MONTEREY COLLEGE OF LAW

BUSINESS ORGANIZATIONS

Final Examination

Spring 2018

Prof. M. Cohen

INSTRUCTIONS:

There are three (3) questions in this examination.

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

QUESTION 1

Ralph Rogue approached Helen Highstakes to solicit funds for a proposed restaurant venture. Rogue intended to bring the Paris Les Grande Marches to Monterey County.

The thought of a fresh market restaurant with stations serving prepared foods from Monterey County's bounty captivated Highstakes. She agreed to back the restaurant financially. Rogue would manage it. They agreed to split profits 65% for Highstakes and 35% for Rogue.

Rogue and Highstakes agreed to create a written partnership agreement with these and other basic terms at some point in the future. For now, Highstakes asked Rogue to seek her prior consent before committing the business to any contracts exceeding $50,000.

The next day Rogue formed Carmel Cornucopia, L.P., a limited partnership, and duly filed all required forms with the State Corporations Commission. The filings contained no defects. Rogue listed himself as the General Partner, and listed Highstakes as the sole Limited Partner.

Later that day Rogue, eager to move forward now that he had funding, entered into a written lease for restaurant space, committing the Carmel Cornucopia, L.P. to a three-year lease requiring monthly recurring $10,000 rent payments, amounting to $360,000 over the lease term. Rogue signed the lease with the notation "General Partner, Carmel Cornucopia, L.P." after his name.

Eager to report on the development, Rogue met Highstakes at the Pine Inn for an afternoon Black Widow cocktail. "You did what?" Highstakes exclaimed. "Whoa, we were supposed to discuss that type of commitment first. I don't trust this process. You're exposing my investment to risk I can't control or navigate. Sorry Ralph but that's it, you'll have to find someone else to back the restaurant, I'm out."

Rogue immediately called the building management for the restaurant space he had just leased and indicated he would have to cancel. The landlord asked what happened, and Rogue disclosed that Highstakes, his investor, had backed out. "Too bad," the landlord empathized, "but you and Highstakes owe me rent until I can find another tenant."

a. **Describe the liabilities, if any, between Rogue, Highstakes and Carmel Cornucopia, L.P. for the rent payments.**

b. **Can Carmel Cornucopia, L.P. continue in business?**

QUESTION 2

Barry Bozo founded and owned 100% of the outstanding stock of Clownfoot Corporation, Inc., a closely held company in the business of training and contracting clowns to circuses around the world.

Clowns were in short supply, along with humor, given world events, and consequently, clowns also found themselves in high demand. Clownfoot Corporation grew rapidly in this economic cycle. Bozo felt that Gary Glowring, the lead clown trainer, was critical to Clownfoot's quick success. Bozo therefore decided to offer Glowring an equity stake in the company.

"Glowring you're an amazing clown," Bozo proclaimed addressing the matter of stock ownership in his conversation with Glowring. "I'd like to keep you here long term, and to that end I am prepared to offer you a 40% stake in the company," Bozo stated.

"Gee thanks Bozo, but what's that worth?" Glowring asked. "I don't have much discretionary income to invest right now," Glowring added.

"No problem," Bozo replied. "I will give you 10% of the company's stock as part of your annual salary each year for the next 4 years. Once you own 40%, in subsequent years you can draw your return on this investment from your salary and more importantly, bonuses that we will distribute at the end of each year in the form of dividends," Bozo explained.

"Great I'm in," Glowring committed.

Over the next four years, Clownfoot Corporation continued its whirlwind expansion and growth. Glowring proved critical to the company's success as Bozo had contemplated, and earned his 40% equity shareholder interest in the company, which Bozo conveyed pursuant to their agreement.

In year 5, Goldman Silver Copper Bronze & Diamonds, the famous investment banking firm, approached Bozo about taking Clownfoot Corporation public. Bozo agreed it was time, and seeing his future potential wealth, he wished he had Glowring's 40% interest in the company back.

"Well Glowring," Bozo said after their journey together, "thanks for everything these past many years, but you're fired. The company will not be making any dividend distributions going forward. If you'd like to sell back your stock the Company will repurchase it for half what you paid."

a. ***What are Gary Glowring's options?***

QUESTION 3

Sharon Scissorhead loved practicing antitrust law. As a young associate attorney in the large Manhattan law firm Profit First, she was thrilled to read the rumors regarding her merger deals in the Wall Street Journal.

Pamela Paperhands, Sharon's best friend and favorite Big Sur bohemian, loved Sharon's new job as well. Sharon seemed to have such great instincts for business now that she practiced law in New York City, a place and profession that Pamela considered complete mysteries.

Sharon admired Pamela's innocence from big business, as well as Pamela's focus on art, painting and poetry in Lucia, California, Pamela's adopted community along a remote stretch of Central California's south coast. And Sharon felt a sense of accomplishment sitting in her Manhattan office with her skyscraper view across the East River toward the Statue of Liberty, as she passed along her stock tips to Pamela. It was good to be able to take care of Pamela this way, Sharon often appreciated silently to herself.

Pamela did not have much to invest, but she was still grateful for Sharon's advice, which had always made her money. And for her part, Sharon did not mind passing along stock tips to her best friend a few days before a merger she was handling became public knowledge. After all, what's the harm to the market balanced against the benefit to poor starving artist Pamela, who would spend whatever she made on oil paints and avocados.

Sharon was, at least, circumspect when communicating her stock tips to Pamela. Sharon would simply say things like "I've learned some things about ABC, Inc., you should buy some stock today it will pay off!"

Sharon was careful never to disclose to Pamela that Sharon knew anything about a merger. Pamela would never understand all that anyway, Sharon thought. And Sharon herself never traded stocks at all. She had adopted that approach to avoid any allegations she ever traded on inside information regarding mergers she was handling.

a. ***Is Sharon liable for her stock tips to Pamela?***

b. ***Is Pamela liable for her purchase and sale of securities based on Sharon's tips?***

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a.)

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In a Limited Partnership (LP), there are General Partner(s), who manage the LP entity and are both principles and agents to each other, and Limited Partners who are only investors, and have no management rights or responsibilities. They are only liable to third parties in the sense that they have put their money into an entity, the LP, which may be liable. However, if a Limited Partner **acts** like a General Partner, especially as to third parties, they will be held liable as as General Partner as they are acting as more than a **passive investor.**

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In order to determine the liabilities of Rogue (R), Highstakes (H) and the entity Carmel Conucopia, L.P. (C), we must determine whether H is for liability purposes a General Partner.

Has H participated in or acted as management sufficient to morph from a limited partner into a general partner for third-party ((3P) here the building management) liability purposes?

H said that she wanted to "finance" the venture, but it does not appear from the facts that she actually put any money into an account. She did say that she wanted to approve any

contract over $50k - this would mean that she wanted to take part in an actual decision and/or direct the direction of the business/restaurant, which may be acting more than a passive investor. Furthermore, when she said that she was out, she indicated that R was "exposing her investment to risk I can't control or navigate" which indicates that even though R put her down as a limited partner and she agreed to "back the restaurant" her understanding and conduct was something more than a passive investor, which would make her a de-facto manager, i.e. general partner, and therefore both agent and principal to R.

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Does R have apparent authority to bind C to a contract with 3P?

Here, the 3P is entitled to depend upon the representation of an agent (one who acts on behalf of another person or entity); from the 3P's reasonable perspective, the the agent have authority to make the contract? Here, it is reasonable for a building manager to believe that a restrauteer representing that he is bringing a well-known and profitable restaurant to an area known for its restaurants has authority to enter into a contract on behalf of the principle (in this case, C).

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For R to have actual authority, the C would have had to know about the contract, or given R specific authority to enter into it. However, if C (the other General Partners) doesn't know about it, but it is reasonable from 3P's perspective that R had authority, the the C would be bound to the contract and would be liable to perform. Therefore C is liable.

Is R Liable to 3P?

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Since R is a general partner of C, he is personally liable - this is why LLC's are way better than a partnership.

Is H liable to 3P?

As indicated above, the 3P almost always comes out on top - 3P is entitled to rely on the reasonable representation (from 3P's perspective) that R had authority to bind C to the contract. Therefore, as far as 3P is concerned, H is liable, but she can take it up with R if he went beyond his authority as an agent, and she didn't ratify it. If, however, H is **just a limited partner,** then she would only be liable for the amount she "invested" into the C, which is not more than $50K, as she did affirmatively give R the authority to enter into contracts UNDER $50K.

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Conclusion:

It is likely that a court would find that C is liable to 3P, as long as it is a legitimate L.P., which according to the facts it is. As R is a general partner is C, he is liable, as the principle and agent of C. It is likely that a court would find that H expected and saw herself more as a manager in the venture and acted as a manager, it would mean that she was also liable as a general partner to 3P.

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Even though R and H did not yet have a written agreement, in a partnership the courts often look to the conduct of the parties to determine if they are acting as partners, which is two or more persons acting together for a business purpose, sharing profits and losses equally, or otherwise by partnership agreement. Since R and H had a verbal agreement to split the profits, they had an agreement for something other than 50/50, so that does not defeat or make the partnership invalid.

However, since H is acting not as a passive investor, but rather a manager, in reality there is not a L.P. (which requires a general partner(s) and passive investor limited partner(s)), but a General Partnership.

Nevertheless, H has declared that she is withdrawing from the partnership, which creates a DISSOLUTION, ending the entity. R cannot continue as a partner of 1!!!

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END OF EXAM

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Closed Corporations

A closed corporation is one in which there are few shareholders, of which may manage the company. In closed corporations, majority shareholders owe duties to the minority shareholders, and must offer equal opportunity to minority shareholders.

Here, although Barry (**C**) was originally the sole shareholder of Clownfoot Corp (CC) allowed Gary (G) to become a 40% owner as well. Considering that C was now a 60% shareholder and G was 40%, C was the majority shareholder who owed duties to G, the minority shareholder. Being the majority shareholder, C was obligated to provide equal opportunity to G. When C was approached about taking CC public that was an opportunity that C had obligation or duty to share equally with G. Instead, C decided that he would oppress G, the minority shareholder and freeze or squeeze G out.

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Oppression

Oppression occurs when there is a majority shareholder who takes action that is not in the best interest of the majority shareholder. Once it has been determined that oppression has occurred the company has to either stop the oppressive conduct, or buy out the minority shareholder.

Here, to determine if oppression was occurring, a court would look to the reasonable expectations of the minority shareholder at the time of investment. In this case, G didn't really seem to have any interest in investing in CC until he was approached by C. G didn't know what a 40% interest in CC would be worth and wasn't sure that he could afford the investment. C's incentive to offer ownership to G was not for capitalization of CC, but instead for employee retention. C knew that clowns were in high demand and in order to

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ensure that he could keep one of his best performing clowns C decided that it would be wise to offer equity in CC. G was gifted 10% per year for 4 years, and had an expectancy in bonuses, and dividends. Based on these facts, it does not appear that G expected long term growth of a huge windfall at the end of his investment in CC, not did it appear that he expected to contribute anything other than his devotion and labor to CC. But, G could reasonable expected continued employment from his minority ownership of CC at the time of his investment.

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Given that C fired G, it is likely that the actions were oppressive and were contrary to the reasonable expectation of G at the time of his investment. Since it is likely that oppression occurred, CC could stop the oppressive conduct or buy out G. But, here C did offer to buy out G. However, C offered half price for the stock. Since there is no public market for the stock, C would not be able to discount the stock price offered to G.

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Management Buy Out

Where there is a management buy out the majority shareholder is usually privy to information that the minority shareholder is not. Because of this, the majority shareholder would be required to meet the Entire Fairness Test during a buy out. The Entire Fairness Test would require that there be fair dealing (process) and a fair price (price).

Here, Considering that C knew that another company had approached his about taking CC public, C had information that G did not. This information would have been critical to G's decision to sell his stock to C or not. Having not revealed that information to G, an instead firing him, would not have been fair dealing in G's opinion. C, however, would argue that he did not need to reveal the idea of going public to G because C's only real intention in offering stock to G was to keep his as a long term employee. However,

because G was a stockholder, and who would have also benefited from taking CC public, C's conduct was not fair, and did not conform to a fair process with G. Additionally, C offered to buy the stock for half price. Considering that there was a possibility of taking CC public, offering half price for what G paid for the CC stock was not likely a fair price. Even if C argued that the value of the CC stock at the time of the offer was only half of what G paid for it, without revealing that there was a potential for increased value in the stock with the public offering, G would argue that half price was not a fair price to buy the stock for since C owed duties to G.

Freeze Out

A freeze out occurs where the majority stockholder is trying to push out the minority stockholder. When a freeze out is occurring the majority stockholder must meet the Wilks test, show that action taken leading to the freeze out was a legitimate business decision and that there was not a less injurious alternative.

Here, C would need to show that firing G was a legitimate business decision. Considering that there are no facts to indicate that and not been fulfilling his obligations as an employee, and in fact G had proven critical to CC's success, and that C's incentive to fire G was motivated by his desire to have G's 40% interest back, Firing G was not likely a legitimate business decision. Even if C could show that firing G was a legitimate business decision, he would also need to show that there was not a less injurious alternative. Considering that just 5 years prior G had commented that he didn't have much discretionary income, and that the been critical to the CC success, and that CC was performing such that Goldman thought the company successful enough to go public, there was likely a less injurious alternative to firing G. G would argue that C could have simply bought back the stock at full price, or offered some type of retirement plan, after disclosing the Goldman information, that would have less injurious to G.

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Although C would argue that anything other than firing G would not have given C the results he was looking for because of his desire to reap all the gains from going public, C would not likely be able to show that firing G was a legitimate business decision or that it was the least injurious alternative.

Duty of Loyalty

A duty of loyalty is imposed upon those are in possession of a corporation. A duty of loyalty requires that any conflict of interest (self dealing, self interest, compensation...) be fully disclosed.

Here, since C did not disclose the potential to take CC public to G, and C was considering his own potential gain, G will argue that C breached his duty of loyalty to CC. Although C will aruge that those factors don't apply in this situation because the ability to take CC public had not yet arisen, it is likely that C was still acting in his own self interest.

Unless C can show that he fully disclosed all information, or that his actions had no impact on CC, he will likely have breached a duty of loyalty to CC.

Duty of Care

A duty of care is imposed upon those who are in possession of a corporation.

Here, C was the founder and 60% owner of CC, and as such owed a duty to CC to act with a duty of care. A duty of care requires that C act as a reasonable person in the same position would act, that he monitor CC, and the participate, attend meetings, vote, object... and the like. If that duty had been beached C can be liable. C would be able to claim that he had the presumption of the business judgement rule when he makes decisions that are informed, in the best interest of CC, and are not interested.

Considering that C fired G, G would claim that C did not act as a reasonable person in a similar situation would have since G was critical to the success of CC. Although C would claim that he is entitled to the business judgement rule presumption (BJR), G would argue that the decision was not in the best interest of CC, given how G was a long time successful employee. G would also claim that the decision was not disinterested because of the fact that C wanted to claim all of the profits from a public offering for himself.

Unless C could somehow show that he used a group of disinterested people to make these decisions on his behalf he would likely have breached his duty of care.

Duty of upmost good faith

The duty of upmost good faith must always be maintained. The majority shareholder cannot circumvent this duty.

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Here, given that C realized the potential future wealth that he could have without G, he attempted to oppress and freeze out G, and impermissibly discount G's buyout in order to benefit himself. C was not looking out for the best interest of CC, or for fulfilling his obligations to the minority shareholder. Without a public market for G's shares, C's actions put G into a vulnerable situation where C can defraud G of potential earnings by withholding information C has come into in his role as a majority shareholder of the closely held corp.

Derivative Suit

A derivative suit (DS) can be brought where there is a claim brought by a shareholder on behalf of the corporation. In order to bring a valid DS, the plaintiff shareholder must bring a suit that the corporation itself could have brought, must have made a demand that was refused, and must have owned stock at the time of the suit and throughout the case.

Here, while G may try to bring a DS, claiming that C is violating the rights of CC, and that G is representing the rights of CC, C will argue that G is in fact repressing his own rights as a shareholder and not the rights of CC. G might try to say that CC's rights are violated because G brought value to CC, but he is not likely to succeed in showing that his claim is one representative of CC, because it is a claim against G's own rights as a shareholder. Additionally, although G meets the contemporaneous ownership rule, because he owned stock and that time that he would bring suit and throughout, he would not likely be able to pursue the suit because there are not any facts that indicate that G has just made a demand on CC that was rejected. G would only be able to get around the demand if he were in the demand futility jurisdiction instead of the universal jurisdiction. A demand futility jurisdiction would allow G to forgo the demand because demand would be futile given that the majority of the board was of interested parties-- here just one party, C, who was 100% interested..

Considering the facts provided and the circumstances here, G would not likely be able to bring a derivative suit, even though as above C likely breached duties of care and loyalty, and instead would need to bring a direct action. The breaches of duties above don't appear to have any harm to CC that would need to be remedied.

<u>Distributions- dividend</u>

Distributions of dividend are in the sole discretion of the board.

Here, if C was able to fire G, and bought out G's share's the decision to distribute dividends would have been in C's sole discretion. However, considering the dynamic of the majority/minority shareholder situation, the lack of dividend would be included in G's arguments for oppression, freeze out and squeeze out. If the decision to distribute were made while G was still able to vote, G would still be a minority shareholder, and thus the

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above discussed protections would be applied... but ultimately distributions are discretionary.

END OF EXAM

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A. Sharon's Liability

Rule 10B-5

Under 10B-5 it is unlawful for any person to directly or indirectly use interstate commerce in connection with the sale or purchase of securities to: employ any devices or schemes to defraud, make an untrue statement of material fact or omit a material fact, or engage in any activity which deceives or defrauds any person. In order to bring a suit under 10B-5 one must show that the Defendant conducted himself in a manner which was manipulative, fraudulent, or deceptive; materiality of the untrue statement or omitted statement; and scienter. One of the man benefits of 10B-5 is the prevention of insider trading. Liability under rule 10B-5 occurs when he/she breaches a duty of trust and confidence to an issuer, shareholder of an issuer or in the case of misappropriation another person with the material non-public information.

Outside Trader

Misappropriation

Misappropriation occurs when a person wrongfully obtains material non-public information which they know is confidential, the material non-public information has value to the lawful owner, and the person who has misappropriated the material non-public information has no lawful right to it.

As an attorney Sharon had access to non-public information regarding mergers. She did not obtain this information wrongfully, but she does owe of duty of confidence to her clients. As an attorney she is a part of an attorney client relationship which is a fiduciary relationship that requires to put the interest of her clients above her own. She is not

putting her clients interest first when she gives tips about mergers before they occur. The tips regarding the mergers are material because a a reasonable investor would want to know about an upcoming merger. Because Sharon is not an insider trader she does not have a duty to inform others about the upcoming merger, in fact she has a duty to keep confidence regarding the merger until it is made public. Sharon also meets the criteria for scienter because she intended to give Pamela a tip that would gain her money. Sharon as an attorney knows what her duties are and that giving Pamela tips is wrong. In fact she purposefully never disclosed to Pamela that she knew about the upcoming merger in order to avoid allegations of insider trading. The fact that she is taking steps to avoid allegations clearly show that she knows that she is in the wrong. Sharon does not have a lawful right to the information regarding the mergers. The right belongs to her clients and she breaches her fiduciary duty to them and position of confidence by sharing that information with her friend.

Tipper

A tipper is liable when they have a duty to the issuer or in a position of confidentiality and obtain material non-public information as a result of that duty or confidence and provide that information to the tippee for some personal benefit.

As noted supra, Sharon has a duty to her clients to keep the information private and she is in a position of confidentiality as there attorney. She gained the information as a result of her position as the attorney and provided that information to Pamela. The information is material as a reasonable investor would like to know about an upcoming merger before making an investment decision and it is non-public information as Sharon gives the tips a few days before they become public knowledge. Sharon will argue that she did not gain any benefit from giving the tip to Pamela because Pamela did not know and did not monetarily compensate her or invest on Sharon's behalf. The prosecutor in this case would argue that while Sharon did not gain monetary benefit from giving the tip she did

gain emotional benefit as she felt a sense of accomplishment and felt good about taking care of Pamela in such a way. Sharon even stated that often appreciated silently to herself.

The court will hold Sharon liable for the tips to Pamela.

B. Pamela's Liability

Tippee

A tippee is liable if they knew that the tipper had a duty to the issuer or was in a position of confidentiality, the material non-public information came from the duty or position, and the tippee used the material information to purchase or sell securities. A tippee is not liable if all the tipper elements aren't first met.

As noted supra, the tipper elements have been met. Pamela did know that Sharon as an attorney had/has a duty to her clients. What Pamela did not know is that the information given to her came from a breach of that duty. Sharon actually went to great lengths to keep Pamela in the dark by lying as saying that she gleaned the information from public sources like ABC. One may argue that Pamela should have known better because she was aware that Sharon was an antitrust attorney and they had been friends for many years. Based upon this knowledge an argument could be made that Pamela should have inferred the source of Sharon's tips. This however, would be very speculative. Pamela did use the information provided by Sharon to purchase stocks.

Pamela will not be held liable because she did not know that Sharon was providing her with material non-public information.

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END OF EXAM