debt at the time the corporation became insolvent. This includes the $30,000 in promis[s]ory notes to Molly and Ruth, and the $90,000 still owed to EC, for the environmentally safe dryer. Dr [sic]

Pre-incorporation contract

The issue is whether the debt to Equipment is owed by the corporation. Corporations are only liable for pre-incorporation contracts that they adopt. Here before the corporation was formed, Molly entered into a contract for the the [sic] purchase of the dryer. The facts do not indicate that there was an express adoption of this contract. However the fact that after the corporation was formed, the dryer was delivered to Dryco, used by Dryco, and the monthly installment payments totaling $10,000 were made by Dryco, is sufficient to establish that Dryco impliedly adopted this contract. Furthermore without the Dryer the business might not be able to comply with the governmental regulations imposed on the drycleaning industry. Therefore the dryer is an essential piece of equipment to Dryco and its adoption of the purchase contract entered into by Molly[.]

Inside/Outside Debt

Dryco only has $50,000 in assets, and has $120,000 in debt. Therefore it must be determined which creditors have prio[r]ity for satisfaction. In determining which creditors will be satisfied first the court will generally, in the interest of fairness, subvert inside debt, and allow outside debt to be satisfied first. The reason for this is that the insiders, Molly and Ruth, could have given the $15,000 for stock interests, which would only receive distributions after creditors are satisfied.

Here Molly and Ruth elected to make $15,000 of their $20,000 contribution as a loan. They were trying to insulate themselves further from any potential losses, by only putting at risk the $5,000 for their stock. The court will not allow inside shareholders to try to put their equity investment on an equal level with outside creditors who have no equity interest in the corporation.

Therefore EC should be given priority as an outside creditor and should receive the $50,000 that Dryco has. Molly and Ruth's interest will be subverted to EC's interest and their loan will not be satisfied.

2. Molly and Ruth Personal Liability

After the $50,00 in assets are given to EC, EC is still left with $40,000 that has not been satisfied. EC will thus try to hold Molly and Ruth, as sole shareholders in Dryco[,] personally liable for the remaining debts.

Incorporator liability

Prior to incorporation Molly entered into a contract with EC for the dryer. As a general rule, an incorporator is not relieved of liability of the pre-incorporation contract, until there has been a novation, that is[,] an agreement by all parties to relieve the incorporator of personal liability. Here Molly would have to show that both Dryco and EC to relieved[sic] Molly of personal liability. As discussed above, Dryco impliedly adopted the contract, and thus becomes primarily liable for the contract. However there is no indication that EC relieved Molly of her personal liability, and can be held secondarily liable, because there was no novation.

However, Molly can argue that the contract was entered into "on behalf of Dryco[.]" The corporation by estoppel doctrine holds that a party who knew the contrace[sic] was being entered into on behalf of a corporation is estopped from later claiming that the other party is personally liable. Molly can argue that because EC knew that Dryco had not been incorporated yet, but knew that Molly was entering "on behalf of Dryco" they should be estopped from claiming that Molly is personally liable.

Molly will likely be successful in this claim, and EC will be estopped from claiming that Molly was personally liable, because EC knew that Dryco was not yet incorporated, but still signed a contract "on behalf of Dryco". It would therefore not be equitable for EC to be able to hold Molly personally liable under this theory[.]

Shareholder liability

As a general rule shareholders are not personally liable for the debts of the corporation. The shareholders only put at risk what they invest in the corporation. As discussed above Molly and Ruth each invested $20,000, which will all be treated as equity in Dryco. Therefore under the general rule Molly and Ruth will not be liable for the $40,000 remainder owed to EC.

However where it is necessary to prevent a fundamental unfairness courts may elect to pierce the corporate veil, and hold the shareholders personally liable. Courts generally elect to pierce the corporate where the corporation has attempted to defraud the corporation[']s creditors. Courts are much less likely to pierce the corporate veil for tort creditors than for contract creditors. Here EC was a contract creditor, so EC will have to have a very strong claim to succeed.

Courts will pierce the corporate veil where the shareholders of the corporation fail to follow corporate formalities, or where there [sic] corporation was inadequately capitalized

at the time of formation.

Here the facts state that Molly and Ruth observed all corporate formalities. There are no facts to indicate that there was any com[m]ingling of personal and corporate funds, or that Molly or Ruth treated any of the corporate assets as their own.

EC will try to argue that Dryco was inadequately capitalized at the time of formation, that is[,] that Dryco would be unable to pay debts at the time they came due. Because the EC is a contract creditor they have to make a strong showing. Here Molly and Ruth put in a total of $40,000 cash. Because the inside claim will be subverted to EC claim the full $40,000 should be considered[.] EC wil[l] fail on this claim because the facts indicate that Dryco was able to make the monthly installment payments.

The court will likely find that there was no fundamental unfairness in this transaction, especially because EC was a contract creditor. EC could have protected itself by entering into a separate agreement with Ruth and Molly to agree to personally assume the debt. Because EC did not do this they cannot later claim Molly and Ruth['s] personal assets. Therefore Molly and Ruth will not be personally liable on this claim.

<u>Director liability</u>

As the sole shareholder[s] of Dryco, Molly and Ruth are probably the directors, and as such owe Dryco fiduciary duties of Loyalty and Due Care. Directors can be held personally liable for injuries caused from breaching this duty. However there are no facts suggesting a violation of these duties, such as self[-]dealing or uninformed decision making and [they] should not be held liable for breaching their fiduciary duties.

July 1999
Question 6

Sally is vice president for research at Chipco Corporation (Chipco), a microchip manufacturer. Chipco's stock is traded on a national stock exchange. During the course of her work for Chipco, Sally's research team developed technology that could reduce microchip production costs by 75%. However, Sally knew that additional testing was necessary to ensure commercial viability of the technology.

Chipco retained lawyer Laura to advise it on patenting the new technology. On March 12, 1998, Laura arranged a conference call with Sally and other Chipco personnel, who explained the new technology to Laura. This information was personally as well as professionally interesting to Laura because she already owned 12% of Chipco's outstanding stock as part of her personal investment portfolio. On March 16, 1998, Laura telephoned attorney Arnold, an opposing counsel in an unrelated matter, and mentioned that her client Chipco might soon become a major competitor in the microchip business because of new breakthrough technology. Shortly thereafter, Sally, Laura and Arnold each telephoned a broker and purchased shares of Chipco stock at $10.00 per share.

On April 10, 1998, a financial newspaper reported a rumor that Chipco had developed new breakthrough technology. Within the next 2 days, Chipco stock increased to $20.00 per share. Chipco had been purchasing large blocks of its own shares and it became fearful of continued price escalation of its shares. Therefore, Chipco promptly responded to questions from the press about the rumor by issuing a release which stated, "Chipco has not developed new commercially viable technology at this time." As soon as the statement was reported by the press, the price of Chipco shares fell to $11.00 per share.

On August 20, 1998, after successfully testing for commercial viability, Chipco publicly announced its new technology, and Chipco shares again rose to $20.00 per share. By September 5, 1998, Sally, Laura and Arnold had each sold all their shares of Chipco stock at the higher price.

Has there been any violation of federal securities laws by:

1. Sally? Discuss. 2. Laura? Discuss. 3. Arnold? Discuss. 4. Chipco? Discuss.

,

ANSWER A TO QUESTION 6

Question Six

1. Did the Court Correctly Decide W's Motion to Dismiss for Lack of Jurisdiction?

Here, the facts indicate that Park, a State X company, has sued wholesale, an Italian company, in federal district court in State X on a breach of contract claim, alleging $100,000 in damages, and Wholesale moved to dismiss for lack of jurisdiction. The motion could have been on one of two bases: subject matter jurisdiction, or personal jurisdiction. These will be discussed individually, below.

Subject Matter Jurisdiction

Contract cases such as this one not generally involving questions of federal law, diversity of citizenship jurisdiction should be the basis claimed, and should lie. Under 28 USC 1332, diversity jurisdiction exists over suits between citizens of different states or between citizens of one state and foreigners, provided a good faith allegation of damages exceeding $75,000 is pled.

Here, Park is a citizen of its state of incorporation and its state of principal operations, likely X. Wholesale is a citizen of Italy. Park alleged $100,000 in lost profits. Diversity of citizenship jurisdiction appears to exist, and the motion should not have been granted on this basis.

Personal Jurisdiction

Personal jurisdiction over Wholesale is required, and is the more likely basis for the motion made. The exercise of jurisdiction requires a showing of both a state statute authorizing jurisdiction, and sufficient minimum contacts by the defendant with the forum state.

Federal courts sitting in diversity only have jurisdiction to the same extent as the courts of the state in which the federal court is located. See F.R.C.P. 4. Here, the facts are silent as to the terms of the statute; if X's is like California's it permits exercision of jurisdiction to the fullest extent constitutional.

In 1945, in International Shoe v. Washington, the U.S. Supreme Court held that before personal jurisdiction may be exercised over a noncitizen of the forum state, it must be shown that the defendant had "sufficient minimum contacts with the forum state such that maintenance of the suit does not offend traditional notions of fair play and substantial justice."

Later, in Burger King v. Rudzeiwicz, the Court clarified that the test is two-fold: "contacts," and "fairness."

Contacts: The present facts indicate that Wholesale is an Italian corporation, which "before entering into this contract ... had never done business with Park." Further, the facts state that Wholesale "sells most of its goods to buyers in Spain." This suggests only very limited contacts with X, certainly not enough to rise to the level of pervasiveness for "general jurisdiction" to be shown. However, "specific jurisdiction" should be met: although the present contract was "negotiated entirely in Italy," Wholesale must have been aware that it was doing business with a State X company, considering the presence of the arbitration clause mandating non-binding arbitration in X. Because the present suit arises out of Wholesale's specific contact with State X; i.e., the contract with Park, contacts should be satisfied.

In Hanson v. Denckla, the Court clarified that contacts alone are insufficient: additionally, the defendant must have "purposefully availed" itself of the benefits and protections of the forum state. Here, the facts indicate that in 1996 Wholesale had sold three shipping containers of vases worth a total of $2.1 million to a state X company. This is probably sufficient purposeful availment by Wholesale, even though it was related to a different transaction: Here, Wholesale had recently and voluntarily entered as a supplier in the

-42-

State X vase market.

In World-Wide Volkswagen v. Woodson, the Court further clarified that, for contacts to be sufficient, it must have been "foreseeable" to the defendant that it would be sued within the form state. Here, too, the element should be met: Wholesale knew it was dealing with a State X company, and had agreed, in its contract, to non-binding arbitration in State X in the event of a dispute. The very idea of "non-binding" arbitration suggests that a more formal proceeding may follow it - and thus a suit would be foreseeable. Since the arbitration was to be in X, the lawsuit would foreseeably be there as well: after all, the parties are already present in X.

Fairness Factors: in assessing the fairness factors, the court will consider the parties' competing interests, and the state interest in adjudicating the suit. Here, Wholesale is seeking redress in its own state, in its own country, under a judicial system it is familiar with. All the relevant Park employees are probably located in State X, and note that the allegedly defective vases are also presently in X. Should the trier of fact need to view the evidence, it's located here. Regarding the state's interest, State X has a valid desire to protect its citizens from wrongdoing by outsiders, and to provide an effective, low-cost, convenient forum for redress of their grievances. Particularly where, as here, the alternative forum (Italy) recognizes fewer theories for recovery than State X law, and imposes a limitation on recoverable damages which State X law does not, the state interest in exercision of personal jurisdiction over the outsider is particularly strong.

In conclusion, State X probably may validly exercise personal jurisdiction over Wholesale, and the motion was properly denied.

2. Did the Court Correctly Decide W's Motion for Dismissal on the Ground of Forum Non Conveniens? The doctrine of forum non conveniens allows a federal court, for the convenience of the parties and witnesses, in the interests of justice, to transfer a case to another federal district where it could have been originally brought, 28 USC 1404, or to outright dismiss it in contemplation of the case being refiled in a foreign jurisdiction, 28 USC 1406. Because the facts state that the federal court sitting in State X was asked by Wholesale to dismiss rather than transfer, what probably happened was Wholesale wished the case dismissed in contemplation of suit being filed in Italy instead.

In Piper Aircraft v. Reyno, an instructive case on discretion to dismiss under the doctrine of forum non conveniens, the Court considered whether a federal court sitting in Pennsylvania should have dismissed a suit under the doctrine which was based in tort on an airline disaster which had occurred in Scotland. In Reyno, the Court identified the relevant factors for consideration as (1) the convenience of the parties; (2) the convenience of the witnesses; (3) the state interest in retaining the case; (4) the foreign court's interest, if any, in resolving the dispute, and (5) the relative ease or burden, which adjudicating the case would impose on the court entertaining the motion.

Regarding convenience of the parties, the facts suggest that Wholesale has no employees or officers in X, whereas Park has no employees or offices in Italy. If this is the case, the equities are reasonably split: one corporation is going to be inconvenienced here. While Park apparently had no difficulty negotiating the contract in Italy, Wholesale did agree to travel to X for non-binding arbitration in case of a dispute, and apparently was able to do so without trouble. Further, the evidence is located in X: for the suit to be brought in Italy, they might have to be returned. It's a close question, but Park probably is ahead on the convenience aspect.

Regarding the application of the law, Park almost inarguably wins: the facts indicate that while Italian law provides a remedy for this type of claim, it recognizes fewer theories of recovery, and imposes a limitation on damages that State X law does not. On this basis, a very strong factor exists in favor of denying,

-43-

Wholesale's motion.

Regarding convenience of the witnesses, the facts clearly state "all of W's witnesses to its design and manufacturing processes are located in Italy." It is fairly clear that Wholesale wins on this factor, though Park's witnesses are probably in X.

Regarding the state interest, as noted earlier, State X has a valid and compelling interest in providing a remedy for its citizens; i.e., ready access to a friendly and efficient judicial process. This state interest is even stronger where, as here, the law of the alternative forum would not provide as much protection.

Regarding Italy's interest in adjudicating the suit, note that this is a simple action on a business contract, in which Italy is unlikely to have any compelling interest other than the protection of its own citizens (compare the facts of Renyo: compelling interest present because airline disaster occurred in Scotland, killing Scotch passengers and flight crew.

Regarding the interests of the court considering the motion, there does not appear to be any serious reason why the State X court would have difficulty, or be burdened, hearing this case. (Compare Renyo: the federal court, located in Penn., would have been required to interpret and apply Scotland's tort law).

In sum, the motion appears properly denied.

ANSWER B TO **QUESTION 6**

1) Sally - Rule 16 - Sally has violated the Federal Prohibition of short term trading by two corporate insiders (Rule 16e). Rule 16 applies anytime a stock is purchased at a lower price than

it is sold by an officer, director or 10% shareholder within a six month window of time. I Additionally, the stock must be traded on a national exchange or meet other requirements.

Here, Sally is an officer of ChipCo, whose stock is traded on a national stock exchange. She purchased stock on March 16,1998 at $10,00 a share. She subsequently

sold the stock on September 5 (within 6 months of the purchase) at $20.00 per share. She must therefore disgorge the profits
therefrom.

Rule 10b5 - Sally probably also violated Rule I0b5. I0b5 requires that in concession with the buying or selling of stock, corporate insiders have a duty to either refrain from trading or disclose relevant information. Additionally, an instrumentality of interstate commerce must have been used in connection with buying or selling the stock.

Here Sally knew about the development of the new technology and knew thus a reasonable investor would find that information material. She, therefore, had a duty to disclose the information or refrain from trading, and she breached that duty when she purchased the stock. Since she used the telephone to call her broker, she used an instrumentality of interstate commerce. Therefore she violated Federal Rule 10(b)5.

2) Laura - Like Sally, Laura's purchase and sale of stock within a six month period violated Rule 16. Laura was a 12% shareholder before she purchased the additional stock on March 16, so the rule applies to her. As mentioned above, ChipCo trades on two national stock exchanges. Because Laura bought stock at a lower price than for which she sold within a six month window, she violated Rule 16. Here, however, she is not required to disgorge the profits on the shares that she owned prior to March 16.

10b5 - Laura is also probably liable for violation of Rule 10b5 on two grounds.

First, like Sally, Laura owed a fiduciary duty to the corporation and was under a duty not to trade on inside information unless she disclosed it. Because she knew the information she learned in the conference call was material, she could not buy additional stock without disclosure. Since Laura used the instrumentality of commerce when she used the telephone call to her broker. Therefore, she violated Rule 10(b)5.

She may also have violated 10(b)5 in disclosing that ChipCo had developed new technology to Arnold. "Tippers" are liable under 10(b)5 when they have a fiduciary duty to a corporation that they breach by disclosing material information to a third party for an improper purpose.

Here, as an attorney for ChipCo, Laura had a fiduciary duty to the corporation. She breached that duty by disclosing material information (one a reasonable investor would deem important) to Arnold. It is unclear whether her purpose was improper; courts typically look to see if the "Tipper" received some benefit in making the tip. The benefit need must be pecuniary; here, it might be argued that Laura benefited by assuming the esteem of a fellow attorney or might have been seeking either reciprocal treatment, or else special consideration in the case in which she was dealing with Arnold. In any case Arnold relied on her tip and bought some of ChipCo's stock. Therefore, if the court thinks that Laura gave the tip for an improper purpose, she violated 10b5 in this second respect as well.

3) Arnold - Rule 10(b)5 - Arnold might be subject to 10(b)5 liability as a "Tippee." Tippees violate Rule 10(b)5 when they receive a tip from a person who owes a fiduciary duty to the issuing corporation, knowing that the Tipper has breached the fiduciary duty, and subsequently buy or sell in reliance on the tip.

Here Arnold received the tip from Laura, who was in a fiduciary relationship with ChipCo. Arnold probably knew that the tip was a breach of fiduciary duty; he knew that Laura was ChipCo's attorney, and he is himself an attorney and must be familiar with what is required in the way of fiduciary duties. Finally, relying on the improper tip, he purchased some of ChipCo's stock. Again, he used the phone, an instrumentality of interstate commerce, to call his broker.

However, it is important to note that Arnold cannot be held to have violated Rule 10(b)5 unless Laura also did so; that is, there can be no tippee liability without a tipper, so all the elements of Laura's liability must be satisfied first.

4) ChipCo - Rule 10(b)5 - ChipCo may have violated Rule 10(b)5 by issuing the press release Rule 10(b)5 prohibits fraudulent misrepresentations in connection with buying or selling stock using the instrumentality of interstate commerce. The misrepresentation must be material as well.

Here the news release may or may not have been fraudulent. It merely says that "ChipCo has not developed commercially viable technology." In a strict sense, this is true, since the facts state that Sally knew it was not commercially viable. However, a court might find that ChipCo intended to mislead the general public in making the statement. Furthermore, ChipCo was actively acquiring its own stock, knowing that the technology would soon be released. Because it was buying and its statement led to stockholders selling ChipCo stock, that element has been satisfied as well.

The misrepresentation was obviously material and relied upon since after the announcement, the price of the stock plummeted.

Finally, since ChipCo is traded on a national exchange, an instrumentality of interstate commerce was involved. Therefore ChipCo has in all likelihood violated Rule 10(b)5.