MONTEREY COLLEGE OF LAW

BUSINESS ORGANIZATIONS

Final Examination

Spring 2017

Prof. M. Cohen

INSTRUCTIONS:

There are three (3) questions in this examination.

You will be given three (3) hours to complete the examination.

Professor's Answer Outline: NOT AVAILABLE

1. Skip often lamented his choice to grind out long hours prosecuting patents for his clients. Practicing intellectual property law was not quite the thrill he imagined in law school. But he did relish his extravagant Manhattan dinners with his investment adviser and old college friend Tye. And the evening's rendezvous at Manhattan's latest to be seen and starve venue relieved Skip's stress as the two friends cracked into their third bottle, a French Margaux to follow the Italian Brunello and Australian Shiraz that lead them to this moment.

   "Man you've been sweating it lately Skip, what's going on with you? I can see the tension in your face. You've gotta let it go brother," Tye advised.

   "Shoot Tye, that's easy to say in your job, you get paid no matter what happens, up or down, win or lose, we all pay you to manage our investments and you get paid for every stock you trade. You can't lose. But heck I'm slaving it out for big law, I'm a corporate tool playing the fool. What's bothering me now? King Pharma that's what. Massive review of their patents for one of my corporate partners," Skip replied.

   "I won't ask you what the King thing is all about, we both know the rules, but I will say it sounds like a transaction's in the mix! Don't respond to that!"

   "I won't, don't be stupid. But I will say, wouldn't it be nice to be King for a day! Cheers old friend, may these times never end," and with that, Skip clinked glasses with Tye and finished his fanciful French fare.

   The next day, groggy from his quasi-blackout, Tye's mind kept repeating the mantra "King for a day," "King for a day," "King for a day." "What could that mean," he asked himself. Then it dawned on him – King was doing a deal. He knew King Pharma well enough to know it was probably the smaller fish to be swallowed.

   Immediately Tye adjusted his client portfolios, purchasing heavy volumes of King stock in the event his hunch was right. And he was. One week later, Pfizer, Inc. announced a deal to buy King Pharma. Tye could not wait any longer, he picked up the phone to call Skip, "Guess what old buddy, you're king on this day, we all are!"

   a. Is Skip a guilty "tipper" under federal insider trading laws?

   b. Is Tye a guilty "tippee under federal insider trading laws?

   Discuss the full basis for your answers.

2. Hose-em Corporation, Inc., an irrigation equipment manufacturer publicly traded on the New York Stock Exchange, has nine Directors on its Board. Three directors are company officers: the CEO, COO and CFO. The remaining six directors are not otherwise affiliated with the company, nor do these six directors own stock in Hose-em.

   At its April 1, 2017 Board of Directors Meeting, held at the Petit St. Vincent resort in the Grenadines, the Board learned that over the past fiscal year, Hose-em's marketplace performance exceeded all expectations, and that the company's retained earnings had increased 35%. Based on that information, and with all directors present, the Board took the following actions.

   First, the Board granted the company's executives, including the CEO, COO and CFO, stock options. The option grants became effective on the date of the Board vote, April 1. The Board wanted the executive options to be effective April 1, because it anticipated that on April 15, after the company's fiscal year-end earnings call with the Wall Street analysts, the firm's stock value would increase. That occurred precisely as predicted. After the April 15 earnings call, Hose-em's stock rose from $24/share to $38/share by the end of the day's trading.

   Second, the Board raised the annual compensation for its Directors from $350,000 to $500,000.

   Third, the Board voted to distribute the Treasury Stock in its possession to its existing shareholders, rather than selling the Treasury Stock on the New York Stock Exchange.

   The Board vote on all three actions was a unanimous 8 in favor and none against.

   Sue M. Often, a shareholder in Hose-em since January 1, 2016 and currently, filed a derivative action challenging the Board's three actions. Her suit alleged the Board's compensation decisions breached duties of loyalty owed to the company. She alleged the Board's decision to make a shareholder distribution with the Treasury stock was negligent, because the company could have received more revenue selling the shares on the stock exchange. She did not serve Hose-em with a demand prior to filing her lawsuit.

   a. What legal standards govern each of Sue M. Often's claims? Include in your discussion any burdens of proof and defenses.

   b. Was Sue's failure to serve notice and demand of her shareholder derivative action proper under the Demand Futility rule?

3. Mega-Mart, Inc., a publicly traded company on the NASDAQ stock exchange, was suffering. Once the largest retailer in America, its business model selling commodity goods at steep discounts was declining sharply with the American public's exponential shift to purchasing online. Mega-Mart, accordingly, had begun closing and shuttering various stores across the United States, laying off tens of thousands of employees.

   Knowing that Mega-Mart owned the real estate where its brick and mortar stores were located, B.M. Breakum, a notorious corporate raider, sensed an opportunity. Breakum's plan was simple: once the stock dipped to a certain level, Breakum believed it would be profitable to gain control of the company and sell its real estate.

   Breakum immediately purchased 10% of Mega-Mart's outstanding stock and demanded a meeting with Mega-Mart's Board of Directors. The Board granted Breakum's request. Breakum indicated he wanted to buy Mega-Mart for $45 per share. Mega-Mart's stock was trading at $22 per share.

   The Board of Directors met and rejected Breakum's offer. The Board concluded Breakum would disassemble the company, and that Mega-Mart still had a profitable future. In fact, the Mega-Mart Board, in reducing its retail stores, was shifting its own brand to create an online marketplace to rival existing online retailers.

   Breakum would not take no for an answer. He launched a tender offer. Specifically, Breakum announced to the public market that he would purchase up to 41% of Mega-Mart's stock for $45 per share. The tender was open to all shareholders, would remain open for thirty days, and otherwise complied with all aspects of the Williams Act.

   The Board responded with a self-tender, offering to buy-back its stock for $55 per share, also in full compliance with the Williams Act.

   Watching from the sidelines, Shamazon, the world's largest online retailer, saw an opportunity itself, and decided to join the contest. Shamazon's CEO J. Bozo approached the Mega-Mart Board and asked for an exclusive 30-day window to explore and negotiate a mutually agreed merger.

   The Mega-Mart Board was skeptical of any potential to merge with Shamazon, but feeling obligations to its shareholders, it agreed to the thirty-day window to hear out Bozo. The Board also concluded a stalking horse could help its defense against Breakum's hostile takeover attempt, or prove an eventual white knight assuming Mega-Mart could be convinced.

   Breakum was no new kid on the block. He had busted bigger bricks than Mega-Mart and was not about to be outplayed now. Immediately, Breakum

filed suit against Mega-Mart. The Complaint challenged the Board's decisions:

a. rejecting Breakum's offer to acquire the company;

b. implementing Mega-Mart's own self-tender; and

c. entering into the exclusive merger discussions with Shamazon.

Discuss the Board's potential liability for each of Breakum's three claims.

85
Excellent Analysis

1)

The Securities and Exchange Act of 1934 governs transactions regarding securities. Rule 10b of the Securities and Exchange Act concerns Securities Fraud. Under Rule 10b, any person who committs an act of fraud in connection with a sale or purchase of a security is liable for securities fraud. This rule extends to one type of securities fraud which is insider trading.

good

Any person who is in possession of material inside information regarding a company must disclose that information to the general public before trading on it, or, if disclosure is not possible, the insider must abstain from making a securities transaction. The test for what is material is whether a reasonable person would find the information relevant to their decision making process of whether or not to purchase the stock.

good

Skip is in possession of inside information regarding the company King Pharma, because he told Tye that there was a "Massive review of their (King Pharma's) patents for one of my corporate partners." Because Skip's information was unknown to the general public, it would be considered inside information. His information about King Pharma would be considered material because a reasonable person would find the information relevant to whether they would purchase King Pharma's stock. A reasonable person may deduce from his information, as Tye did, that King Pharma's patents were being reviewed in preparation for acquisition by another company. As insider, Skip had a duty to disclose the material inside information he knew to the public before trading the stock of King Pharma, or a duty to obstain from trading the stock of King Pharma.

good

Because Skip shared with Tye his material inside information, he has given Tye a tip, and therefore Skip is a "tipper." Because Tye received a tip, he is a "tippee." A tippee's liability is

derivitive of the tipper. Therefore, whether Tye is liable for insider trading depends on Skip's liability for insider trading.

A statutory insider is a director, officer, or shareholder of more than 10% of a company. Insiders have a duty to disclose material inside information or to abstain from trading the company's stock. Skip is not a director, officer, or 10% shareholder of King Pharma, so Skip is not an insider. Therefore, Skip is an outsider.

An outsider has no affirmative duty to disclose. However, they may be liable for insider trading if they acquired the material inside information through missappropriation. Missappropriation occurs when a person gains confidential insider knowledge that does not belong to them through theft or deception. In this case, Skip is a lawyer for a corporation conducting a massive review of King Pharma's patents, possibly Pfizer. The knowledge of his clients actions in relation to King Pharma is confidential, and belongs to his client, not himself. Therefore, because Skip gained his information through misappropriation, and later purchased King Pharma stock, Skip is liable for insider trading.

In order for the tippee to be held liable for insider trading, the tippee must know that the information came from a breach of an insider's duty or from the missappropriation of an outsider, and there must be a benefit to the tipper.

Because Tye is an investment advisor to skip, and Skip's old college friend, Tye is likely well aware that Skip is a lawyer and that the information Skip disclosed to him came from inside knowledge of Skip's clients. In fact, Skip specifically told Tye "I'm slaving it out for big law . . . What's bothering me now? King Pharma . . . Massive Review of their patents for one of my corporate partners." Therefore Tye is well aware that Skip, as an outsider, missappropriated his client's confidential information.

Additionally, As the tipper, Skip has received a benefit. Because Tye is Skip's investment advisor, and as a result of Skip's tip, Tye adjusted his client portfolios and purchased heavy volumes of King stock. Skip is one of Tye's clients, and therefore when Tye adjusted his client portfolios and purchased heavey volumes of King stock, Skip purchased King Pharma's stock and presumably profitted from the transaction when, a week later, Pfizer, Inc announced a deal to buy King Pharma.

Skip would argue that his breach of his client's confidentiality and missappropriation was unintentional, because he was drunk when he shared the inside information with Tye. However, Rule 10b / Securities Fraud is subject to Strict Liability. Therefore, both Skip and Tye are guilty under federal insider trading laws.

— Recklessness (would still be culpable).

END OF EXAM

good answer - more analysis of 1 & 2.

80

2)

What Legal Standards govern each of Sue M. Often's Claims?

Sue M. Often filed a derivitive action challenging the Board's 3 actions and arguing that the Board's compensation decisions breached their duty of loyalty to the company. The Duty of Loyalty requires that company officers, directors make decisions with the best interest of the company in mind. A director or officer breaches their duty of loyalty when they make decisions with a conscious disregard for their duties to the company, or take actions which place their personal interests above the company's interests.

When a plaintiff claims that company directors have breached their duty of loyalty, it is the plaintiff's burden of proof to show that the company's directors were self-interested. In defense to challenges to the Board's duty of Loyalty, there are 2 available defenses to the board: 1) shareholder ratification and 2) majority vote by disinterested directors. If the defendants can prove that their actions were approved by a vote of informed shareholders, (shareholder ratification) then their decisions are not considered to be self-interested because there was full disclosure to the shareholders and the shareholders approved of their actions. Likewise, if the decisions in question were made by a majority vote of disinterested directors (directors who are not also employees of the company or who do not own company stock) then the directors cannot personally gain from their decsion and it is presumed that they did not violate their duty of loyalty.

However, if a plaintiff proves that the directors acted in their own self-interest, the burden shifts to the defendants / directors to show that their self-interested actions were fair and reasonable. The standard by which their actions are judged is the Entire Fairness Standard. The directors must show that their actions taken as a whole were fair and reasonable - This standard requires fair dealing, fair price, and complete candor.

good

Sue is challenging 3 actions of the Board. In order to discuss their legal standards which govern Sue's claims, we must examine each action:

1) Board's decision to grant the company's executive's stock options effective April 1, prior to April 15's year-end stock value increase.

Sue M. Often will argue that the Board breached its duty of loyalty in granting the exectutive's stock options for April 1, knowing that the stock options would increase in value on April 15. This practice is known as spring-loading the options. There are no facts which state that the Board made any disclosure to the public or to the shareholders regarding the expected increase in value of these stock options. Therefore, the CEO, COO, and CFO who received these stock options received an undisclosed personal gain.

In defense, the Board will argue that it made the decision to grant these stock options by a majority vote of disinterested directors - Since the stock options were goign to the CEO, COO, and CFO, and not themselves, there was no self-interest in their action.

Analysis - outcome?

2) Board's decision to raise the annual compensation for its Directors from $350,000 to $500,000

Sue M. Often will argue that the Board breached its duty of loyalty in raising the annual compensation for its directors, because this is a self-interested action by these directors.

Compensation to the Board is an action which is self-interested. Therefore, the court will use the Entire Fairness standard to determine whether this action was fair. The Board may submit evidence to show that in light of the company's 35% increase in retained earnings, a raise in compensation was reasonable and affordable for the company. It is likely that the

court will find that this raise in compensation was fair, and this did not violate the Board's duty of loyalty.

More analysis!

3) Board's decision to distribute the Treasury stock in its possession to its existing shareholders.

Sue M. Often will argue that the board's decision to make a shareholder distribution with the Treasury stock was negligent, becasue the company could have received more revenue selling the shares on the stock exchange.

A Board has almost absolute discretion to award distributions of profits / dividends to shareholders. In order for a Board's decision to grant dividends to be upheld in court, any business justification will suffice. However, there is one rule with which the Board must comply when awarding dividends: the Net Earnings Rule, which states that all dividends must come from profits. In this case, Treasurey Stock would be considered capital of the company, not profits. Therefore, the court is likely to find that the award of Treasury Stock to shareholders violates the net earnings rule and cannot be upheld. ✓

good

– Also BJR w/ near absolute discretion

b) Was Sue's failure to serve notice and demand of her shareholder derivitive action proper under the demand futility rule?

In order for a shareholder to file a derivitive lawsuit, the company must first have a valid claim. Then the shareholder is required by law to present the Board with a written demand that includes notice of the alleged wrongs and a demand for actions to be taken by the Board to correct them. If the Board does not act on the demand within 90 days, then the shareholder may bring a derivitive suit. However, the requirement for a written demand is excused under the demand futility rule if the board is self interested.

In this case, the board making the decisions was made up of a majority of disinterested directors, who awarded stock options only to the CEO, COO, and CFO, not themselves. Their award of a raise in compensation to themselves may be seen by the court as reasonable and fair, and therefore not a breach of their duty of loyalty. Additionally, the 6 disinterested directors did not own stock in Hose-em, so their award of Treasury stock as dividends could not be considered a self-interested action. Therefore, because the self-interest of the board of directors was not self-evident, sue's failure to serve notice and demand under the demand futility rule was not proper.

END OF EXAM

– was evident in Director comp but not others.

85

3)

Breakum's Offer

The Mega-Mart board has the right to defend itself from takeover. Under Unocal a corporate board may take defensive action if it reasonably perceives a serious threat to the future or the essential character or function of the company, and if that action is proportionate to the threat. In addition, the action must neither be coercive or preclusive. Having accurately concluded that Breakum's offer to purchase MM was for the purpose of dismantling MM and selling the real estate beneath its retail locations, MM perceives a serious, indeed terminal, threat to its existence. A board is not obligated to sell the company for parts merely because the price is right.

good

Self-Tender

In response to Breakum's tender offer, MM implements its own self-tender at a higher price than Breakum's offer. Again, Unocal instructs that the self-tender is proper if the perceived threat is serious and the response is proportionate. The self-tender is a reasonable response that is not coercive.

✓

Merger Talks

MM has entered into a lock-up/no shop situation with Shamazon. This act, in itself, is appropriate yet any prospect of a merger with Shamazon will require a shareholder vote. Moreover, at some point in the merger talks it may become apparent that governance will be altered at MM or whatever the new corporate entity may be upon combining with Shamazon. This is the Revlon moment. If defense against Breakum's takeover leads a potential merger with Shamazon then all roads lead what is basically a sale of MM. At this stage the directors then owe the shareholders a duty of simply fetching the best price for their stock. The Revlon moment arises when a change in Mega-Mart governance appears inevitable.

good

END OF EXAM