Kern County College of Law

343B Business Organizations

Final Examination

Spring 2023

Prof. J. Harvey

Instructions:
There are 3 questions in the examination.
You will be given 3 hours to complete the examination.

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QUESTION 1

Until recently, Fred and George were law students. But after deciding their skill sets were better suited to careers as entrepreneurs than as attorneys, they dropped out to start a business together. After one short conversation in which they agreed to share equally in all profits and management responsibilities, they opened a small shop selling novelty gifts.

At the end of their first year, the shop had earned $100,000 above its expenses. Fred and George decided it was time to hire some help and open a second location. Following a series of interviews, they hired two employees, Harry and Ron. Harry is assigned the role of store manager for the original store, referred to within the company as Shop A. Ron is assigned the role of store manager for the new location, Shop B. With day-to-day management of the shops now accounted for, Fred and George begin devoting all of their time to market research and product development.

Harry quickly proves himself a capable manager and Shop A remains just as successful the following year, earning a profit of $100,000. Ron, however, gets off to a slow start and Shop B concludes its first year with total earnings of $50,000 and expenses of $70,000. Fred and George warn Ron that unless he generates a profit the following year, his store will be closed and his position eliminated.

Lacking confidence that he has the management acumen to turn around the shop, Ron comes up with a plan to avoid further losses. He meets with Oliver, the owner of a local sporting goods company, and agrees to lease Shop B's business premises to Oliver, for a term of two years, in exchange for lease payments of $4,000 per month, which amounts to $1,000 per month above Fred and George's mortgage payment for the premises. Upon learning what Ron has done, Fred and George immediately contact Oliver and let him know there has been a mistake; Shop B is not available for lease. But Oliver has already begun moving merchandise into the premises and indicates that he intends to enforce the lease. Fred and George promptly take matters into their own hands, relocating all of Oliver's merchandise into the alley behind the store and changing the locks. Oliver ultimately secures a new two-year lease across town, but the monthly rental rate is $500 higher than the price he had agreed to with Ron. In addition, Oliver incurs expenses of $1,000 relocating merchandise to the new location.

As a newly-hired associate at a local law firm, Oliver comes to see you regarding his rights and potential remedies. In particular, he wants to know the following:

1. **Is Oliver entitled to damages? Why or why not? Explain your analysis. (Assume specific performance is not available.)**
2. **Now assume Oliver is entitled to damages. Who is liable to pay those damages and what is the amount of their liability to Oliver? Explain your analysis.**

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QUESTION 2

After 15 years in business, Fred and George have become highly successful. Notwithstanding some early issues at Shop 2 that led them to part ways with Ron, they now own a chain of twenty novelty gift shops in five different cities. Harry remains with the business and has risen to the position of company president. Fred and George no longer hold day-to-day positions, but remain the only owners of the business.

After a series of meetings with their financial advisor, Fred and George decide it is time to take the company public. They form a corporation, calling it Magical Merchandise, Inc. Fred is issued 30% of the shares. George is also issued 30% of the shares. Harry is issued 15% of the shares. After agreeing that the board of directors will consist of three directors and appointing themselves to the three positions, the trio sells the remaining 25% of the shares to numerous investors. One year later, on December 1, 2022, the company is listed on the New York Stock Exchange.

As often happens when a public stock offering succeeds, the venture capitalists began to move in quickly. On January 1, 2023, a representative of a large hedge fund, Gringott's, Inc., notified Harry that Gringott's had acquired a 5% interest in Magical Merchandise and was considering a tender offer at $13 per share. At the time, Magical Merchandise was trading on the public exchanges at $10 per share. Harry tells Fred and George about the conversation and then begins loading up on Magical Merchandise stock at the current price of $10 per share, increasing his percentage of ownership from 15% to 20% over a series of several transactions between January 1, 2023 and January 31, 2023.

On February 1, 2023, Gringott's makes the tender offer at $13 per share and the market price of Magical Merchandise stock immediately rose to $12 per share in response. But despite an initial surge of subscriptions, interest in Gringott's offer began to taper off and Gringott's advised Harry on February 10, 2023 that the tender offer was likely to fail. In response, Harry sold off all the shares he had acquired during the month of January at the current market price of $12 per share.

Not wanting to keep secrets from Fred and George, Harry advised them what he had done and why. Fred and George each followed suit, selling off 5% of their own holdings at $12 per share.

One week later, Gringott's withdrew the tender offer for insufficient subscriptions.

Assume all stock transactions involving Fred, George, or Harry are accomplished through the respective individual's E*TRADE smartphone app, with no direct communication between the transaction participants.

1. **Does Harry have any potential liability under Rule 10b-5? Why or why not?**
2. **Do Fred and George have any potential liability under Rule 10b-5? Why or why not?**
3. **Does Harry have any potential liability under Rule 16b? Why or why not?**
4. **Do Fred and George have any potential liability under Rule 16b? Why or why not?**

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QUESTION 3

A few months after Gringott's unsuccessful tender offer, the shares of Magical Merchandise are delisted from the public stock exchanges. Harry subsequently purchases many of the outstanding shares not owned by Fred and George, and ends up owning 25% of the company while Fred and George retain their 25% each. The other 25% is now owned by 50 other investors in varying proportions.

Sensing an opportunity to gain market share, a representative of Neville's Novelties—a large and well-established competitor to Magical Merchandise—approaches Fred, George, and Harry with an offer to purchase all of the assets of Magical Merchandise. The price appears reasonable, and will leave Magical Merchandise with substantially no operating assets but enough cash in the bank for Fred, George, and Harry to all retire in luxury after paying off the company's debts and distributing the remaining funds to themselves and the other shareholders.

Excited about the prospect of joining the leisure class, and comfortable in the knowledge that they collectively control 75% of the voting power at any meeting of shareholders, the trio decides to seek procedural advice from your law firm. They consult the managing partner of your office, who directs you to draft a memo outlining and explaining the steps the trio will need to follow in order to ensure the sale goes off without a hitch. After briefly wondering why you became an attorney instead of opening a novelty gift shop, you set to work preparing your response to the following questions:

1. **What steps will the board of Magical Merchandise need to take to properly consummate the asset sale?**

2. **Assume the board properly follows the steps you just described. What options are available to a minor shareholder who is opposed to the sale? What steps will the shareholder and the corporation need to follow to effectuate the shareholder's rights?**

3. **How would your answer to Question 2 change if the board does not properly follow the steps you described in response to Question 1?**

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THIS EXAM DOES NOT HAVE ANSWER OUTLINES.

1)

1.

Fundamental Change

A fundamental change of a corporation can be: altering the articles of incorporation; merger/consolidation; selling off all or substantially all of the corporations assets outside of the normal course of business.

A fundamental change requires: (i) a resolution from the board of directors consenting to the fundamental change; (ii) there must be notice given to the shareholders, no sooner than 10 but no later than 60 days in advance of a meeting; (iii) The shareholders must approve the fundamental change; (iv) The board then must adopt the change and file the paperwork with the state.

Board of Directors Meeting

Board of Directors meeting must be: at the prescribed annual time, or if it is a special meeting, 2 days notice. The notice must specify the time, date, and place of the meeting, as well as the business to be transacted. There must be a quorum present, consisting of a majority of the board of directors, or whatever is in the articles of incorporation, but must not be less than 1/3 of the directors. Any business agreed to at the meeting can be approved by a majority of the directors present, but there must still be a quorum present. Any business conducted without a proper vote will be void, unless ratified by a later act.

Here, the board of directors consists of Fred, George, and Harry. They are considering a fundamental change in the course of their business, as they want to sell off all of Magical Merchandise's assets outside of the regular course of business. They must have a board meeting, and since it will most likely be a special meeting they must provide 2 days notice to each of the board members, and state the time, place, and purpose of the meeting, which is to sell off all the assets of the corporation. There must be at least 2 of them present, as this is a majority of the board, and no facts indicate that there is anything in the articles of incorporation approving a greater or smaller number. As long as the majority of the directors present vote on the sale of assets, and two of them don't leave before the vote, then it will be approved. Nonetheless, since they are all in accord on the sale of assets, they could even do an improper vote, and ratify the act later when the make the sale.

Shareholders Meeting

After they have made the resolution, they must give notice to the shareholders, which mirrors the notice for the board meeting, except for the amount of time needed for notice, which is larger for a shareholder meeting.For a quorum at the shareholder meeting, there must be a majority of the shares present, which means that as long as Fred, George and Harry show up, they will have a quorum. Traditionally, there must have been a majority of the votes present cast to approve an action, but modernly only a majority of the votes cast are sufficient to approve the action.

Once the shareholders approve of the action, the board will adopt the change, and then file the paperwork with the state.

If all of these steps are taken, they may sell the assets, pay the debts, distribute the funds to the shareholders, and retire in luxury.

2.

Dissenters Appraisal Rights

After step 2 in the fundamental change analysis above, the corporation and any dissenters must do a back and forth which consists of: (i) the corporation giving notice that dissenters will have appraisal rights; (ii) the dissenters will give notice of intent to demand payment; (iii) the corp. will give notice within 10 days of the vote passing the change; (iv) the dissenters will demand payment; (v) the corp will pay the dissenters the fair market value of their shares; (vi) the dissenters who do not accept this valuation have 30 days to submit their own valuation of their shares; (vii) the corporation has 60 days to bring an action in court to ask the court to determine the value of the shares, if they don't they must pay the dissenters valuation.

Market Out Exception

If they had attempted to make this fundamental change prior to delisting the corporation from the stock exchange, or if there were 2000 shareholders, or $20 million in assets, none of which are given in the facts, they would have a defense against the (dark arts) Dissenters appraisal rights, called the "Market Out Exception". The Market Out exception is triggered in the above mentioned scenarios, and basically forces the dissenters to sell their shares on the open market.

3.

Improper Procedure

If there is an improper procedure in the above analysis, such as lack of notice, or fraud/misrepresentation, then a shareholder can enjoin the sale of assets, unless the defect is waived. Waiver of a defect must be made expressly in writing, or impliedly through showing up to the meeting and not saying anything.

If there is an improper procedure issue, the shareholder will most likely enjoin the sale of the assets. The board then must go through the entire process again, but make sure they follow all the steps. or they could ask the shareholder to waive the defect in writing.

2)

Rule 10b-5 Liability

Rule 10b-5 prohibits the use of fraudulent schemes in the sale of securities of a privately or publicly held corporation. Such liability arises when a person (1) makes a fraudulent statement or omission of material fact in connection with another statement (2) in connection with the purchase or sale of a security (3) with the intent to deceive or reckless disregard for the truth (4) causing loss. A plaintiff must show their reliance on the fraudulent statement or omission, unless it falls under the "fraud on the market" exception. This exception indicates that traders of publicly traded securities generally rely on the market price when trading.

Does Harry have liability under Rule 10b-5 for securities fraud?

See rule above.

Fraudulent Statement or Omission. The facts do not provide any indication that Harry made a fraudulent statement or omission to any other party in this situation.

Connection with Purchase/Sale of Security. While Harry did increase his stock holdings by 5% over the course of one month, thus making a purchase and sale of company securities, he fails to meet the first element of making a fraudulent statement or omission.

Deception or Reckless Disregard for Truth. Harry does not fulfill this element because he specifically told Fred and George what he was doing because he did "not want[] to keep secrets from" them. Thus, Harry had no intent to deceive nor acted with reckless disregard for the truth.

Causing Loss. No party in the transaction experienced a loss; Harry sold his stock at $12 per share, as did Fred and George, which was the price per share Magical Merchandise's stock was going for on the market. Thus, no losses were suffered due to Harry's actions.

Generally, a plaintiff must show reliance, but because this is a publicly traded company, the plaintiff would fall under the fraud on the market exception and would not have to show reliance. This is irrelevant anyway because Harry does not have liability under Rule 10b-5.

Is Harry liable for insider trading under Rule 10b-5?

Under Ruel 10b-5, directors, officers, or persons that would otherwise have access to nonpublic knowledge cannot use this knowledge in a transaction for their benefit.

Harry used knowledge of Gringott's tender offer, that was not public knowledge and was communicated only to him, to purchase 5% of shares at a lower cost per share than what he knew Gringott's would offer. He further used nonpublic knowledge of Gringott's intention to withdraw its tender offer to sell his shares before the stock price plummeted for MM.

Thus, it is likely Harry is liable for insider trading.

Do Fred and George have liability under Rule 10b-5 for securities fraud?

See rule above.

Fraudulent Statement or Omission. The facts do not provide any indication that Fred or George made a fraudulent statement or omission to any other party in this situation.

Connection with Purchase/Sale of Security. Fred and George learn of the tender offer from Harry, but the facts do not indicate whether Fred or George purchased more stock in response. Harry, however, did purchase additional stock, but the information regarding the tender offer came from Harry, so there was no exchange of information in connection with a purchase or sale of security.

Deception or Reckless Disregard for Truth. Neither Fred nor George acted deceptively or with reckless disregard for the truth because they did not act; the only time after the initial stock assignments that Fred and George acted was when Harry warned them of Gringott's withdrawal, so Fred and George sold their stock. Thus, neither acted with the intent to deceive or with the reckless disregard for the truth.

Causing Loss. No party in the transaction experienced a loss; Harry sold his stock at $12 per share, as did Fred and George, which was the price per share Magical Merchandise's stock was going for on the market. Thus, no losses were suffered due to Fred or George's actions.

Generally, a plaintiff must show reliance, but because this is a publicly traded company, the plaintiff would fall under the fraud on the market exception and would not have to show reliance. This is irrelevant anyway because neither Fred nor George has liability under Rule 10b-5.

Are Fred and George liable for insider trading under Rule 10b-5?

Under Ruel 10b-5, directors, officers, or persons that would otherwise have access to nonpublic knowledge cannot use this knowledge in a transaction for their benefit.

Fred and George used information from their company president to sell a portion of their shares before the stock price of MM dropped. Fred and George will argue this was simply advising from the company president

to the owners of the corporation. However, Harry explained exactly what he did by selling his stock and why he did it--because of Gringott's intention to withdraw the tender offer. This was nonpublic knowledge that Fred and George used to their advantage to sell their stock at a higher price.

Thus, it is likely Fred and George will be held liable for insider trading.

Rule 16b Liability

Rule 16b prohibits officers, directors, and shareholders holding more than 10% of stock in a publicly traded company from earning a profit on short swing transaction. A short swing transaction is any purchase and sale or sale and purchase of a company's securities within a six month period.

Does Harry have liability under Rule 16b?

See rule above.

Position. To be liable under 16b, the actor must be an officer, director, or shareholder holding more than 10% of stock in a publicly traded company. Harry owns 15% of the stock in Magic Merchandise, Inc., and he also holds the position of company president. Thus, he holds a position that could make him liable for profiting off of a short swing transaction under Rule 16b.

First Transaction (Purchase). From January 1, 2023, to January 31, 2023, Harry began to purchase more company stock while he was a 15% shareholder of the company. Within 30 days, Harry purchased an additional 5% of the company's stock at $10 per share after learning about Gringott's consideration of a tender offer at $13 per share. Harry became a 20% shareholder by January 31, 2023.

Second Transaction (Sale). When Gringott's advised Harry that the tender offer will most likely fail, Harry sold the 5% of stock he purchased in January at $12 per share on February 10, 2023--less than two weeks after his last transaction on January 31, 2023. At this time, Harry returned to being a 15% shareholder.

Liability. Harry, as a 15% shareholder and company president on the board of directors, profited $2 per share from the purchase then sale of company securities within a six month period.

Thus, Harry has liability under Rule 16b.

Do Fred and George have liability under Rule 16b?

See rule above.

Position. To be liable under 16b, the actor must be an officer, director, or shareholder holding more than 10% of stock in a publicly traded company. Here, Fred and George each hold 30% of Magic Merchandise, Inc.'s shares and remain as owners of the entity. Thus, both Fred and George hold positions that could make them liable for profiting off of a short swing transaction under Rule 16b.

First Transaction (Sale). Fred and George's transaction occurred in February 2023 when Harry notified them of Gringott's withdrawal of the tender offer. Fred and George then sold 5% of their holdings at $12 per share. At this time, both Fred and George were each 25% shareholders in the company.

Second Transaction. Neither Fred nor George conducted a purchase within the six month period following their sale of stock.

Liability. Because there was only one sale and no subsequent purchase, this is not considered a short swing transaction.

Thus, neither Fred nor George have liability under Rule 16b.

3)

I) Is Oliver entitled to damages?

At its heart this question requires an analysis of Oliver's reliance on Ron's representation that he has authority to enter into the lease.

De-facto partnership

A de-facto partnership is formed even without their knowledge, when two or more people enter into and carry on a business for profit, without forming another entity. In a partnership each partner is liable for the debts and obligations of the business.

Here Fred and George entered into a business for profit, and in fact earned $100,000 in year 1. They did not form another business entity such as an LLC or corporation.

Liability and Agency

Actual Authority

An agent has actual authority when they are given express authority to engage in a course of conduct. Where an agent has actual authority the agent cannot be liable to the principal for entering into contracts within their authority.

Here Fred and George made Ron the store manager of Shop B. After Shop B lost $20,000 in year 2 Fred and George told Ron that unless the store generates a profit next year his position would be eliminated. Fred and George did not expressly or impliedly tell him to lease Shop B, despite what Ron may contend.

Here Ron did not have actual authority and thus can be held liable to Fred and George for exceeding his authority.

Apparent Authority

Where an agent is held out by the principal as having authority based on public statements or representations to third parties the principal could be bound if a third party enters into a contract in reliance on that representation, even where no actual authority exists.

Here Fred and George made Ron the Store Manager for Shop B. Oliver will argue that this provides apparent authority for Ron to lease the premises to Oliver. Fred and George will argue that a store manager generally does not have authority to not manage the stores and instead lease the store out from under the owners.

Oliver being a sophisticated store owner would likely know this distinction and will likely lose on the issue of apparent authority.

Implied Authority

Implied authority gives the agent the power to act in a manner reasonably calculated to achieve the principal's objective.

Here Ron will argue that the principals (Fred and George's) objective was for the store not to lose money in year two. Fred and George will state their objective was the Ron be a better store manager, not become a commercial real estate agent and lease their store out for 12% of the profits from Shop A (not accounting for Ron's pay).

Ron as store manager did not have implied authority to lease out Shop B and make his position superfluous.

Assuming Oliver is entitled to damages. Who is liable to pay those damages, and what is the amount?

Assuming Oliver is entitled to damages that means that Ron had to have either Actual, Apparent, or implied authority to enter into the lease.

Principal liability

Where actual, apparent, or implied authority exists the principal is liable to the innocent third party for damages.

Here the partnership is liable. If the partnership cannot pay the damages each partner is severally on the hook for the damages.

The partnership will have to pay Oliver's damages, but that does not mean the partnership cannot obtain indemnity from Ron.

Indemnity

Where an agent exceeds their actual authority they can be held liable to the principal for damages.

Here Oliver did not have actual authority to enter into the lease agreement and exceeded his actual authority. The partnership can seek indemnity from Ron

Contribution

Where on partner is forced to pay more than their fair share of a claim against the partnership the partner(s) who pay over more than their share can seek contribution from the partnership (i.e. the other partner(s))

If Ron is unable to compensate the partnership for the damages and if the partnership cannot absorb the loss and one partner has to pay more than their share of the damages the partnership can seek contribution from the other partner(s)

Amount of damages

Oliver's damages are $13,000 plus any lost profits while he was not able to open his store.

24 months x $500 = 12,000

Relocation x $1,000 = 1,000

END OF EXAM