MONTEREY COLLEGE OF LAW

BUSINESS ORGANIZATIONS
FINAL EXAMINATION
Spring 2021
Prof. D. Lamb

INSTRUCTIONS:

There are three (3) questions in this examination. You will be given four (4) hours to complete the examination. The examination is closed book.

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Exam Question 1

Finding themselves in the midst of a world-wide pandemic and out of work because of the local shelter in place orders, four friends decided to open a business together that they could operate from their homes. Mary is a is an experienced business manager, Suzie is a talented fashion designer and seamstress and Kelly is a hot-shot salesperson. Adeline doesn't have any business experience, but had $50,000 to contribute to help get the business off the ground.

The four of them put their heads together (over Zoom) and orally agreed to form a cloth face mask business and to share profits equally. Mary said she could run the logistics of the business, i.e. collect accounts receivable, pay the bills and distribute the profits. Adeline said she would contribute her $50,000 for the business to use to start up, but wanted to limit her liability to that amount. Suzie said she could design and sew the cloth face masks. Kelly said she could market the face masks online and handle sales. They all agreed to this plan and specifically agreed that Suzie would be solely responsible for designing the masks and selecting the supplies, such as the fabrics, but that if Suzie ever made a purchase that cost over $10,000, she would need advance approval by all.

The four friends began doing business under the name MASK Face Coverings ("MASK"). The friends operated independently in performing their respective duties, but met weekly over Zoom to discuss and decide business matters. The business became very successful primarily because of Kelly's aptitude at online marketing and Suzie's prowess at procuring rare and designer fabrics that she transformed into flattering face coverings.

All ran smoothly until Suzie, captivated by her success using unusual fabrics and the attention her designs had received by celebrities, found 20 rare silk kimonos to use as fabric from KIM Co. Her contact at KIM Co. told her she had to act fast if she wanted to secure the kimonos, which cost $20,000, so Suzie purchased them without discussing the deal with Mary, Adeline or Kelly. When Mary received the bill from KIM Co., she told KIM Co. that the purchase was unauthorized and refused to pay for the kimonos. KIM Co. sued MASK for breach of contract.

Not long after that, MASK received an offer from the clothing store, Bonanzo Republic, Inc. ("Bonanzo") to become its exclusive supplier of masks for its stores and in turn Bonanzo would advertise their masks as being made exclusively by MASK. Given Suzie's propensity to make the masks with rare and designer fabrics, Suzie felt that Bonanzo did not portray the sophisticated image she envisioned for her designer masks and said she would never agree to any contract with Bonanzo. Mary, Adeline and Kelly disagreed and thought that Bonanzo's offer was too good of an opportunity to turn down and in spite of Suzie's objections, entered into the contract with Bonanzo, purporting to act on behalf of the partnership.

- What is the legal relationship of Mary, Adeline, Suzie, and Kelly?
- Is KIM Co. likely to succeed in its lawsuit against MASK?
- Did Mary, Adeline and Kelly have the right to enter into the contract with Bonanzo?

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Exam Question 2

Clint, West and Forest are the 3 directors of a successful corporate restaurant in Carmel County, the Horse's Breath Inn ("HBI"). Clint and West are HBI's officers. The 3 directors each own 25% of the outstanding shares of common stock of HBI. The remaining 25% of the shares are held by 5 individuals, including Harry, who purchased 5% of HBI's shares in November 2019 and thought that investing in the restaurant industry would be a sure bet to earn a good return. Little did Harry know that two months later a pandemic would hit that drastically affected the restaurant industry. By January 1, 2020, the governor, wanting to slow the spread of the virus, ordered the shutdown of dining inside of restaurants, but permitted dining outside as long as the county remained in the red tier. If the virus numbers increased, the county would move to the purple tier and outside dining would be shut down. Carmel County was in the red tier.

At the January 5 board meeting, the directors discussed for 6 hours what the restaurant should do. HBI had a quaint outdoor patio that was popular in summer. But because the patio was uncovered, it was rarely used in winter and spring due to the weather. At that meeting, the directors received a detailed report from HBI's CFO, about how much HBI historically earned over the months when the patio was utilized. The CFO calculated projections and concluded that the restaurant could sustain itself if it offered outside dining through the rest of the year. The board then reviewed past meteorological reports and concluded that Carmel County was likely to experience rain and cold weather for many more months and it was necessary to cover the patio if HBI wanted to use it for the rest of the year. Having decided to cover the patio, the board then discussed at length how to do it. Some other local restaurants had put up tents, but everyone agreed that this type of cover would not fit in with the quaint ambiance of HBI's patio. The directors decided that despite the extra cost, they would invest in a retractable roof. This decision was unanimously approved by all directors in a board resolution.

At the January 15 board meeting, Clint announced that the roof would be built by the end of the month and that he had negotiated a contract with Callahan Cleaning ("CC"), a partnership owned by Clint and West that specialized in deep cleaning restaurant kitchens in response to the virus. Clint disclosed CC's ownership and informed the Board that CC would charge HBI \$500/week to clean. Clint had solicited bids from other cleaners and CC's bid was by far the lowest. After reviewing the bids, the board approved the contract with CC by unanimous vote. The retractable roof was built, CC began its weekly cleaning and HBI opened for outside dining. All went well until Carmel County's cases pushed it to the purple tier and outdoor dining was shut down. Carmel County was hit hard, and it stayed in the purple tier for the next 6 months. The expensive, new retractable roof went unused, and HBI struggled financially to make ends meet through to go orders. Unhappy that his investment did not turn out to be lucrative and that HBI spent so much money on the roof when it could have bought a cheaper tent and spent that money on other things, such as a pick-up window for to go orders, Harry brought a shareholder derivative suit against all 3 directors seeking a judgment voiding the CC contract and for damages to HBI arising from the approval of the retractable roof. Harry did not make a demand on HBI because he wanted to get the suit on file as soon as possible, and because he believed that the Board would never agree to the suit. What should be the result?

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Exam Question 3

Jackson & Jackson (JNJ) and Mergj & Co. (MRG) are both large, publicly traded (on a major stock exchange) American corporations that develop medical devices and pharmaceuticals. When the COVID-19 pandemic hit the U.S., both JNJ and MRG rapidly began to develop vaccines. Development went well, both companies got potential vaccines into clinical trials and soon after both companies received results. In January, JNJ's CEO, Alec, received an internal and confidential report stating that JNJ's study demonstrated the vaccine was 95% effective in preventing disease. Alec was ecstatic. His first call was to his 80-year old mother, June, who was the person he had been most concerned about getting the virus over the last year. In addition to being ecstatic about the prospect of her getting an effective vaccine, Alec also knew that his mother was an active stock trader and that she would appreciate receiving this information, from her son the CEO, before it was announced to the public. Sure enough, as soon as June finished thanking Alec for sharing this internal and confidential report with her, she immediately telephoned her broker and purchased 1,000 shares of JNJ stock. As expected, JNJ's stock skyrocketed after its public announcement and June made a bundle.

The report received by MRG's CEO, Kent, however, decisively indicated that MRG's vaccine was not effective. Kent worried that despite MRG's robust vaccine manufacturing facilities and expertise, the company would struggle because it failed in its efforts to make a viable vaccine. As Kent feared, MRG's stock price plummeted when its vaccine results were made public, dropping from $50/share (which was historically its highest stock price) to $5/share. But, a few days later, Kent heard from Alec, who raised the possibility of a merger since although JNJ had developed a good vaccine, it did not have sufficient manufacturing facilities to produce as much vaccine as was needed. Kent and MRG's directors were intrigued by this offer and merger discussions between the companies progressed rapidly. Kent and Alec engaged in a number of direct negotiations, ironing out the detailed terms of the merger, both companies' investment bankers were instructed to prepare, and MRG's directors adopted a board resolution to enter into the merger agreement with JNJ even though the exact terms were still being worked out. The companies had agreed to keep the discussions confidential, in order to keep MRG's stock price low. And for the most part, they had managed to stay out of any public rumors, until Kent was directly asked by a reporter during an interview with the Times, a newspaper with nation-wide circulation, whether MRG had been approached about a merger by any of the successful vaccine makers. Taken off guard and not wanting to reveal MRG's likely merger with JNJ, Kent told the reporter that "MRG had not been approached about a merger by any company and MRG had no intent to merge with any other company at any time soon." The Times reporter included Kent's quote directly in the article that was published. Soon after, MRG's stock price dropped down to $3/share. Patty, who was a MRG shareholder, read the article, and believing Kent's statement, was disappointed that there was no possibility of a MRG merger any time soon, sold her shares at $3/share. One week later, JNJ and MRG finalized the terms and publicly announced the merger, stating that MRG's board had endorsed JNJ's offer of $100/share for MRG's common stock. MRG's stock price immediately shot up to $99/share.

- What, if any, are Kent's liabilities under Rule 10b-5 to the SEC and to Patty?
- What, if any, are Alec liabilities under Rule 10b-5 to the SEC?
- What, if any, are June's liabilities under Rule 10b-5 to the SEC?

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1. GENERAL PARTNERSHIP

A partnership is an association of two or more persons who are carrying on as co-owners of a business, whether or not the parties intent to form a partnership. There are no formalities required to form a partnership so a partnership is found based on the intent of the parties to carry on a business as co-owners.

Here, Mary, Suzie, Kelly and Adeline orally agreed to form a cloth face mask business and to share profits equally. Thus, there was an agreement in place which shows their intent. In addition, the contribution of money or services in exchange for a share of profits creates a presumption that a general partnership exists. Here, Mary is offering to run the logistics of the business (a service), Adeline contributed $50,000 (money), Suzie said she could design and sew the masks (service) and Kelly said she could market the masks (service). Thus, since they all offered to contribute money or services in exchange for a share of profits (they were to share the profits equally) the presumption has been met.

LIMITED PARTNER - ADELINE

Limited partners are not liable for the obligations of the partnership itself beyond their capital contributions. Here, Adeline states she wanted to limit her liability to the $50,000 that she contributed. However, the role of a limited partner is typically passive and the person doesn't have any management or control. Adeline didn't only have a passive role in the partnership since she made decisions with the others such as that if Suzie ever made a purchase that cost over $10,000 she would need advance approval by ALL (including Adeline) and Adeline was one of the partners who entered into the contract with Bonanzo purporting to act on behalf of the partnership. As a result, it is likely that although Adeline attempted to make herself a limited partner this argument would fail because she acts like a general partner by acting as more than a passive investor. Thus, the court is likely to hold Adeline as a general partner. In addition, to form a limited partnership which is a partnership that has at least one general partner and at least one limited partner, the partners must file a partnership certificate of formation with the state, identify the name which includes the words "limited partnership" and other formation duties. Here, MASK never filed a certificate of formation and thus the court is likely to hold them as a general partnership regardless of Adeline's attempt to limit her liability.

CONCLUSION

The legal relationship of Mary, Adeline, Suzie and Kelly is that they are all partners in the general partnership of MASK. Thus, they equally share management, control, profits, and liabilities (the default rule) since they didn't have a partnership agreement stating otherwise. All four of them have actual and apparent authority as partners and are all liable.

2. KIM CO. V. MASK

California has adopted RUPA and under RUPA a partnership is considered an entity which can sue and be sued and hold property. If the partnership is located in another state that is under UPA then a partnership is considered to be an aggregate of individual partners and not an entity that can be sued so KIM CO. would have to sue the individual partners. However, we will assume this takes place in California and Kim Co. can sue Mask. Each partner is an agent of the partnership for the purpose of conducting its business. The partners' authority to bind the partnership when dealing with third parties follows agency law principles.

AGENCY

Partners have a fiduciary, agency-like relationship which means the partners are bound by contracts entered into with authority by their co-partners. An agency relationship exists when a principal authorizes an agent to act on her behalf and represent the principal in dealings with third parties.

Here, Suzie entered into a contract on behalf of MASK and thus was acting as an agent while MASK was the principal. The agent's actions will bind the principal if the agent was acting under the actual or apparent authority to act for the principal. Here, Suzie wasn't acting with actual express authority since the others specifically told her to get advance approval by all for purchases that cost over $10,000.

ACTUAL IMPLIED AUTHORITY

Actual implied authority occurs when the agent reasonably believes the principal gave her authority because of necessity (task reasonably necessary to accomplish agency goals), custom, or prior dealings. Here, it can be argued that Suzie had actual implied authority because they all agreed that Suzie would be solely responsible for designing the masks and selecting the supplies and because Kim Co. told her that she had to act fast that Suzie felt it was necessary to accomplish the partnership's goals of using unusual fabrics. Thus, it will be argued that Suzie reasonably believed she had authority. However, since she was clearly told that she needed advance approval for costs over $10,000 and this purchase was $20,000, it will be argued that this was unreasonable. Even if Suzie is found to have acted without actual authority, MASK is still likely to be bound to the contract through apparent authority.

APPARENT AUTHORITY

Apparent authority will bind the principal when the principal has provided the agent with the appearance of authority, on which a third party reasonably relies. Although Suzie exceeded her actual authority, the principal may still be bound if the agent is in a position that would normally allow the agent to take such action. Here, Suzie is a partner and the individual solely responsible for designing the masks and selecting the supplies. Thus, she has apparent authority. However, if the third party actually knew or received proper notice that the partner lacked such authority then there would be no apparent authority. Here, there are no facts to support that Suzie told Kim Co. that she needed approve from the others or that Kim Co. knew she lacked authority.

CONCLUSION

Suzie acted with apparent authority and thus bound MASK to the contract with Kim Co. thus, KIM co. is likely to succeed in its lawsuit against MASK for breach of contract. However, the other partners can seek damages from Suzie for breach of her fiduciary duties such as duty of care, duty to disclose, duty to account, duty of obedience, and duty of good faith and fair dealing. Here, the action that would be the most likely to be successful is for the breach of duty of obedience. Partners are agents of the partnership and must act in accordance with their authority as a partner. Here, Suzie clearly knowingly exceeded her actual authority by entering into the contract with Kim Co. despite knowing she needed prior approval by ALL the partners.

3. CONTRACT WITH BONANZO

Mary, Adeline and Kelly entered into the contract with Bonanzo in spite of Suzie's objections. In a general partnership each partner is entitled to equal control and management of the partnership. As a result they are entitled to equal votes. Ordinary business decisions are controlled by majority vote. Mary, Adeline, and Kelly will argue that entering into the contract with Bonanzo was an ordinary business decision since it was within their normal line of business. However, Suzie will argue it was an extraordinary decision which required consent of all partners.

CONCLUSION

Since the contract was for supplying masks and their masks will be advertised as being exclusively by MASK, the court is likely to find that this was an ordinary business decision and controlled by majority vote. Since it was 3 to 1, they did have the right to enter into the contract with Bonanzo.

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Question 2

Whether Harry's suit meets the elements of a properly brought derivative suit.

Derivative Suit

A derivative suit can be brought where there is a claim brought by a shareholder on behalf of the corporation. In order to bring a valid derivative suit, the plaintiff shareholder must bring suit that the corporation itself could have brought, must make a demand that was refused and must have owned stock at the time of the suit and throughout the case. Here Harry did not make a demand so the question is whether Harry's demand was excused.

Futility Doctrine

Demand on the board is excused when it would be futile. Demand will be futile, and thus excused, if the board is accused of having participated in a wrongdoing or self dealing. The complaint must allege particularized facts that create a reasonable doubt that the directors are disinterested or independent or that the transaction was otherwise not the product of a valid exercise of business judgment (Arnonson).

Clint

Clint, owns 25% of the outstanding shares of the Horse's Breath Inn (HBI), he is also a partner (we assume 50% interest) in Callahan Cleaning (CC) along side West. Since Clint would profit from the cleaning contract. This transaction is self dealing as to Clint and he is an interested director.

West

West, like Clint, owns 25% of the outstanding shares of the HBI and 50% interest in CC. As such he will benefit from the cleaning contract and as such he is self dealing and is an interested director.

Forest

There are no factors to indicate that Forest has any interest in CC so we can assume he is disinterested with regards to the cleaning contract.

Conclusion

Arnonson is satisfied because Harry has pled particularized facts sufficient to create a reasonable doubt as to whether two of the three directors, a majority of the board, are disinterested or independent. The action should not be dismissed for failure to comply with the demand rule. Demand was excused. Harry's suit may proceed.

Whether Clint and West are guilty of self dealing with regards to the CC cleaning contract

Self dealing/Conflict of interest

This issue may arise when a fiduciary acts in a way that benefits themselves or a relative at the expense of the corporation they purport to serve. This can be overcome by disclosure and approval of disinterested shareholders in the board of directors. A self interested transaction is reviewed under the **entire fairness standard**. It would not be enjoined or give rise to damages if the conflict was

1. Fully disclosed and approved by disinterested majority or

2. Entire fairness to the corporation (taking both price and procedural consideration into account) was met

Full Disclosure and Approval by Disinterested Board

Here, the burden of proof is on the conflicted directors, Clint and West. They must show entire fairness to rebut the claim that they breached their duty of loyalty to HBI by contracting CC for the cleaning of the restaurant. As stated above, Clint and West must show that they disclosed their interest in the transaction. The facts state that during the January 15 board meeting, Clint announced that he had negotiated a contract with CC, a partnership owned by Clint and West. Clint disclosed CC's ownership and informed the Board that CC would charge HBI $500/week and the board approved by unanimous vote and approved the CC contract. Clint meets the requirement of disclosure but not the approval by a disinterested board. Harry will argue that 2 out of the 3 members of the board are interested and as such could not vote on this resolution since it represents self dealing.

Since there is not possibility of a vote by a disinterested board, HBI's board of directors could have requested a vote by the outstanding disinterested share holders. They could have fully disclosed the conflict of interested and then submitted the CC contract up for a vote. Here, the facts don't state that the transaction was put up for a vote of the disinterested share holders so Clint needs to prove that the transaction does not represent waste of the company's assets and that the contract is intrinsically fair to the corporation. There is no waste since Clint requested bids from other companies and CC's contract was the least expensive.

Entire Fairness

Fairness has two elements, fair dealing and fair price. the business judgment rule does not apply, once Harry shows Clint and West's conflict of interest. Fair dealings looks at the process, and the problem here is that Clint and West are on the other side of the deal and they negotiated a contract for HBI.

Fair price in this instance should be met since Clint requested bids from other cleaning companies and established that CC's bid was by far the lowest. The board had the opportunity to review the bids and they also approved. Again we encounter the problem and the majority of the board is interested but the price is fair.

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Conclusion

Clint and West will not be able to prove that the CC contract is not self dealing because while it is a good deal for HBI, the contract was not approved by a disinterested board as Clint and West are the majority of the board and they have a personal interest and are expected to get personal gains from the CC cleaning deal. He could have cleansed the transaction by asking for a vote from disinterested shareholders but he did not do that.

The retractable roof

Whether the decision to purchase the retractable roof is protected by the Business Judgment Rule

Business Judgment Rule (BJR)

The BJR is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company. The presumption can only be overcome by conflict of interest, fraud, illegality, or gross negligence. Simple carelessness is not enough to establish a breach director's corporate duty. Directors are not liable for ordinary negligence.

A Court will show great deference to the business directors when they make decisions on issues that pertain to the running of their business. The Court will not inquire into the motives of the board members, as long as their acts are within their lawful powers since the purpose of a corporation is to make a profit for its shareholders. Business decisions are not guaranteed to be successful decisions and the board of directors are not held liable for a business decision made in good faith that ended up not being successful.

Here, the board came together to come up with strategies that would help the corporation survive during the pandemic. They realized that because of the state mandated lock down inside dining would not be an option and they had to utilize their outside patio. On January 5 during a regular board meeting, the board discussed for 6 hours what the restaurant should do. They agreed that utilizing the patio would be their best option of maintaining an income while the lock down was in effect. They discussed the fact they would need to cover the patio due to the inclement weather and that a simple tent would not be sufficient. HBI is known for a certain ambiance and a tent would not promote that image and would deter customers from coming to dine there. The directors did some extensive research and decided that buying a retractable roof would be the best option even if it was more expensive. The facts show us that the board made the decision to buy the roof after doing research and having serious discussions about the pros and cons of the purchase. They were all aware that the current pandemic situation was uncertain and they would have to adapt to the state regulations as they came along, even if that included shutting down the outside dining. The result was that their profits for the year were less than they were expecting and that is why Harry is unhappy and filed the derivative suit. The board should not be held liable for the lost profits since the pandemic and lock were outside their control. Harry can argue that the pandemic itself should have given the board pause and that because of it they should have purchased the more inexpensive then, but as stated above, the Court will not interfere with business decisions as long and they are done in good faith.

Conclusion

The board made the decision to buy the retractable roof after doing their due diligence and extensive amounts of research, they deliberated for 6 hours and voted unanimously to make the purchase, because of these factors the Court is likely to find that the board is protected by the BJR and cannot be prosecuted for buying the roof.

Result

Harry can proceed with this suit regarding the self dealing contract between HBI and CC because Clint and West are not able to prove that a disinterested board voted in favor of the transaction. They will also not be able to prove that a disinterested majority of stakeholders voted since they never put the decision up for a vote. Harry's claims regarding the retractable roof will not succeed since that decision is protected under the BJR. The Court is likely to rule in corporation's favor regarding the CC contract.

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1. Kents liabilities under 10b-5 to the SEC and P

SEC 10b-5

Rule 10b-5 of the SEC states that it is unlawful to commit fraud in the purchase or sale of security. The maker of the statement needs to be an entity with ultimate authority over the statement. It needs to involve interstate commerce, and be in connection with person who sold the stock (except the SEC) and the D does not need to be a buyer or seller. It also prohibits a false or misleading statement of material fact.

The Private Securities Litigation Reform Act PSLRA has created 6 elements that a P must allege and prove in order to be successful with a 10b- action. They are: D made a material misrepresentation or omission, D acted with scienter, material misrepresentation or omission was made in connection with the purchase or sale of a security, P relies upon that material misrep or omission, P suffered economic loss as a result, P can allege and prove loss causation (causal link between statement and harm).

With regard to the SEC bringing forth such a claim, the SEC does not need to satisfy the elements of being the person who purchased or sold the stock, or causation

Here, the SEC will state that K made a statement that was a material misrepresentation that resulted in harm to their stock holders, purchasers, and sellers. The stock was traded publicly on a major stock exchange and therefore is effected by the SEC who has standing to bring such a claim. The SEC does not need to be a party that purchased or bought a stock, nor do they need to prove that the harm they received was caused by D. The SEC just needs to show that a material misrepresentation was made, with the intent to deceive, manipulate, or defraud, and that harm occurred thereof. First SEC will show that K was the maker of the statement and had authority over the statement. K was the CEO of MRG and had all the necessary information, knew about the merger and the stock price, and the goal of keeping the stock price down. SEC will state that the statement made was with the intent to defraud, deceive, or manipulate, because there is evidence to show that the merger was meant to be keep confidential with the sole purpose of keeping MRG stock down. That means that when K made the statement, he knew that there would be consequences to his statement. K has stated that he was caught off guard, however that is not an excuse for a flat out lie. K could very well have walked away or said "no comment." K had no duty to answer the question, but once he chose to do so, he had the duty ot answer honestly because of all the people, purchasers and sellers alike, that would rely on his words. The SEC will next show that there is direct evidence of harm. The stock had dropped from 50- 5 a share, as soon as news came out that they did not make a viable vaccine. After Ks statement, soon after, the stock fell again to $3 a share. However the harm can be shown by the fact that the stock rose to $99 a share after the merger was announced. Finally, the SEC will show that the statement made was one of material information. Materiality is tested by way of a reasonable investor considering the information given to be important when making investment decisions. The SEC will obviously show that the statement made was material. MRG announced that they failed to make a viable vaccine, and stock dropped from 50-5, K announces no merger, even though one is in the works, and the stock drops again, and P sells, K then announces the merger and the stock rises to $99. The facts show, even from P, below, that a reasonable investor would care if a merger was in the works. P is stated to have specifically sold because she relied on the statement made that no merger was in the works.

However, K will argue that he was under an obligation to keep the merger confidential, and that there was no officially signed merger at the time of his statement. K will also state that the statement made was not material and that the merger was uncertain to happen. K could argue that it was his opinion that no merger was going to happen, however his statement made was not opinion but of one asserting a fact. He flat out stated that "MREG had not been approached about a merger by any company and MRG had no intent to merge with other company any time soon." This is a statement of fact by the CEO. K will likely fail all these defenses.

As discussed above. If K wanted to keep the merger confidential, he had no duty to speak, the law had no created any duty for him to speak. But once he decided to answer the question, he is not allowed to flat out lie. With regard to materiality, it was shown above that the issue of a merger was very obviously material. Ks bets argument is that the merger was uncertain, deals always fall through. However, several conversations had been had, lawyers were involved, while they were still ironing out the details, there are facts to show that it was taken seriously and was a serious option. A and K engaged in a number of conversations and negotiations, directors were notified and involved, both companies investment bankers were brought in and told to prepare, and MRG directors adopted a board resolution to enter into the merger agreement, even though the exact terms were yet to be determined. These are several serious steps taken. Ks statement was in its entirety, a contradiction to the truth of the matter.

Therefore, the SEC will likely win in a 10b-5 cause of action

With regard to Patty, the above discussion applies, with the addition of connection and causation.

Patty was directly in connection with the sale and purchase of the securities. At the time of the statement made by K, she was an owner ot MRG stock. While listening to K she was attempting to determine fi she should sell her stock or hold out for a merger. As a result of the statement, she sold her stock.

Therefore, the courts will find that P is in connection to the statements made

Next, the court will like at causation with regards to P.

Causation under 10b5 requires Ds misrep to cause harm to P. It requires Ps reliance on Ds statement.

Here, P will argue that she was specifically trying to determine if she should sell or hold her MRG stock, while buying more is a third option, it was never stated. P stated that she watched Ks statement, and after being disappointed that there was no possibility of a merger, decided to sell. This is direct causation from D to P. P was holding onto her stock after MRG announced no viable vaccine, and watched the stock drop from 50-5. Her next hope was for a merger. As soon as she heard K say that there were no talks of a merger and they would not consider a merger, she sold her stock. While there is no evidence to show what the purchase price for her stock was, it is reasonable to assume that it was more than 5, given that the cause of the drop form 50-5 was the lack of a vaccine. This leads a reasonable person to believe that a normal price for the stock was around 50, at the very least not 5 or 3. Therefore, at the time of Ps sale it is reasonable to assume that P at least lost $2 a share, from 5-3, and most likely $47 a share, from 50-3. She will have to make a specific showing of loss in court. However given the facts that it is told she held stock at the time the stock was 5, and sold it at 3, even though we do not know how many stocks she owns, even if it was 1 stock it is still at least a loss of $2, which is a direct causal connection. P relied in Ks statement, and sold her stock directly because of it. If he had not made such statement, or told the truth, she would have not sold her stock, which would have lead to her have the stock at the time of the stock increase to 99.

Therefore, the court will likely find for a successful 10b-5 motion for P.

2. Alex Liabilities under rule 10b-5 to the SEC

SEC rule 10b-5 prohibits insider trading. Insider trading occurs when an insider has a fiduciary duty to a corporation, learns of material, non-public facts, and trades on that information. Rule 10b5 also has violations for tippers/tippees.

Tipper

With regard to insider trading, Tippers are insiders that are liable for the violation of sec 10b5 if they breach of duty and give material, non public information to a tippee for improper purchase.

Here, A, as CEO of JNJ, received an internal confidential report that JNJ had created a viable vaccine. This information was private and confidential and was not yet made public. With regard to materiality, the test is if a reasonable investor considers the information important when making an investment decision. Here, it is very reasonable to assume that a stock trader would find information that a pharma company making a viable vaccine during a pandemic is important trading information. Especially if the information is nto yet made public. One piece of evidence to support such a claim is that J was described as being an active stock trader, and that as soon as she got off the phone with A, she immediately phoned her broker to purchase stock in JNJ. This shows that her, as an investor, took the information told as being very material to trading information. With regard to materiality, the court looks at probability and magnitude. With this information, there was a high chance that this one piece of information would have a major impact on the company. A confidential report concerning a vaccine made during a pandemic, by a phrama company, has a very high probability of causing a major impact of significant magnitude. This kind of information can make or break a company, as referenced by what happened to JNJ. Insiders owe a duty of trust and confidence to their corporation. Here, A violated that duty, the report itself was said to be confidential and was obviously very important to the company. A had a duty to maintain confidentiality as CEO and to non public information to his corporation.

Therefore, it is likely that the court will find that A breached a fiduciary duty owed to the company by released non public, material information to an outsider who then traded on said info.

Next, the court will look to the improper purpose of the information being disclosed. In order for a Tipper to be liable, the info disclosed needs to be for personal benefit. This does not require a monetary benefit, can be a gift to friend or family

Here, A will argue that he was only telling his mother about the vaccine because she was in her 80s and was worried about her getting a vaccine. He wanted to support her and give her hope, to let her know that a vaccine is coming and his company did it.

However, this argument will likely fail. A has stated himself that he knows his mother is an avid stock trader, and that she would appreciate receiving the information before it was announced to the public.

Here, the SEC will likely argue that A knew that his mother would trade, or at least should have known, and given that he said he knew she would appreciate it, applies a gift nature to the information provided.

Therefore, A will likely be held to be an insider Tipper, and will likely be held liable by the SEC

3. Junes Liabilities under rule 10b-5 to the SEC

SEC Rule 10b-5

see above

Insider Trading

see above

Tipper

See above

Tippee

Under rule 10b-5 of the SEC, Tippees can be held liable along with Tippers if first, the Tipper is found to be liable (see above) and second, if the tippee knew that the tipper was breaching a duty.

Here, the SEC will first show that A has (or will) be held liable for his insider tipper violation, thus satisfying the first prong.

Next, the SEC will argue that J, as tippee, knew that the tipper was breaching a duty. SEC will argue that J, as As mom, knew that he was CEO of a pharma company, was working on a vaccine, and that news of vaccine release would be huge for the company and the world. The SEC will state that J should have known, given her sons job and job title, that what he had told her had not yet been made public. J is said to have immediately phoned her broker to make the purchases. The fact that she made this call immediately goes to show that she felt time was of the essence, that any moment the info could be released and she would miss her chance.

However, Js best defense for a 10b5 violation is that she did not know her son A was breaching a duty. She could have thought, my son just made the announcement, i am not watching tv, he then calls me to celebrate and give me peace of mind regarding the vaccine, and im so happy for him and his job that i want to buy stock in his company. The fact that A and J were so worried about Js health, and the status of the vaccine in the country, could show that that was the main reason for the telephone call, and that J had no reason to believe that A was violating a fiduciary duty.

While possible, given that A knew his mom J liked to trade stock, and that J got off the phone and immediately contacted her broker, there seems to be enough evidence to support that J knew A and her were doing something wrong.

Therefore, it is likely that the court will rule in favor of the SEC and find the J is liable under 10b-5 as a tippee.

Misappropriation

If the court does not find for the SEC with regard to the Tippee violation, the SEC would next bring forth a charge for misappropriation.

Misappropriation is when the tippee violates their duty of trust owed to the course of information.

Here, the SEC could argue that A had a fiduciary duty not to disclose the information, but that J also had a duty not to misappropriate that information, give the duty of trust between them as mother and son, with regard to her health. A and J will argue that the main point of the phone call was to inform her of a vaccine, which is very important for an 80 year old women. With that said, the SEC will state that if J is found to not have known that A was violating a fiduciary duty, at the least she should have not violated her duty of trust owed to her son. She took private information, material information, and used it for her own personal gain. J should have realized that her son was a CEO of a major pharma company, and that the information disclosed was material and should have been kept private, and not used to purchase stocks. P, as an outsider, should have knwon that she had a duty of trust with her son, and that she should not have misappropriated the material information

However, J (and A), will argue that there was no duty owed, while they are a family, and that is a special relationship, it is not a special legal relationship. The courts could determine that Mother-Son has no duty of trust owed. However it is likely that the courts will determine that there was a reasonable duty of trust owed. The courts will likely find that due to the health nature of the vaccine, J could assume why A was calling her to tell her, but that it was reasonable that it should stay private. This was a "give hope" phone call, not a public announcement.

Therefore, if the court does not find J liable under Tippee status above, the court would likely find that J is liable under misappropriation.

END OF EXAM

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Professors Lamb & Torrez

Exam Question 1 Checklist

Relationship between Mary, Adeline, Suzie and Kelly

- **Was MASK a limited partnership?**
- (1) A limited partnership is comprised of one or more general partners and one or more limited partners; and (2) general partners are personally liable for partnership obligations; and (3) while limited partners generally do not have any liability beyond their contributions.
- To form a limited partnership a certificate of limited partnership must be filed with the secretary of state.
- Adeline's desire to limit her liability to the amount she contributed shows that she may have wanted to set up a limited partnership.
- The other nonmonetary contributions do not affect the formation of a limited partnership.
- Despite Adeline's desire to limit liability, MASK is not a limited partnership because no writing was filed with the secretary of state.

- **Was MASK a general partnership?**
- (1) A general partnership is an association of two or more persons to carry on as co-owners a business for profit; (2) the parties need only to intend to run a business as co-owners, not to specifically form a partnership; and (3) no formalities are required to form a partnership.
- The intent of the parties to carry on as co-owners of business can be implied from their conduct.
- The sharing of profits raises a presumption that a partnership was formed.
- Mary, Adeline, Suzie and Kelly orally agreed to form a business for profit and to share profits equally.
- It is irrelevant that Mary, Adeline, Suzie and Kelly did not reduce their agreement to writing.
- Thus, MASK is a general partnership.

KIM Co. Contract

Actual Authority

- Each partner is an agent of the partnership for the purpose of its business.
- Actual authority (1) is authority that a partner reasonably believed she has based on communications between the partner and the partnership; and (2) can be granted either in the partnership agreement or by the consent of the partners.
- Suzie did not have actual authority to enter into the KIM Co. contract because the partners agreed that Suzie needed permission to enter contracts over $10k.

Apparent Authority

- (1) Apparent authority is the authority a third party would reasonably believe a partner has based on her being held out by the partnership as a partner; and (2) under the RUPA, the act of any partner for apparently carrying on in the ordinary course of the partnership business or business of the kind binds the partnership, (3) unless the partner had no authority to act for the partnership in the particular matter and (4) the person with whom the partner dealt had notice that the partner lacked authority.
- Under the RUPA, notice means that the third party actually knew or received notice that the third party lacked authority; under UPA notice means actual knowledge or when the third party had knowledge of other facts that show bad faith, which created an implied or inquiry notice.
- It would be reasonable for KIM Co. to believe Suzie has authority to enter into contracts for the purchase of fabric because: (i) Suzie is a partner; (ii) such purchases are within the scope of MASK's business (bonus points for discussion of kimono's not being a traditional fabric so purchasing kimonos may not have been clearly within the scope of MASK's business); (iii) there is no indication that anyone at KIM Co. knew that Suzie lacked the authority to do so; (iv) KIM Co. was not notified by MASK about Suzie's lack of authority until after the contract was already signed.
- Therefore, Suzie will likely to be found to have had apparent authority and KIM Co. will prevail in a suit against MASK.

<u>Bonanzo Contract</u>

The Right of Mary, Adeline and Kelly to enter into the Bonanzo Contract.

- Partners have an equal right to manage the business of the partnership, absent an agreement otherwise.
- A particular act within the ordinary course of partnership business must be approved by a majority of partners.
- The Bonanzo contract is a contract to sell masks, which is in the ordinary course of partnership business.
- Mary, Adeline, and Kelly constitute a majority of partners and they approved the Bonanzo contract.
- Mary, Adeline, and Kelly had the right to enter into the Bonanzo contract on behalf of the partnership.

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Exam Question 2 Checklist

Did Harry Comply with the Requirements for Bringing a Derivative Suit?

- If a shareholder believes that the corporation has been harmed, but the corporation does nothing to vindicate the harm, the shareholder may bring a derivative action on behalf of the corporation if certain prerequisites are met.
- The shareholder bringing the action (1) must have been a shareholder at the time of the institution of the lawsuit, (2) remain a shareholder throughout the pendency of the lawsuit, and (3) must have been a shareholder at the time of the act or omission complained of (or obtained his shares by operation of law from one who was).
- Some jurisdictions have a universal demand requirement, and a demand must be made on the board of directors. A derivative suit cannot be filed in these jurisdictions until 90 days after the demand has been made, unless the board rejects the demand or if waiting that long will cause irreparable harm.
- In a number of other jurisdictions, such as DE, a demand may be excused if making a demand would be futile. Courts vary in their interpretation of when a demand would be futile, but typically courts find that a demand would be futile if the majority of directors are interested in the transaction or if the decision was not a valid exercise of biz judgment.
- The facts indicate that Harry was a shareholder at the time he instituted the suit and do not indicate that he sold his shares after institution of the suit, thus the first two requirements are met.
- Harry bought his shares in November 2019 and the board decided to build the retractable roof and approved the CC contract in January 2020 making Harry a shareholder at the time of the complained wrong and the contemporaneous ownership rule is met.
- Harry did not make a demand, so if the jurisdiction had a universal demand requirement, the court would dismiss the case.
- If the jurisdiction does not have a universal demand requirement, the court would likely excuse the demand for futility because the suit is against all 3 directors, and the majority of the directors (2 out of 3) were interested in the transaction.

Will the Court Void the Contract with CC?

- Directors are fiduciaries of the corporation and owe the corporation the duties of care and loyalty. The duty of care requires directors to act with reasonable care under the circumstances. The duty of loyalty requires directors to act in good faith with a reasonable belief that they are acting in the corporation's best interest. If these standards are met, under the business judgment rule directors are presumed to have exercised due care and satisfied their duty of care to the corporation.

- The business judgment rule does not apply where the act in question involves self-dealing, a conflict-of-interest transaction.
- The CC contract was a conflict-of-interest transaction because both Clint and West (a majority of the directors) were on both sides of the transaction.
- Historically, any self-dealing contract was voidable by the corporation.
- However, courts have shifted away from that approach and now most states have statutes that permit conflict-of-interest transactions if the transaction is:
    - (i) approved by the shareholders;
    - (ii) approved by disinterested directors; or
    - (iii) proven to be fair to the corporation.
- There are no facts that indicate that the shareholders approved the CC contract. Although, the three directors owned 75% of the shares, they weren't meeting as shareholders. Moreover, under many conflict-of-interest statutes, such as California's statute, Clint and West's self-interest would disqualify their votes as shareholders to approve the transaction.
- There are also no facts that indicate that only disinterested directors approved the transaction. Moreover, two of the three directors are interested in the transaction, so it is unlikely that there were enough disinterested directors to approve the transaction (depends on how the state statute deals with quorum).
- Therefore, Clint and West have likely breached their duty of loyalty to the corporation, and perhaps the third director, who voted for the transaction with knowledge of Clint's and West's conflict of interest.
- To receive safe harbor, the transaction must be proven by the directors, to be fair to the corporation.
- To prove that the transaction is fair, the directors have the burden to prove that the contract was fair and reasonable to the corporation at the time it was approved by the board. There must have been both a fair process and fair terms.
- Here, Clint solicited bids from other cleaning companies and discussed and disclosed these bids to the rest of the board. The board reviewed these bids before the board approved the contract with CC. Therefore, the board engaged in a fair process.
- The other bids were significantly higher than CC's bids, thus demonstrating that the terms of the CC contract were fair to HBI.
- As such, it is unlikely that the court will void the CC contract.

<u>Can Harry Hold the Directors Liable for Damages for the Retractable Roof Decision?</u>

- Directors owe duties of care and loyalty. The decision to build a retractable roof does not involve self-interest, on the part of the directors, therefore the duty of loyalty is not implicated.
- The BJR will apply and the duty of care will be presumed as long as disinterested directors made an informed decision, in good faith.
- Here, the directors made a decision - to build a retractable roof – this is a malfeasance, not a non-feasance case.

- The decision was made in good faith, because there is no evidence of fraud or illegality.
- Although Clint and West were interested in the CC contract decision, there was not a conflict of interest in deciding to build the retractable roof, because it is unrelated to the CC contract.
- As such, the business judgment rule will apply, and Harry will have the burden of proof to overcome the presumption that the directors breached their duty of care.
- In discharging their duty of care, directors are entitled to rely on reports and opinions of other directors, officers, employees, and outside persons who are reporting on matters within their competence.
- Here, the directors spent 6 hours discussing the retractable roof decision.
- The directors appropriately relied on the report and recommendation of the CFO.
- The directors also studied meteorological reports to confirm that a covered patio was necessary.
- The directors discussed alternatives to the retractable roof – such as the tents – but decided that these options didn't meet the appropriate aesthetic.
- Although the directors knew that outdoor dining could be shut down if Carmel County went into the purple tier, they could not have known for certain that this would happen and how long that shut down would be. Hindsight is not a reason to second guess the director's decisions.
- Because the process that the directors engaged in was informed, a court would not find that the directors breached their duty of care and the directors would not be liable to the corporation for damages.

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Exam Question 3 Checklist

Does Kent Have Any Liability Under Rule 10b-5?

Liability of Kent in an SEC Action:

- Under Rule 10b-5, it is unlawful for any person, directly or indirectly, by the use of interstate commerce to, in connection with the purchase or sale of any security: (i) employ any device, scheme or artifice to defraud, (ii) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading, and (iii) engage in any act, practice, or course of business that would operate as a fraud.
- For the SEC to prove a breach of Rule 10b-5, the SEC must show that (i) there was a false or misleading statement of material fact, (ii) in connection with the purchase or sale of a security, (iii) use of a means of interstate commerce, and (iv) scienter.
- A false or misleading statement will be considered material under Rule 10b-5 if a reasonable investor would consider it important when making an investment decision.
- For events that are uncertain, such as a potential merger, courts apply the probability/magnitude approach. Materiality will depend upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Probability should be assessed by looking at indicia of interest in the transaction. Board resolutions, instructions to investment bankers, actual negotiations between principals or their intermediaries are examples of indicia that indicate probability. Assessing the magnitude of the transaction involves looking at the size of the two corporations and the potential price premiums over market value.
- In order to bring a Rule 10b-5 suit, the false or misleading statement must have been made "in connection with" the purchase or sale of a security, but this requirement does not affect the SEC's ability to bring an enforcement suit.
- Although the rule itself does not address intent, scienter is required. To show scienter, the plaintiff must show that the defendant had "a mental state embracing intent to deceive, manipulate, or defraud."
- Here, Kent's statement was false because he told the reporter that MRG had not been approached about a merger by any successful vaccine maker, when it had already been approached by JNJ, and that MRG had no intention of merging with any other company, when the facts indicated that MRG did intend to merge with JNJ.
- Kent may argue that his false statement was immaterial because the merger had not yet been finalized and therefore a reasonable investor would not consider the potential merger important. But because the merger was an uncertain event, the probability/magnitude approach should be applied.
    - Applying that approach, the JNJ/MRG merger appears to be highly probable because the facts demonstrate a strong indicium of interest in the transaction.

        - Here, the CEOs themselves, were meeting directly and ironing out the details of the merger.
        - The investment bankers on both sides had been advised to prepare for the merger.
        - And the MRG board adopted a resolution to merge despite the fact that all the details were not yet nailed down.
    - The facts also indicate that the magnitude of the merger was great.
        - Both companies were large companies, thus the merger of the two of them would have a big effect.
        - The price premium is also high. MRG's previous and highest stock price was $50/share, and that price had slipped to $3/share. JNJ's offer of $100/share is double MRG's highest stock price and $97/share above the currently trading price.
    - Given both the high probability and the great magnitude of the merger, a court would find that Kent's misrepresentation was material.
- Although this material misrepresentation was not in connection with the sale or purchase of a security by the SEC, this is not required for an SEC enforcement action.
- Kent's misrepresentation was published in the Times. Because the Times is a newspaper with nationwide circulation it is an instrument of interstate commerce.
- Finally, Kent made his false statement knowing that it was false and intending to deceive the reporter because he did not want to reveal the potential merger between JNJ and MRG. Because Kent intended to deceive the element of scienter is met.
- Thus, because all four elements are met, Kent would be liable for a breach of Rule 10b-5 in an SEC enforcement action.

Liability of Kent in a Private Action by Patty:

- For a private plaintiff to prove a breach of Rule 10b-5, the plaintiff needs to prove all of the elements that the SEC must prove, as well as causation - both transaction causation (reliance) and loss causation.
- As discussed above, all of the elements that the SEC must prove for a breach of Rule 10b-5 have been met.
- In addition, Patty will be able to meet the "in connection with" element, because Patty, the private plaintiff, did sell her MRG stock based on Kent's misrepresentation.
- Transaction causation, also called reliance, establishes the link between the misrepresentation and the harm. When stock is traded on an "impersonal market" a rebuttable presumption of reliance may be invoked if the plaintiff can prove that (1) the misrepresentation was publicly known, (2) it was material, (3) the stock traded in an efficient market, and (4) the plaintiff traded the stock between when the misrepresentations were made and when the truth was revealed.
- To prove loss causation, the plaintiff must show that it was the very facts that the defendant lied about, which caused the plaintiffs harm, i.e. that the misrepresentation was the proximate cause of plaintiff's loss.

- Here, Patty will be able to invoke the rebuttable presumption of reliance because she can meet all four required elements.
    - First, the misrepresentation was publicly known because it was published in the Times which was circulated nation-wide.
    - Second, the misrepresentation was material, as discussed above.
    - Third, the stock traded in an efficient market, because it traded on a major stock exchange which is an open and developed market.
    - Fourth, Patty traded the stock after hearing Kent's misrepresentation, but before the truth was revealed, i.e. that MRG was in fact going to merger with another company.
- There are no facts that indicate that Kent would be able to rebut this presumption and sever the link between the misrepresentation and the price. Indeed, after Kent's statement was published, MRG's share price sank even further and after the truth was revealed, MRG's share price shot up by $96/share.
- Finally, Patty will also be able to prove loss causation because it was hearing Kent's misrepresentation, that the company was not going to merge with another company, that led Patty to sell her stock at $3/share rather than wait to sell her stock as part of the merger to JNJ for $100/share.
- Because Patty can meet all elements to prove a breach of Rule 10b-5, Kent will be liable.

<u>Does Alec Have Any Liability Under Rule 10b-5?</u>

- A corporate insider who breaches a duty not to use inside information for personal benefit can be held liable under Rule 10b-5.
- Typical securities insiders, such as directors and officers, are deemed to owe a duty of trust and confidence to their corporation that is breached by trading on inside information.
- The duty is breached when (i) the insider trades on the inside information, or (ii) the insider gives a tip of inside information to someone else who trades on the basis of the information, if the tip was made for an improper purpose.
- Alec is a corporate insider because he is JNJ's chief executive officer.
- JNJ's vaccine results were inside information because the internal and confidential report that Alec received had not yet been released to the public.
- JNJ's vaccine results were also material since most investors would consider positive vaccine results in the midst of a worldwide pandemic, important in deciding whether to purchase stock. The facts that JNJ's stock skyrocketed after their positive results were released to the public and MRG's stock plummeted after their negative results were released supports this conclusion.
- Although, Alec did not himself purchase any JNJ stock on the basis of the inside information, he did disclose the information to his mother, June.
- It is likely that a court would hold that Alec disclosed the information to June for an improper purpose. Alec knew that June was an avid stock trader and he believed she would "appreciate" having this inside information so that she could trade on it. It is also

clear that Alec's relationship with his mother is important to him because she was the one he most worried about getting the virus and she was his first phone call after receiving the positive vaccine results. As such, a court would find an improper benefit, in that the use of the inside information was intended to benefit Alec's close family relative.

- Finally, June did use the information to purchase JNJ stock by calling her broker on the telephone and purchasing stock. Using the telephone to purchase the stock, constitutes a means of interstate commerce.
- As such, Alec will be liable for breaching his duties to JNJ as a tipper under Rule 10b-5.

<u>Does June Have Any Liability Under Rule 10b-5?</u>

- June does not owe any duties to JNJ since June is not a corporate insider.
- A tippee is liable under Rule 10b-5 if the tipper breached a duty by disclosing the information and the tippee knew that the tipper was breaching the duty.
- Here, June knew that her son was the CEO of JNJ and that the information he shared with her was internal and confidential information. Indeed, given the nature of the information, most people in the general public were following the development of the COVID-19 vaccines – and were aware of public announcement of vaccine results. As such, it is likely that June would know that Alec was revealing to her important, non-public information.
- As such, June knew, or at least should have known, that Alec was not supposed to disclose the information to her for her own benefit.
- Accordingly, June will likely be held liable as a tippee under Rule 10b-5.