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Larry (L) has legal rights against several of the parties in question.

SEC Act 10b-5 will govern the majority of the causes of action. 10b-5 governs manipulative and deceptive practices involving securities traded on the stock market. The elements of a 10b-5 cause of action are :

1) Material Misrepresentation or Nondisclosure
2) Scienter (recklessness will suffice)
3) Reliance
4) Economic Loss
5) Loss Causation

The information regarding the breakthrough is clearly material, as a reasonable investor would attach importance to that information before buying or selling Z stock. Thus, one who knowingly acquires this material information is under an obligation to either disclose the information to everyone, or not trade. Larry did rely on the information available to him, which did not include the insider information. Larry's potential remedy would be his losses. His recovery would further be limited to the profits enjoyed by those who traded using the insider information.

<u>Amos</u>

Amos shared the information with Z's Board at a weekly barbeque. He did not trade on the information. He received no benefit from the insider information. While an outside barbeque may not the the best setting to reveal such information, Amos is not lialble to Larry for his passing the information on the Board of Z.

<u>Martha</u>

Martha was a gardener who overheard the information about the breakthrough by Zero (Z). She then passed the information on to Barney, who Barney. Martha herself did not buy. Since Martha herself did not buy, she gained no benefit from the insider information. She did pass the information on to Barney, but since she did not trade and got non of the profits from Barneys buy/sell, she is not liable to Larry under 10b-5.

<u>Barney</u>

Barney acquired the information from Martha. The issue is whether Martha had a duty to Z, and if she did, did Barney know or should he have known that the information was secret non-public information. Since Martha worked for an independent landscape company, Barney will argue that she had no duty to Zero. However, she was on Zero grounds at th time, and courts have extended a duty to such employees working for a company (printer cases). Under such a theory, it could be argued that Barney misappropriated the insider information and made a profit with the requisite scienter, to the detriment of Larry. Barney will argue that Martha did not have a duty to keep the information to herself, as she was not an insider. This is a close call. If the courts extend the duty to Martha, Barney could be liable to Larry through misappropriation under 10b-5. Barney clearly enjoyed a benefit (25% profit).

Diane

Diane worked for Z and disclosed the information to her boyfriend (George - director of rival Pagico). This is clearly a breach of Diane's duty of due care and duty of loyalty to Zero. This type of information should never be disclosed to rival. Diane also traded on the information, buying 1,000 shares on Jan 2, and selling on Jan 12. Diane is liable to Larry under two theories.

She is guilty of a 10b-5 violation for trading on the insider information. She trading based on the nondisclosure of material information, with scienter. Larry suffered economic loss as a result. Larry relied on the stock price as being representative of all known information. Diane is liable to Larry under 10b-5.

Addionally, Diane is a director of Zero and she bought and sold Z stock within a 6 month period. As a director of Z, this is a clear violation of SEC Act 16(b) - a Short Swing Sale. However, under a 16b theory, the profits from Diana transactions go back to the corporation, not to Larry.

George

George is lialbe to Larry. George knew or should have known that Diane breached her fiduciary duty to Z by revealing the information to him. The facts say that directors of Pagico bought shares of Z in the names of the individual directors of Pagico and their relatives. If some of the purchases were made in George's name, this would be a clear violation by George under a 10b-5 analysis. He used the insider information to and traded with the requisite scienter. Any profits that George gained individually would be disgorged, possibly to Larry.

Pagico

There are several theories of liability against Pagico (P). P's plan was to buy 51% of Z and force a merger. Such a merger, unless it was a statutory short form merger, would require majority approval from the shareholders of P and Z. If it was a short form merger the minority shareholders of Z would be entitled to appriasal rights if they dissented. Furthermore, the Williams Act requires filing if a tender offer is made pushing holdings over 5% of the target company. This may not apply here since it appears to be an attempted hostile takeover and merger. This does not create a remedy in Larry, but is is important nonetheless.

P is also liable for a violation of 10b-5. The Board of P became aware of the breakthrough information and started buying Z stock. P knew or should have known that George came into the information via Diane's breach of her duty to Z. P then traded on the material nondisclosure with the requiste scienter. P also gained a benefit by making $20 a share. P is liable under 10b-5 to Larry. There was a material nondisclosure which Larry relied on not being known to others, and he suffered an economic loss.

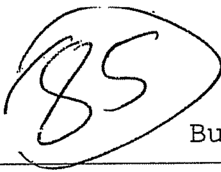
Furthermore, P became a 35% owner on Z after buying up Z stock. The then sold that stock within a 6 month period, violating 16(b) as a short swing sale. An issue surronding this is that not all the profits would be given back to the Z under this theory. The purchase by P of Z stock that pushed them over the 10% ownership barrier would the triggering purchase. Assuming P sold all it's Z stock on or around Jan 12, only those profits from 35% back down to the percentage that resulted from the triggering purchase would be recoverable. The rest would not be availble to go back to Z under 16(b), as ownership is measured prior to the purchase.

However, Larry may still be entited to those last profits under his 10b-5 theory, *supra*.

There are potentially other investors out there besides Larry who were victimzed by this scheme of insider trading. The SEC may very well step in under a fraud on the market theory. This would result in civil penalties aginst those who violated 10b-5 above.

Additionally, Sarbanes-Oxley creates criminal violations for many of the deceptive and manipulative actions demonstrated by Diane, George, Pagico, and maybe Barney. Under S-O those found guilty can serve up to 20 years in confinement and face criminal fines.

At the very least, Larry is entitled to return of his losses that resulted from his trading. His recovery would be limited to the gains enjoyed by those who violated 10b-5, much of which will end up going back to Z under 16(b) theory anyway.



The Business Judgment Rule (BJR) provides that absent fraud, illegality, or conflict of interest, a director's business decisions are presumed to be in good faith and no personal liability is incurred absent gross negligence. However, in the tender offer context, court's recognize a director's inherent self-interest in continued employment. Thus, decisions to defend against tender offers are subject to the Enhanced BJR.

The EBJR requires that before directors decide to defend against a tender offer, they must first detemine that the offer is not in the best interests of the corp -- that it poses a threat to corporate policy or effectiveness. This must be shown upon evidence of a reasonable investigation. Then, directors must further show that their response was proportional to the threat posed. If the measures were either coercive or preclusive they are illegal. If not illegal, the measures still must be shown by directors to have been within the range of reasonable responses to the threat posed.

Here, the JohnCo (J) directors were notified that DeepDu (Du) was making a tender offer for an additional 42% of J's stock for $6.50 a share, a $1.50 premium above market price. Alex (A), Mary (M), and Glenda (G), directors of J, convened to deal with the tender offer and determined it was in J's best interests to defend against it. It is reasonable to infer that the J directors determined that the tender offer by Du posed a threat to their 5-year plan to increase share value. This would suffice for reasonable investigation.

The responses by J each require individual scrutiny.

First, the $5 per share dividend was declared to the exclusion of shareholders (SH) who tendered to Du. A dividend may not be discriminatory -- it must be declared for all holders of a specified class of stock. Discriminatory dividends give the SH a right to bring a direct action against the issuing corporation, since the dividend is a contractual right in the SH once declared. Since the right to receive the dividend arises independently of any right of the corporation, Tom (T) may bring an action against the J board for his $500K loss as a result of the discriminatory dividend. Further, since the dividend is funded with a high-interest loan which creates a large liability for J, a court will likely find that this measure was not only illegal, but also disproportional to the threat involved. It should be noted that this measure is a poison pill, which grants a SH additional rights upon the occurrence of a triggering event, usually acquisition of a substantial number of shares by one entity or by a hostile tender offer. This is a flip-in poison pill, since it grants the SH additional rights in the target company upon the occurrence of the contingency. Blank check preferred stock is often used as a defensive measure in the tender offer context, and may be used by directors, once authorized, to place poison pills (as here).

Second, golden parachutes are a common defensive tactic in a hostile takeover context. Initially this would pass scrutiny, however, the EBJR requires a showing that this measure was proportional to the threat posed by Du's tender offer. Any involuntary discharge of the existing directors, or expansion of the board beyond the three existing directors, will result in a $5M payout for each director -- a total liability incurrence of $15M. This measure would likely be found preclusive by a court -- there is no way for Du to take control of J's board without incurring huge liability, even if the tender offer were successful. This action will likely be found not to satisfy the requirements of the EBJR upon judicial review.

Third, the board voted to transfer ownership of the porta-pottie mold to A personally. This would likely be found to be a preclusive measure, since J could not manufacture if A decided to remove the mold. While transfer of the crown jewels (primary or valuable asset) is used as a

defensive measure in defending against tender offer, here it seems to be a disproportionate response. If Du's tender offer were successful, J would become worthless beause A personally holds the mold for the primary product. A court would likey find this measure inappropriate in the instant context.

As for the directors own tender offer to J's SH, it should be noted that A, M, and G are all SH of J, for a total of 45% of the shares held. While a dominant shareholder does not usually assume fiduciary duties to the corp or minority SH, courts have implied such duties in some instances. If that is the case, and a controlling SH is on both sides of a transaction, then the burden is on the majority SH to demonstrate the entire fairness of the transaction to the corporation and minority SH. However, here the combinatino of A, M, and G only amounts to 45%, which is not a controlling percentage. As such, there is no duty to show entire fairness.

Regarding Joan's predicament, she should seek judicial review of whether the directors of J are in fact disinterested and independent. When the directors are interested, then the burden is on the directors to establish the entire fairness of the transaction to the corp and to the minority shareholder. Here, A, M, and G all have a personal interest in defending agaisnt Du's tender offer. Each of them wants to remain SH in J corp (presumably) and would like to retain their $150K directorial compensation. As such, A, M, and G will have the burden of establishing that their tender offer is fair to the minority shareholders. If they are acting out of self-interest, rather than in the best interests of the corp and its SH, then they are violating their fiduciary duty of loyalty owed to the corp.

Here, it is likely a court will find that the proposed tender offer is fair. It is motivated by a desire to continue implementation of a strategic 5-year plan to increase share value. The tender offer for the first tier of $8 per share is well above the market price of $5 per share. If successful, completion of the first tier would result in a 75% controlling share for A, M, and G combined. The second tier (mopping up) price is also fair, since it comports with the current market price and would likely be commensurate with the appraisal value for SH objecting to the tender offer.

A related issue, although not strictly raised in the facts, will be Du's disposal of its 10%+ ownership of J if Du's tender offer is unsuccessful. Rule 16 prohibits directors, officers, and beneficial owners of more than 10% of a corporation's stock from engaging in any sale and purchase or purchase and sale of the issuer's securities during a period of less than six months. Here, Du owned 10% of J's stock as of June 1, 2010 when it made its tender offer, and the fact show that Du acquired more shares after that. If Du were to attempt to sell those shares, as it likely would if it's tender offer is unsuccessful, before six months has passed, any profit realized on that sale would inure to and be recoverable by J. This action would be brought as a shareholder derivative suit to enforce a right of the corporation against a third party -- here, Du. If Du wishes to avoid these losses, it should not sell the stock before the statutory restriction expires. However, if Du wants to cut its losses and sell the stock as soon as possible, a "step transaction" should be undertaken. In a step transaction, the beneficial owner of more than 10% of an issuer's shares sells off a portion of the shares, thus reducing its holdings to less than 10%. The profits from this transaction are recoverable by the issuing corp. However, the remainder of the shares may be sold without penalty, since beneficial ownership is measured immediately prior to the challenged transaction.