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Empire College School of Law
Business Organizations
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FINAL EXAM/ANSWERS

3 Hours

This examination covers Introduction to Forms of Business Entities through Insider Trading and Other Securities Fraud (Chapters 1-19).

This examination will test your knowledge of the materials that we covered in class. Please answer each question concisely. Please use headings, underline issues and rules, as this will help you organize your thoughts, spot and frame the legal issues, and present the rules and doctrines clearly. Try to answer all questions with complete sentences. Do not use abbreviations, other than those commonly used for each business organization (like LLP). Answer all questions presented. If you cannot answer a question completely, answer as best you can. If not all fact are present, by all means, address scenarios. Partial answers will be given partial credit. Please write clearly. **Good luck!**

PART I (50 POINTS)

A. In June 2014, photographer Anna Smith (A) and her college friend, another SSU fine arts major, sculptor Bob Williams (B), approached you about an idea to open a new art studio in Healdsburg, which they would like to call AB+Arts. They also have an idea for an interactive App called Sono-Arts that lets people post invitations to experiential events at different gorgeous Sonoma County venues, post photos from the art created or seen there, sell tickets, and any art objects left over from those events. Anna's aunt Cheryl

(C), who is an art gallery owner in San Francisco, with a second home in Healdsburg, will invest \$200,000. Cheryl also has Cloverdale office space that the former art students are allowed to use for free (following the dot-com bust, local commercial leasing space was at 20% vacancy rates). Cheryl is also a lawyer and has offered to be their lawyer. Anna and Bob come to you (a friend from a local yoga class) for advice.

- a. Draft a memo on which business forms to consider, the pros and cons of each
 - b. In the case they choose a Corporation, what must Articles of Incorporation include?
 - c. Address whether it is advisable for Cheryl to be their lawyer, and if not, why not
- Purpose (general or specific/"lawful Business purpose ok)
 - Names & addresses of incorporators & registered agents
 - Business Name (Inc, Co, LLC, LLP, etc).
 - Financial Structure (authorized/issued/outstanding stock/# of shares; prefs of classes; as applicable.
 - Business forms: sole proprietorship – no;
 - i. general partnership
 - ii. limited partnership
 - iii. limited liability partnership
 - iv. corporation (public or closely held)
 - Pros/cons – costs/formalities-exposure to liability; ability to get additional funding
 - Red flags re personal Esq./family conflict of interest

B. By May 2016, benefiting from the artistic founders' hard and creative work, AB+Arts (by then a Healdsburg-based corporation) has become a well-known art gallery in Healdsburg. This notoriety, coupled some remarkably well-timed growth in the economy (and with it, and interest and expendable income buy art) and a spike in art appreciation due to the announcement of an internationally renowned photographer moving to Sonoma County, AB+Arts has stock is valued at \$50/share. Things have changed a bit since 2014. Cheryl would like to get paid for the office space (even the Healdsburg market for depilated buildings is hot), Anna has become a certified Yoga teacher. Anna still creates art, but she is working less on the client/sales side; leaving Bob with most of the day-to-day work to both be an artist and an art gallery owner/seller. Bob is tired of working long hours (evening shows for tourists on weekends). During a hike at Lake Sonoma, Bob

decides he wants to get out of their company, to help children in Kenya, with his sculptures.

ARTBOX, a publicly-traded Lifestyle Brand corporation headquartered in New York, enters into an agreement with Cheryl (now both a majority shareholder and a director) of Sono-Arts. The agreement states that, as long as no AB+Arts directors lost their seats on the board of directors, Cheryl would sell her 60% interest to ARTBOX for \$100 per share, giving ARTBOX control of AB+Arts. The sale is likely to make the other 40% of AB+Arts stock less valuable because Sono-Arts has over the years borrowed heavily (on art supplies and "inspirational trips," and paid its shareholders large travel reimbursements as well as dividends to create "content" for the Sono-Arts App.

Without telling Anna and Bob, Cheryl entered the agreement with ARTBOX, as she felt strongly that transforming AB+Arts, and the Sono-Arts App into a "Sonoma life style brand" would be the only way to save the company from impending bankruptcy. She has also signed contracts on behalf of AB+Arts for water bottles, coffee mugs, picnic blankets, wine label art, and wine event sponsorships, without consulting her fellow board members.

Shortly thereafter, ARTBOX put on an experiential Art Installation in Geyserville. Sadly, the pyrotechnic component of the mobile art object back-fired. Tourist/Plaintiff David Brown (D), had severe burn injury on 50% of his body and had to be treated at Memorial Hospital for 2 months. The bills were in the amount of \$200,000, and as he was the sole provider of his family of three, the economic loss to them was 2 months of salary at his San Francisco tech company.

- Liability of Cheryl as Director
- Which element may be missing (causation)
- Duty of Care.
- BJR
- Enhanced BJR
- Duty of Loyalty
- Derivative Suit
- Duties of shareholder
- Shield of Limited Liability
- Piercing Corp Veil
- Liability of Sono-Art
- Other

PART II (50 POINTS)

Answer the following questions.

1. When seeking minority shareholder approval for a proposed cash-out merger, which test must the corporation involved comply with. After naming the test, please also name and explain the two interrelated aspects of that test.

- Fairness Test

- Fair dealing. Imposes a duty on the corporation to completely disclose to the shareholders all information germane to the mergers; and
- Fair price. Requiring that the price offered for the outstanding stock be equivalent to a price determined by an appraisal where all “non-speculative factors” were considered. Weinberger.

2. What are the three venues under which Securities Fraud actions may be brought?

- Private Action/Civil Case/Civil Liability
- Securities & Exchange Commission (SEC): Criminal Investigation/charges/liability
- Department of Justice (DOJ): Criminal (and Aiding and Abetting charge is possible)

3. Describe the different tools used to shield directors and officers from personal liability for actions (or inactions).

- D&O Insurance
- Mandatory Indemnification
- Permissive Indemnification

4. When might Board of Directors be found to have violated his or her Oversight responsibilities?

- Directors utterly failed to implement any reporting, information systems or control, and/or
- Having implemented such a system of controls, conscientiously failed to monitor or oversee if implementation/use.
- OR: Where Directors fail, in the face of a duty of act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary duty in good faith.

5. Describe the Williams Act and the policy reasons behind its enactment.

- §14(e) of the Williams Act is a law that prohibits deceit, fraud and manipulation in connection with tender offers. The purpose is to protect investors, not tender offerors. Piper v Chris-Craft (takeover bidder lacks standing under W Act). Policy reason is to help ensure solicited have access to the information needed to make a considered appraisal of the proposal put before them. Hanson Trust.

6. In what three instances may a fiduciary's failure to act in GOOD FAITH be shown?
- Where the fiduciary intentionally acts with a purpose other than advancing the best interest of the corporation,
 - Where the fiduciary acts with the intent to violate applicable law, and
 - Where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.
7. Describe the Business Judgment Rule, as well as factors to be considered in "piercing the corporate veil."
- BJR is doctrine relieving D&Os from liability from decisions honestly and rationally made in corp's best interest
 - Piercing of Corp veil will occur (BJR protections will be lost) if a combination of some of these factors:
 - Absence or inaccuracy of corporate records;
 - Concealment or misrepresentation of members;
 - Failure to maintain arm's length relationships with related entities;
 - Failure to observe corporate formalities in terms of behavior and documentation;
 - Failure to pay dividends;
 - Intermingling of assets of the corporation and of the shareholder;
 - Manipulation of assets or liabilities to concentrate the assets or liabilities;
 - Non-functioning corporate officers and/or directors;
 - Significant undercapitalization of the business entity (capitalization requirements vary based on industry, location, and specific company circumstances);
 - Siphoning of corporate funds by the dominant shareholder(s);
 - Treatment by an individual of the assets of corporation as his/her own;
 - Was the corporation being used as a *façade* for dominant shareholder(s) personal dealings; *alter ego* theory. (not all of these factors need to be met in order for the court to pierce the corporate veil. Further, some courts might find that one factor is so compelling in a particular case that it will find the shareholders personally liable.)
8. To recover for corporate "waste," what must a plaintiff typically show?

- The exchange was so one-sided that no business person of ordinary sound judgment could conclude that the corporation has received adequate consideration. (Where directors intentionally squander or give away corporate assets.)

9. What is the “Misappropriations Theory”?

- Tippee
- Tipper
- Chiarella (printer case #1)
- Materia (printer case #2)
- Dirks v. SEC

10. Who is a Promoter, what does he/she do, and what is the extent of a promoter’s liability?

- Person acting on behalf of CO not yet formed; i.e. arranges everything before there is a business (lease, partner ships, bringing in money, people, knowledge, ideas, etc.)
- P liable for their actions on behalf of pre-incorporated corp until there is novation (corp replaces Ks). Corp liable for pre-incorporation Ks if later adopted.
 - Express Adoption. Board of Director resolution
 - Implied Adoption. Corp accepts benefits of K

END OF EXAMINATION