Model Answer

88

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======== **Start of Answer #1 (3133 words)** ========

A.

MEMO

To: Nancy Smith and Linda Cohen

From: Law Student

Re: Proposed business idea to manufacture sporty bags

It sounds like you both are excited to begin planning for your new business. I'm happy to help by providing information on which business forms are available to you.

When deciding on which business organization to choose, there are some fundamental issues to consider, including:

- the ease and expense of creating the business entity
- how management and control will be structured
- how the business will be capitalized [at the outset, and once the business is going, if needed]
- continuing formalities for certain business types
- how investors would like to get a return on their investment
- liability of owners and investors [to what extent owners/investors are personally liable for the debts and obligations of the organization]
- tax consequences

With that in mind, here are some types of business organizations:

Sole Proprietorship

A sole proprietorship is a business run by one person [or one married couple]. It is easy to create, needing no formality at all, and the owner retains full power and control over the business. It can be funded by personal assets or loans. The owner is taxed as an individual on the moeny the business makes, and can deduct business expenses from that income. The main drawback is that the owner is personally liable for all the obligations and debts of the business.

Because both of you are interested in going into business together, this is proably not the best option for you.

Joint Venture

A joint venture is two or more people working together for profit on a specific determined project, such as a housing development. No formalities are required, and the individuals are personally liable for the venture's obligations.

Because you are interested in a continuing enterprise, a joint venture would not be appropriate.

Partnership

A partnership is two or more people engaged in a business together for profit. There are different types of partnerships, with varying formalities required and liability to owners and shareholders. All partnerships enjoy the benefit of pass-through taxation, which means that the income you recieve from the partnership will be taxed only once, as individual income. Partners [and people in joint ventures together] owe each other the highest duty of fair dealing.

General Partnership

A general partnership is the most simple form of partnership. It is created whenever two or more people decide to go into business together for proft. This agreement can be express or implied, and need not be written down, although that is certainly advisible. Absent an agreemetn to the contrary, all partners enjoy equal management and control of the partnership, and are entitled to be reimbursed for their contribution to the partnership, whether that be cash, property, or labor. Once all obligations are satisfied, including to the partners, the profits from the business are split equally. The partners are also jointly and severally liable for the obligations and debts of the general partnership. This can be a major drawback if you have personal assets that you would like to protect [such as if you own your own house].

A general partnership could be used in your case, but because of the personal liabliity, it may not be the best choice.

Limited Partnership

A limited partnership is a partnership that has two types of partners. The general partners manage and control the business, and also have personal liablity for the obligations of the partnership. The limited partners do not manage or control the business at all, but they are only liable to the extent of their investment. Limited Partnerships require filing with the secretary of state.

A limited partnership would allow Uncle Bob to be a limited partner in the business and escape personal liablity, but you, as general partners, would still have personal liablity.

Limited Liability Partnership

A limited liability partnership limits personal liability of partners, and all partners have equal management and control of the business. They require strict adherence to statutory filing requirements to retain the limited liability.

In California, these are only available for professionals, such as attorneys and architects, so this would not be an appropriate business form for you.

Corporation

A corporation is a commonly-used business organization because it allows for limited liability for shareholders and owners, and flexible capitalization and internal organization. Corporations require adherence to statutory filing requirements, both initally and ongoing for the limited liability to continue. This includes conducting Board Meetings, keeping minutes of all meetings, and filing specific financial documents at least yearly. In addition, corporations are subject to double taxation- the corporation is taxed on its earnings, then the shareholders/owners are taxed on the dividends or distributions they recieve from the corporation.

There are both publicly traded corporations and closely held corporations. Publicly traded corporations require adherence to many statutory filings and audits, which can be costly. Closely held corporations also need to adhere to some statutory requirements, but they are easier to comply with. However, because owners in close corporations consider the business as 'theirs,' it is very important to make sure that it is decided beforehand what to do in case one owner wants to sell their shares. This is an operating agreement. It is always prudent to have an operating agreement in any business, but especially important in a close corporation because the shares are not publicly traded and the remaining owners want to have some control over who comes into the business with them.

A corporation form would allow Uncle Bob to buy into the corporation as an investor/shareholder, and could allow him to sit on the Board of Directors if he would like to have some control. Often in close corporations, owners see the business as 'theirs' [instead of being 'just shareholders'], and can act as both executives and board members, subject to duties which arise from those postions, such as the duty of care [act prudently as you would in your oqn

financial affairs] and the duty of loyalty [act in the best interest of the corporation].

A close corporation may be a good fit for your business, if you are willing to comply with the statutory filing and ongoing formalities.

Limited Liability Company

A limited liablity company is a fairly new statutory business model which provides the limited liablity of a corporation with the pass-through taxation of a partnership. There are statutory filing requirements which must be stricktly adhered to in order to retain the limited liability for owners [called 'members'].

A limited liability company may be a good fit for you also.

Should Bob Be The Business' Lawyer?

You also asked whether it is advisable for your Uncle Bob to be your lawyer. He is wiling to invest $100,000 into your company, which is ether very generous, or very wise depending on how well your business goes. An attorney for a corporation has a duty to the corporation itself, not the owners, officers, or directors. They must act in the best interest of the company. Because he is wiling to give you free rent right now, if he does become your attorney, ~~if and~~ when he decides the company must pay rent, this could create a conflict of interest. As a landlord, he would want the best rate the market could bear, but as the corporate attorney, he would want to pay the least amount possible. Because of this impending conflict of interest, it would not be advisable to have him both as a landlord and as the business attorney.

If you decide you really do want to tkae him up on his offer of free rent, I would advise creating a written agreement stating that he would provide free rent for a certain amount of time, then the business would look for rent on the open market. If Bob wanted to rent the office for fair market value to the business at that time, and all the owners/investors/shareholders knew of this and consented in writing, it may work out alright.

B.

After the great stock market crash, Congress enacted the Securites Act of 1933, which required registration and regulation of issued securites, and outlawed securites fraud. The next year, they enacted the Securities Exchange Act of 1934 ["Exchange Act"], which further regulated securites, including secondary trading of securites, and included vast anti-fraud measures. Section 10(b) of the Exchange Act was a core enactment. Following Section 10(b), the Security Exchange Commission [SEC] enacted Rule 10b-5, which states in essense:

It is unlawful for any person, directly or indirectly, through any means of interstate commerce, to employ any manipulatice or fraudulent device or scheme, or to make any material misrepresentation or omission, in connection with the sale or purchase of securities.

Originally, 10b-5 applied to misrepresentations or omissions to stockholders, potential stockholders, or the SEC. This rule has also been expanded to cover insider trading: trading on non-public material information by insiders,

tippers/tippees, or misappropriators. It is a criminal provision, with criminal enforcement carried out by the Department of Justice [DOJ]. The SEC can bring actions for civil sanctions and injunctions, and private plaintiffs also are able to bring suit for damages.

For a public plaintiff to prevail in a 10b-5 suit, the SEC or DOJ must first show that a means of interstate commerce was used, then must show:

- material misrepresentation or omission, or insider trading on non-public material information
- scienter [wrongful state of mind, intent to decieve or defraud]

For a private plaintiff to previal in a 10-b5 suit, in addition to the above, they must show:

- the misrepresentation or omission was in connection with the sale or purchase of securities
- the plaintiff relied on the information [although this is presumed by the fraud on the market theory]
- the plaintiff suffered economic loss
- the loss was caused by the misrepresentation or omission

Nancy's liablity under 10b-5 for Material Misrepresentation and Ommission

Nancy accepted an offer by Squirrel [which also breached her common-law duty

of loyalty, which we will get to later], and knew that she was going to sell all her shares to them. However, she flatly told Nany that she was going to sell the shares in bits so as to not alert the public or other shareholders. When interviewed by the press, she failed to disclose her sale, and instead stated that she was going to buy more stock. Because the shares are traded on the open market, instrumentalities of interstate commerce were used, and there is federal subject-matter jurisdicion for this case.

Public Plaintiff Suits under 10b-5:

The SEC and DOJ would bring suits against Nancy, with civil damages and injuctions, as well as criminal penalties, respectively. Nancy made a flat-out lie about buying more stock, and failed to disclose that she was selling to Squirrel. This information would most likely be material because a reasonable investor would find this information important in deciding whether to buy or sell the stock. The issue would be whether she had scienter, or wrongful state of mind. If she knew her sale to Squirrel would adversely affect the price of the stock, then concealing her sale with that knowledge would fulfil this element. Nancy would most likely be found civilly and criminally liable by the SEC and DOJ.

Private Plaintiff Suits under 10b-5:

Plaintiff Peter bought stock after Nancy said she was optomistic about the future of the company, and that she was going to buy more stocks. Later, when Squirrel came out with the information that they were now controlling shareholders in Sono-bags, the price dropped. Peter will likely bring a private 10b-5 suit against

Nancy. In addition to the elements discussed above for a public plaintiff, Peter must fulfull the additional elements needed for a 10b-5 private action.

In connection with sale of securities

For Peter to prevail, he must show that he actually bought or sold securities in the company at issue. He did buy Sono-bags stock during the time of the material misrepresentation and ommission, so this element is fulfilled.

Reliance

Peter will say that he relied on the article in deciding to buy the shares. If there were any facts to show that he was already considering purchasing shares, this element may be mitigated. Absent any such facts, it is presumed by the fraud on the market theory that there was reliance and this element is satisfied.

Economic Loss

Peter bought shares at $60/share, and after the information from Squirrel came out, it went down to $20/share. This is economic loss, even though he didn't sell his shares at $20/share. His equity was diminished, and so this element is also fulfilled.

Loss Causation

The law presumes that a loss because of reliance on a material misrepresentation is caused by the material misrepresentation. Unless there was anything else that could have caused the price of Sono-bags to go down [a large-scale market crash in all areas], this element will also be filfilled.

Result of Peter's Claim

Peter can recover from Nancy for his economic loss due to her misrepresetnation and omission.

Linda's liablity under 10b-5 for Insider trading

Linda may also be liable under 10b-5 for trading on material non-public information. Linda is an insider because she is on the board of directors of Sono-bag. Any insider [or tippee, or missapropriator] who trades on non-public material information, when they have a duty not to, is liable under 10b-5.

Public Plaintiff Cause of Action under 10b-5:

The SEC and DOJ will bring suit against Linda because she sold her shares after Nancy told her that Nancy was going to sell. This was material non-public information. The reason Linda sold was because she thought her stock may go down after Squirrel took over. This satisfies scienter, a wrongful state of mind

because she had the intent to get out while the getting was good, to the detriment of the other stockholders. This is a classic example of insider trading. Linda will be civilly liable to the SEC, and criminally liable to the DOJ.

Private Plaintiff Cause of Action under 10b-5:

Peter would not have a cause of action against Linda because Linda's actions did not cause her loss.

If Linda's insider trading made the stock go down and caused losses to other shareholders, Linda could be liable to them under 10b-5 if the same private plaintiff elements explained above were satisfied. These plaintiffs could include Bob, and other shareholders. There are not enough facts in this scenario to determine whether she is subject to that type of liablity.

Short swing profits under section 16(b)

If either Nancy or Linda bought and sold [or vice versa] shares within a six month period, as insiders they would be liable for any profits gained as a result. Their gains would be divested and given back to the corporation, regardless of their intent as short swing profits are a strict liability cause of action. It does not appear that the facts support a 16(b) cause of action in this case.

Squirrel's liablity under the Williams Act

The Williams Act of 1968 amended the Exchange Act and applied to varied areas of securites issues, and takeover bids [such as proxy contests] but its core addressed tender offers.

Tender offers

Tender offers are a takeover strategy whereby one corporation solicits shareholders of the target corporation in order to try to gain a controlling share of the securities issued by the corporation.

To determine whether an offer to purchase is a tender offer, courts look to whether the following elements are present:

- direct offer to shareholders
- limited time offer
- offering price above fair market value
- contingent on purchase of a minimum and/or maximum amount of shares
- pressure on the shareholders to sell

The offeror may first go to the board of directors to get their blessing [a 'bear hug'] or just go straight to the shareholders.

Requirements of the williams act

The Williams act requires that any person who plans and offers to buy more than 5% of the shares in a corporation must register with the SEC, and make accurate disclosures regarding their intention. This is to protect shareholders and give them the information they need to decide whether to under the tender offer.

In this case, Squirrel intended to purchase Nancy's 60% majority share, but the facts do not state that they disclosed or filed with the SEC. The deal seems to be done in she shadows. If the Williams act was complied with, all the shareholders would know of Nancy's intent to sell, and Squirrel's intent to buy, but it did not appear that this happened.

The Williams act does not provide for a private cause of action [unless there is fraud or misrepresentation], but the SEC would likely bring suit against Squirrel for failure to register and adhere to other requiremetns of the Wiliams Act.

Common Law Duties

Directors and officers [DnOs] owe a common-law Duty of care and duty of loyalty to their corporations. Majority shareholders owe a duty of care to minority shareholders. These are based originally on Agency law. An agency is created whenever someone [the agent] agrees, expressly or by their actions, to act for the benefit of, and under the control of another, the principal. It is a consensual fiduciary relationship. Because directors and officers are agents of the corporation, they are bound by agency law.

Duty of Care

The duty of care is based in prudence: the DnOs must act in conducting the corporations' affairs as a reasonably prudent person would in conducting their own affairs. The business judgement rule, described in the second question, infra, presumes, absent fraud or illegality, that decisions made by DnOs on behalf of the corporation fulfil this duty.

Duty of Loyalty

The duty of loyalty is based on the idea that DnOs must be loyal to the corporation, and put their personal benefit second. There are three major scenarios where the duty of loyalty comes up:

- self-dealing
- corporate opportunity doctrine
- executive salary

In this fact pattern, Squirrel offered to buy Nancy out. This is an opportunity which Sono-bags may have wanted to take advantage of. By not disclosing this opportunity to the corporation as a whole, she breached her duty of loyalty to the corporation and to the minority shareholders.

Nancy also breached her duty of loyalty to the monority shareholders by not

disclosing her plans to sell.

======== End of Answer #1 ========
2)

======== Start of Answer #2 (1118 words) ========

1. There are three venues under which Securities Fraud actions may be brought: Private Civil Actions, Securities Exchange Commission Civil Action, and Department of Justice Criminal Action.

2. There are three main tools to shield directors and officers [DnOs] from personal liability:

- exculpatory clauses/statutes
- indemnification
- Director and Officer Insurance

However, none of these tools may insulate a director who acted in bad faith or knowingly committed criminal acts in their capacity in the corporation.

Exculpatory clauses/statutes may be written into the charter or bylaws, and limit liability. They are contractually binding.

Indemnification may be mandatory, permissive, or court ordered. It is where the corporation reimburses or covers the cost of defending cases against DnOs for

their actions. Mandatory indemnification is required where a DnO defends a case and is successful on the merits or otherwise. Permissive indemenifcation means the corporation can choose to indemnify if the officer acted in good faith but was still held liable. Court ordered indemnficiation is used where a corporation is required to indemnify but refuses to do so, or where the court determines that injusice would result if there was no indemnification.

DnO Insurance can provide a wider shield for DnO's. THe corporation contracts for an insurance policy to cover liability for cases against DnO's.

3. A de jure corporation is a corporation formed through adherence to staturoty requirements. It usually entails filing the charter [articles of incorporation] with the secretary of state, paying the required fee, and holding a first board meeting.

4. The Williams Act of 1968 amended the Exchange Act and applied to varied areas of securites issues, and takeover bids [such as proxy contests] but its core addressed tender offers.

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5. The three omst common shareholder agreements are voting agreements, buy/sell agreements,and purchase agreements.

Two voting agreements are voting trusts [which are seldom used because they require severance of ownership and are irrevocable for a set amount of time; the trustee who holds owneship votes as the trustor mandates], and pooling

agreements [which are an agreement to vote a certain way, and can be contractually binding]. Buy/sell agreements, often used in close corporations, dictate who may purchase stock when a shareholder wants to be bought out. purchase agreements give existing shareholders a right to purchase newly issued shares first so their interest in the corporation is not diluted.

6. The business judgment rule is a presumption that, absent fraud or illegality, the actions of DnOs on behalf of a corporation adhere to the duty of due care. The duty of due care is the requirement that a DnO acting for a corporation must act as a reasonably prudent person would in the management of their own affairs.

Usually corporate DnOs and shareholders enjoy a shield of personal liablity for corporate debts and obligations. However, where the unity of interest and ownership is such that adherence to the fiction of a separate corporate entiry would sanction fraud or promote injustice, a court can 'pierce' the corporate veil and hold the DnO or shareholder personally liable. Some of the factors considered, but not dispositive, include:

- failure to adhere to corporate formailites [no board meetings, minutes, filing, etc]
- using corporate assets as the DnO's own
- alter-ego theory [corporation is really just a sole proprietorship taking advntage of corporate limited liability]
- comingling of corporate and personal funds
- fraud in filing with the secretary of state

7. Common anti-takeover strategies include Poison Pills and staggered boards.

Poison pills are where, upon a triggering event, something is made to occur to maket the target corporation less enticing. Often, upon notice of a tender offer, the Board will enact a poison pill device which either allows shareholders to sell their shares back to the corporation for market value, or the corporation issues more shares for a reduced price, which are only available to existing shareholders with a maximum number of shares. THis dilutes each share, making the tender offer less likely to succeed. If a poison pill is enacted without shareholder approval, it is subject to the Unocal_standard- it must be a reasonalby proportionate response to the danger seen by the board.

Staggered boards make it harder to take a corporation over through a proxy contest because not all the board members come up for election at once.

8. The misappropriations theory is a way to extend liablity for insider trading. Where one gains material non-public information, and has a duty to not disclose or act on it, but buys or sells using the knowedge, they can be liable under SEC rule 10b-5. Originally 10b-5 insider trading only applied to insiders [DnO's or shareholders of more than 10%], or tipper/tippees [insiders who tell, or people who gain information from insiders knowningly]. This liablity has been extended to misappropriators also.

9. A promoter is one who acts on behalf of a not yet incorporated corporation. Thay can make business plans, borrow money, enter into contracts and hire employees on behalf of the fledgling corporation. THey are an agent of the not

yet incorporated corp. The promoter is personally liable for all contracts and liablitieis entered into on behalf fo the corp, unless and until the corporation is incorporated and the board of directors issues a novation.

10. Articles of incorporation must include:

- name of the business [including Inc. or Co.]
- name and address of the promoter [incorporator] and agent for service of process
- purposes of the corporation [can be general or specific]
- financial structure including how many shares issued, capitalization, etc
- name and address of the board of directors

======== End of Answer #2 ========

END OF EXAM