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**Paul Rights Against Various Parties Involved with his May Co Stock:**

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**LIABILITY OF MIKE AS A DIRECTOR-**

**Federal Anti-Fraud Rule-**

Rule 10b-5, the federal anti-fraud rule provides that it is unlawful for a person to use fraudulent or manipulative means in connection with the sale or purchase of securities. In order to successfully prove this cause of action, one must show:

1. the plaintiff is the SEC or a buyer or seller of the affected corporation
2. the defendant gave a materially misleading or materially omitted information
3. defendant acted with scienter
4. there was reliance and causation as to the material information
5. plaintiff's suffered economic loss.

In this case, Paul will want to bring a 10b-5 cause of action against Mike.

Paul was a buyer of Mayco stock. Paul purchased the stock based on Mike's statement to the Wall Street Journal. In that interview Mike stated he was so optimistic about Mayco's future he would buy more stock if he could. In reality, Mike was planning to sell all his stocks. Mike intentially omitted this material information.

Materiality for 10b-5 purposes means that there is a substantial liklihood that an investor would consider the information important in deciding whether to buy or sell shares in a corporation. If Paul knew that Mike, the director and majority shareholder of Mayco, was about to sell all his shares in the company, Paul would not have bought the shares. This is futher substantiated by the fact that Paul specifically purchased shares because he relied on Mike's optimism for the future of Mayco.

Not only has Mike provided materially misleading information (future of Mayco good), he has omitted material facts as well (selling all his stocks).

Mike may be a tipper. He secretly told his friend Don of his plan to sell his Mayco shares. In order for a tipper to be liable to under 10b-5 they must have had some personal gain in the transaction. However, monetary gain is not necessary. Establishing a good reputation or making a gift is sufficient for a personal gain. Because it is unclear why Mike told Don the information, Mike may not be liable as a tipper.

Scienter is the intent to manipulate, defraud, or deceive. Mike failed to disclose his intent to sell his stocks. He clandestinely sold his stocks in an effort to avoid other Mayco shareholders catching wind of his plan. This is evidence of an intent to manipulate and decieve. Scienter has been established.

Paul relied on the misleading and omitted information. Further, there is a direct cause from Mike's misreprestation and Paul's loss. After Jaxco made the public announcement that it took control of Mayco, a mere two days later, Mayco stock fell from $50 a share to $20 a share.

Mike will fight this 10b-5 suit by alleging that it was not his actions that caused the drop in

Mayco stock. He will assert the fall in price is attributed to the fact that Jaxco caused a major oil spill and polluted in the Mississippi River. Mike will argue that this unforseeable event caused the price of Mayco stock to drop.

While Paul has been able to meet nearly all the elements to sustain a 10b-5 cause of action, he is missing a crucial element: causation. It cannot be said for certain what caused the Mayco price to drop: the oil spill or Mike's sales. The two events happened only days apart. Paul should find out if Jaxco stock dropped as a result of the oil spill. If Jaxco prices remained stable despite the spill, then the price of Mayco stock can be attributed to Mike's sales, and not the oil spill. This will enable Paul to meet all the elements of a 10b-5 cause of action against Mike.

If the court agrees with Paul, then Paul will be able to recover damages from Mike. This will be $40.00 per share of stock that Paul owns in Mayco.

**Duty of Care-**

Mike is a director of Mayco and thus has a duty of care to the corporation. The standard Mike must meet is that he must act as a reasonably prudent person would act in his own business affairs.

According to *Caremark*, a plaintiff successfully establishes a breach of care when the following elements are satisfied:

1. defendant knew or should have known his actions were violative of the law;
2. defendant did nothing to prevent or remedy that action; and
3. that action was the proximate cause of the economic loss.

In this case, Mike knew his actions were violative of the law; he went on record with the Wall Street Journal and said he would buy more Mayco stock if he could. Yet he knowingly was about to sell his all his shares. He did nothing to prevent the economic loss that would occur. Relying on the statement that Mayco was doing so well, Paul went out and purchased shares and as a result of that reliance, Paul lost money. Further, a prudent business person would not sell all their shares in a company that was doing well and would not sell their shares to a company that was famous for borrowing heavily on the assets of the purchased company.

Under the regular standard and the *Caremark* standard, Mike has breached his duty of care as a director of Mayco. However, Mike will counter this argument with the Business Judgement Rule.

**Business Judgment Rule-**

The BJR provides: absent fraud, illegality, or conflict of interest, a director who acts in good faith will not be liable for the debts of the corporation for mere errors of judgment.

In his defense of a breach of care, Mike will argue that he acted in his best judgment. He made an agreement with Jaxco that the remaining board of directors would not lose their seats because of Mike's sale. Mike has not disturbed Mayco's board; all the board members remain in the same position as when Mike was on the board.

However, this argument fails because Mike did not use his best judgment. Mike did not want to alert the board that he was selling his shares and he therefore came up with a plan to surrepticiously transfer his shares over a period of time. This was likely done to not alert the board of the major change that was about to come.

Mike's reliance of the BJR will fail and he will be liable to Paul and other shareholders for a breach of duty of care.

**Enhanced Business Judgment Rule-**

Because the transaction between Mike and Jaxco deals with a tender offer and eventual takeover, Mike will be subject to the Enhanced Business Judgment.Rule.

The Enhanced Business Judgment rule provides that a director must decide if a tender offer is in the best interest of the corporation.

To not breach this rule, Mike must consider whether the takeover was fair to the corporation or if it violates company policy or effectiveness. If so, Mike and the rest of the board should implement defensive measures to counter the takeover.

Here, it is known that Jaxco was famous for borrowing heavily using assets of the companies it acquired. Further, it was nearly certain that a takeover would result in Mayco's stock substantially losing value. These are two facts that should definately go against Mayco's corporate policy and certainly make Mayco a less effective corporation. Therefore, a defensive measure would have been in the best interest of Mayco.

Mike failed to implement the best stategy possible for the company in the impending takeover and he will be liable to Paul for violating the Enhanced Business Judgement Rule.

**Duty of Loyalty-**

As director, Mike has a duty of loyalty to Mayco.

A duty of loyalty provides that a director must act in good faith and do what he reasonably believes is in the best interest of the corporation.

Clearly, Mike has not done what is in the best interest of Mayco. Mike sold his stocks, leaving Jaxco in control of the Mayco. Mike secrely sold his shares thus preventing any other shareholders to take preventative measures against the takeover. Mike also made false statements in a published interview that Mayco was doing well, knowing that in a short time, the corporate structure would significantly change for the worse.

No reasonable director would act in this manner. As such, Mike is liable to Paul and other shareholders for a breach of loyalty.

**Derivtive Suit-**

A derivitive suit is one where the shareholders allege there was a wrong against the corporation. Before bringing a derivtive suit, the shareholders must, post bond in order to pay for the defendant's legal fees if the plaintiff's lose and must show they are adequate representatives. Once this is satisfied, the shareholders are essentially bringing two suits in one.

First it is a suit to compel the corporation to sue. Next, it is a suit by the corporation against those liable to it.

In this matter, Paul and the other shareholders of Mayco may bring a suit against Mayco compelling them to bring a suit against Mike. They will allege that Mike fraudulently caused the fall in prices of Mayco stock.

## MIKE AS A SHAREHOLDER

### Majority Shareholder and Fiduciary Duty-

Majority shareholders owe a fiduciary duty to the minority shareholders and the corporation itself. This fiduciary duty is to act in the best interest of the shareholders and the corporation. Even if a majority shareholder wants to get out of the corporation, at the very least, the majority shareholder has a duty to sell disclose that he will sell his shares.

Here, Mike owns 60% of the shares in Mayco. He is a majority shareholder and thus owes a fiduciary duty to the other shareholders. As part of this duty, Mike should disclose his intent to sell his shares because a sale of this magnitude will surely effect the corporation. Mike however, failed to disclose this intent and the corporation as suffered economic loss as a result.

Mike would counter this by arguing that as a shareholder it is his right to sell his stock to whomever and at whatever price. While this may be true of regular shareholders, Mike his held to higher standard because he is a majority shareholder. This argument will fail.

Mike is liable to Paul and other Mayco shareholders for a breach of fiduciary duty.

### Shield of Limited Liability-

The shield of limited liability does not hold a shareholder personally liable for the debts of the corporation.

Here, Mayco could go into debt because Jaxco may borrow heavily against it in order to pay dividends to Jaxco shareholders. If Mayco goes into debt for this reason, Mike will argue that he is not personally liable for such debts. A court will decide otherwise by piercing the corporate veil.

### Piercing the Corporate Veil-

To avoid fraud or fundemental unfairness, a court will pierce the corporate veil and make a shareholder personally liable for the debts of the corporation. In this matter, it would be Mike's direct sale of his shares that would cause Mayco to go into debt. Therefore, Mike could be personally liable for the debt's of the corporation.

## LIABILITY OF MAYCO-

In this case Jaxco has made a tender offer to Mayco, and more directly to Mike May, a director and shareholder in Mayco.

A tender offer is an offer made by an outsider (raider) to purchase shares from a shareholder usually offering above market value for the shares. A tender offer generally is the first step in a takeover stategy.

In this case, Jaxco has offer to purchase Mike's shares for $100 per share. At the time of the offer, the market value for Mayco shares was only $50 per share. Jaxco's offer is well above

market value and in return Jaxco gets 60% interest in the company, giving Jaxco control of the Mayco board. Jaxco has made a tender offer.

When dealing with tender offers, a board of directors must adhere to the Williams Act. The Williams Act is a federal regulation that was implemented to give protect investors and give the market fair warning of impending tender offers. Some of the requirements a board or seller must adhere to is:

1. no secret profits
2. disclosure by the offeror if the puchase will result in more than 5% ownership
3. the SEC requires tender offers to be kept open for at least 20 days; and
4. no fraudulent means as to the offer.

In this instance, Mayco has not disclosed that they are selling 60% of their entire stock, which would result in the buyer, Jaxco, having more than 5% ownership in the Mayco corporation.

Accordingly, Paul would be able to bring a cause of action against Mayco for failing to adhere to the Williams Act.

**LIABILITY OF DON:**
**10B-5**

As with Mike, Paul may bring a 10b-5 cause of action against Don. See 10-b5 rules, *supra.*

In a 10b-5 cause of action, a tippee is liable for the losses sustained to the plaintiff if the tippee knew or should have known that the information they received was not public knowledge.

In this matter, Don learned about Mike's secret plan for Mike to sell his shares of Mayco stock. Don knew this was a secret plan because Mike shared that he did not want to alert the public or other shareholders of his plan. This plan was relayed to Don one night over drinks; this informal and nonbusiness setting created an atmosphere where Don knew he was receiving insider information.

As a result of this inside information, Don decided to sell his stocks as well. When he sold his stocks he made a profit of $30.00 per share.

Don used this information to get the best price possible for his stocks, as he knew the price was about to quickly fall. He acted with scienter.

Damages in this case will be the disgorgement of his profits: that is $30.00 per share of each stock he sold in reliance on the inside information.

**16b Cause of Action-**
Don and Mike may be liable for a 16 b cause of action if it can be shown they bought and sold their stock in Mayco within a 6 month time period. It is unknown when Don and Mike purchased their shares. Paul should find this out.

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## SHORT ANSWER SECTION

1. Cumulative voting is an approach used in shareholder (SH) voting for directors. It is in contrast to the statutory (default) approach to director voting called regular/straight voting, which allocates one vote per share. Thus if SH X has 100 votes and there are 4 directors to be elected, X has 1600 shares to vote but can vote only 400 shares for each of the 4 directors. This represents a significant disadvantage to the minority SH, and cumulative voting is an effort to remedy this disadvantage by permitting the SH to allocate her votes however she chooses. So in the above example, X can allocate all her 1600 voting shares to one director, or split it up between two directors, and so on.

2. A staggered board is a board that rotates the election of directors to the board. The usual term for a board member is 3 years, however in a staggered board, board members are being elected on an annual basis, and this tends to advantage the majority shareholders, who can more easily influence election of a small number of board members to the board at any given time. The minority shareholder will need to gather more votes, perhaps through a pooling agreement, to effectively influence elections.

3. It will look at whether there is evidence of (1) fraud or illegality, or whether there is evidence that the separation between the corporation and its fiducaries has become one of "unity of interest and ownership" such that separation is a fiction and the corporation is being used as an "alter-ego". In that case, the court will look at elements established in Sea-Land,

including (2) commingling of assets (the most fatal); (3) lack of corporate formalities; (4) undercapitalization and (5) use of corporate assets as if they were individually owned. No one element, on its own, is controlling and the court will look at the totality of the circumstances.

4. Stated capital, traditionally, referred to par value of a corporation and assured creditors of a corporation's solvency and minimum capital security. This is because shares were given a par value at the time of authorization, and stated capital was the par value multiplied by the number of outstanding shares (shares authorized, issued, and purchased by shareholders). Today, par value is essentially meaningless and the Model Act does not require that shares be issued at a minimum price. As relates to payment of dividends, basic policy requires that dividends be made from corporation surplus, and jurisdictions vary, but some jurisdictions require that dividends only be issued if there is money left over after subtracting liabilities from stated capital (this is called the balance sheet test). Other approaches to dividend distribution don't require a surplus approach calculated based on stated capital, however.

5. By borrowing money one is capitalizing the corporation by "selling debt". An advantage to capitalizing this way are is it allows the shareholders of the company to retain greater control over management of the company, because there are fewer owners (i.e. shareholders). The advantage to selling debt to investors is that they are first in line with creditors if the corporation becomes insolvent, whereas shareholders owning stock are last in line with creditors. The advantage to capitalizing by issuing and selling stock - called "selling equity" - is greater liquidity for the company. The advantage to the shareholders is greater control over the corporation through election of directors.

6.

In the operating agreement, issues such as distribution of profits, sharing of losses, divorce, withdrawal of a member, breach of the duties of loyalty or due care (good faith and fair dealing in particular), necessity for further capital. The fiduciary duties of members of an LLC, which are simply the duty of loyalty and the duty of due care, can be modified up to a point. For example, the duty not to compete can be modified in the OA, permitting members to compete.

In the By-laws, elements to include are reference to shareholding agreements (which are contractually binding) and election of directors, any modification from statutory powers granted the board of directors, any

matters pertaining to share acquisitions, the classes of shares, distributions, and any policies or procedures relating to voting approaches other than default, such as cumulative versis regular and majority vs plurality approaches.

7. The contract could contain language that states that upon formal establishment of the limited liabilty entity, a novation will be signed that creates a new agreement between the entity and the third party, thus relieving the person from personal liability. When a corporation is formed, the corporation can adopt the agreement but this still leaves the person liabile, thus a novation is necessary.

8. The most common shareholder agreements are pooling agreements and voting trusts and they allow minority shareholders to influence election of directors to the board. Pooling agreements are the most popular and are, like all shareholder agreements, contractually binding (as long as they don't contradict the Articles or the By-laws). Voting trusts are rarely used because they require a shareholder to legally transfer his shares to a trust. Other types of shareholder agreements include Buy-sell agreements that give the shareholder control over who purchases shares when a shareholder wants to sell.

9. Intent is the issue. The majority of jurisdictions look to conduct of the partners to determine if intent to form a P/S was present. A minority of jurisdictions require a number of elements to be present, including a community of interest in the venture, sharing of profits, sharing of losses, and sharing of control and management of the business.

10. A close corporation is a statutory corporation and can have a minimum number of shareholders. Its shares cannot be publicly traded, therefore there is a very small market for shares when a shareholder sells, versus sale of shares for a publicly traded corporation. Since shares constitute units of ownership in a company, it is significant, in the case of a close corporation, who purchases shares, as they will be able to influence the company in ways that don't occur with purchase and sale of shares in a publicly traded company.