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Question 1

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DAVID'S RIGHTS AND REMEDIES

AGAINST PETE

Pete is a director with Classic Guitars (C) and as such owes a duty of care and loyalty to the C and its shareholders.

– Duties are increased in a closely held corporation.

Duty of Loyalty

When Pete was contacted by Giant (G) he had a duty to disclose to the other directors/shareholders this fact, because an attemted aquisition by G could materially and negatively impact C and its shareholders, particularly in light of the fact that G had a reputation as a "looter." Failure to do so was a breach of his duty of loyalty to C and the other shareholders because he was acting in his self interest, without full disclosure to the board and shareholders.

Rule 10b 5 Violation

Rule 10b 5 states in relevant part:

It is a violation for any person to directly or indirectly use any means of interstate commerce, wire, mail or security exchange in the sale or purchase of any security, to employ any manner of deceipt, practice or artifice intended to defraud in such a sale or purchase, or make any material mistatement, or fail to disclose information, the circumstances of which would lead a reasonable investor to act against their best interest, or engage in any manner in the sale or purchase of securities with the intent to defraud.

In order for a private action to go forward, the plaintiff must show:

- they were a shareholder
- defendant used interstate commerce, wire, the mail, etc. in their mistatement or omission
- acted with scienter
- the action was the proximate cause of their damages
- damages

In this case P knew that G was going to offer top dollar for shares of C and so when he offered to buy D's stock without telling him of the offer he was omitting information that D needed in order to fully understand his position. Further, D specifically asked P whether anyone else had "expressed any interest" in C, to which P said no, which was a lie and material mistatement. The omission and mistatement by P is evidence of scienter on his part to defraud D and get him to act against his self interest, by selling his shares in C without the knowledge that G was interested in buying and that he could

get substantially more for his shares than P offered.

Against G

This might be difficult. Remember, no aiding and abetting liability under 10b-5.

If G knew what was going on they could be liable as well for aiding in the fraud.

RIGHTS AND REMEDIES

P has breached his duty of loyalty to D and as such could seek an action based on that and the 10b 5 violation.

He could ask the SEC to take action against P, for the 10b 5 violations which it could through civil penalties and criminal complaint through the attorney general.

Private actions based on 10b 5 violations must be through the federal courts. D could seek recission in equitable relief or damages in the form of the difference between what D paid him for his shares and what G paid to D.

D could also seek damages from G, if they could not be obtained from P, if he could show that G knew what P was doing and were acting in conert with him. Since G is known for being a "looter" this may be possible, but D would have to show that they knew what was going on and that they too had scienter in gaining control of C.

Right, aiding and abetting not enough.

MARK'S RIGHTS AND REMEDIES

<u>AGAINST PETE</u>

Pete is a director with Classic Guitars (C) and as such owes a duty of care and loyalty to the C and its shareholders.

Duty of Loyalty

When Pete was contacted by Giant (G) he had a duty to disclose to the other directors/shareholders this fact, because an attemted aquisition by G could materially and negatively impact C and its shareholders, particularly in light of the fact that G had a reputation as a "looter." Failure to do so was a breach of his duty of loyalty to C and the other shareholders because he was acting in his self interest, without full disclosure to the board and shareholders.

Fiduciary Duty Owed to Minority Share Holders → also, this is a closely-held corporation

A majority share holder owes a fiduciary duty to minority shareholders, particularly when they know that a tender offer is being made by a "looter." When P bought D's shares he became the majority shareholder creating the additional fiduciary duty to M as the minorty. Selling his 200 shares to G breached this duty on P's duty to M as the minority share holder.

Dividends

The decision to pay out dividends is a matter of discretion for the Board of Directors, which is generally covered by the Business Judgment Rule. However a board may not pay out dividends if doing so would make a corporation insolvent and under the circumstances of forcing C to borrow money at a high interest rate and depriving C of its inventory, such action would result in insolvency.

Duty of Parent to Subsidiary of Intrinsic Fairness

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The dealings of a parent with a susidiary has to be intrinsically fair and cannot harm the subsidiary, or treat it differently than any other subsidiary that it may own. The actions by G, through the directors that they elected, to sell C's inventory to other subsidiaries at a fraction of their market value would not be intrinsically fair and would harm C.

develop why this — the BJR applies to the dividends and not to the sale of inventory. The difference is that mark participate in dividends but not in benefit of inventory sale.

RIGHTS AND REMEDIES

Against P and G

P has breached his duty of loyalty to M and as such could seek an action based on that and the 10b 5 violation.

He could ask the SEC to take action against P, supra, which it could through civil penalties and criminal complaint through the attorney general.

Private actions based on 10b 5 violations, supra, must be through the federal courts. M could seek recission in equitable relief or damages in the form of the difference of the value of his shares what G paid to D. His action could be based on the 10b 5 violation, against P and G as described supra, as well as the violation of the duty owed to him as a minority share holder, rule against issuing dividends that make the corp. insolvent and based on the violation of intrinsic fairness owed to a subsidiary from a parent.

Good Paper

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Blue Book

NAME

SUBJECT Bus Orgs

INSTRUCTOR Rutherford

EXAM SEAT NO. SECTION

DATE 4/9/12 GRADE Q2

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Derivative Suit

A shareholder may bring suit on behalf of the corporation. Any damages awarded belong to the corporation.

One Requirement is the shareholder must have standing. To have standing the plaintiff must have been a shareholder at the time of the alleged wrong, or if by succession, the owner was a shareholder at the time of the alleged wrong.

In this case it is not stated whether the shareholders were actual shareholders at the time of the alleged wrong. If not, they don't have standing to go forward. Assuming they were, which would need to be verified, they would have standing to bring the suit.

Another requirement is the demand requirement. This varies from jurisdiction to jurisdiction but the Delaware Corporate Law requires that a demand must first be made on the board of directors. If the directors reject the demand the plaintiff may go forward with the ~~demand~~ suit. They are required to plead with particularity the attempts & steps made to secure action by the board. If the plaintiff has plead with particularity acceptable to the court then the court will review the corporate's decision under the business judgment rule.

In some cases demand will be excused when the

plaintiff can plead with particularity why the demand would be futile. (It cannot be conclusory statements) It would be futile because directors are self-dealing interested parties or too controlled by those who are.

If demand is excused and ~~a litigation~~ an independent litigation committee is formed and they then decide not to pursue litigation the business judgment rule will apply. However, the courts vary on how it will be applied. The court in Auerbach applied the presumption of the business judgment rule and the burden was upon the plaintiff to prove the board ~~acted~~ breached their duty of care, loyalty or acted in bad faith.

The court in Zapata placed the burden upon the corporation to first show they acted in good faith, on an informed basis with the honest belief that it was in the best interest of the corp. not to pursue litigation.

[Margin note: And then the court decided if the action should proceed.]

In this case the plaintiffs are alleging a majority of the directors approved the illegal payments. This, in itself is a conclusory statement. The plaintiffs would have to plead with more particularity who the directors were, ~~when and~~ etc. Therefore, if the ct. determined it was to conclusory the demand would not be excused. If demand was then made on the board and they rejected it, the

court will review the decision based on the business judgment rule.

If the court determines their pleading was with sufficient particularity we then have to look at the independent litigation committee.

The committee consisted of directors who were not board members at the time the illegal payments were made. ~~and~~ Under Auerbach, the court would review under the business judgment rule with the plaintiffs carrying the burden of proving a breach of duty, loyalty or ~~[illegible]~~ bad faith.

The business judgment rule is a presumption that the directors of a corporation, when making a business decision, are acting in good faith on an informed basis with an honest belief it is in the best interest of the corporation. Therefore, under the Auerbach court the suit would most likely not go forward because the corporation appointed an independent litigation committee of disinterested directors.

However, in Zapata court they would look at the fact that the independent litigation committee was made up of board directors and not outside counsel which is suspect. It may not be that independent at all. They consulted with Fishing's accountants

and lawyers but they may be ~~being~~ controlled and influenced by the directors who did know of the illegal payments and were directors at that time. Under Zipata standard the burden would be on Fishing to prove they did not breach their duty of care, loyalty or act in bad faith.

In this case Jim's suit will most likely go forward. ~~Th~~

To demonstrate a breach of duty of care the director has to be negligent in his duties. In this case ~~Jim was not negligy~~ even if Jim is found to be in breach of his duty of care the company has an exculpation clause in its Articles of Inc. That exculpate a director to the fullest extent permissible by law. This will include a breach of duty of care. However, it will not protect a breach of loyalty.

A breach of loyalty is when a director is engaged in self-dealing or conflicts of interest or where he knowingly and completely disregards his duties.

Bad faith is demonstrated by not being informed. In this case Jim will be found to have breached a duty of loyalty by self-dealing, to secure fishing permits, & by illegal conduct.

Sec 145 of the Delaware Corp. law provides for

A little confusion here. The "plea" probably takes him out of mandatory indemnification on the criminal case, since he was not "wholly" successful. But he <u>might</u> qualify for permissive indemnity if he acted in good faith. Of course, that is in ~~doubts~~ doubt because ~~that~~ the payments were illegal.

mandatory indemnification when a director is successful on the merits or otherwise in a litigation brought in his capacity as director of a corp. This provision allows for reimbursement of reasonable expenses incurred in litigation including attorney fees. There is no good faith requirement. A director may ask for the attorney fees upfront.

In this case Jim was successful or "otherwise" upon his dismissal of a crime. Therefore, under the mandatory indemnification he could be reimb. for expenses.

To the charge where he plead no contest he would not be able to get reimb. for litigation costs, ~~to~~ under mandatory indemnification.

Under the permissive indemnification section of 145 it allows you to go out of the scope of the mandatory provision, but even if the corp bylaws or articles extended the indemnification provision, they cannot supersede the good faith requirement. Of which Jim has breached. Therefore, either way he cannot be reimb. for expenses related to this litigation.

The corp. could have circumvented this restriction by purchasing director liability insurance or having contracts with the directors for such protection.

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Williams Act 14(e)

§14(e) of the Williams Act is a federal law that prohibits deceit, fraud or manipulation in connection with tender offers. Innovative as a publicly traded corporation would fall under the jurisdiction of the Act. Here Innovative made false accusations against Betty the President of Fast. Such false statements were made to pursuade their

shareholders to approve Innovative's amendments to protect it from a hostile takeover by Fast. Innovative's actions clearly violated the Williams Act.

Fast as the tender offeror can seek an injunction against Fast for making such false statements in connection with its tender offer. Fast however cannot sue for damages. In Chris-Craft v. Piper, the US Supreme Court held that the plain text and legislative history of the Williams Act indicated the Act was intended to protected investors not tender offerors. Thus Fast can only seek an injunction.

The shareholders however, can seek both an injunction and damages. It is more likely that the shareholders will seek damages. They relied on the false statement made by Innovative in the proxy statement in deciding to approve the ammendment. This ultimately resulted in the price of the company to plummet.

It should also be noted that Innovative could have sought an injunction against Fast for failing to make the ✓ necessary disclosures. The Williams Act requires all bidders to disclose their identity, funding and purpose. The facts do not indicate that the necessary disclosures were made by Fast. If Innovative had sought the injunction they would likely not have needed to employ such defensive measures to prevent the takeover by Fast.

Unocal Modified BJR Test

In order to defend against a hostile takeover, a target corporation can employ defensive measures to make the corporation less desirable or to make such takeover more difficult. Such defensive measures will be upheld if they pass the modified BJR rule which was established in

Unocal. Under the BJR veriation defensive measures will be upheld by the court if the corporation had 1. a reasonable fear that the corporation would be in danger if the takeover were to occur; and 2. proportionality-the response was proportional to such fear.

Reasonable Fear

Here the facts indicate that the takeover would threaten Innovative's business plan. This would likely qualify as a reasonable fear. Fear that Fast's takeover would hurt Innovative's long term business plan and ultimately hurt its shareholders seems to be a valid fear. Although an independent board of directors approving of the defensive measures would help in the reasonableness prong, it appears that the first prong of the Unocal test has been satisfied by Innovative.

Proportionality

The response to the takeover attempt must be reasonable proportional. Such response cannot be preclusive or coercive. The decision to sell Lucky a large block of shares was an attempt to get a "white knight" to save the corporation. Innovative's reaching out to Lucky as a "White Knight" would likely be deemed a proportional response.

The shareholders however, can argue that by making misrepresentations to induce them to amend the articles, Innovative was coercive and thus such actions would fail the proportionality prong.

Revlon Duties

Assuming that Innovative's defensive measures initially

passed the Unocal Test, their duties changed once they decided to sell the corporation. Under Revlon once a corporation decides to sell; determines that a sale is inevitable; sales control of the corporation to a single individual or single entity; or decides to abandon their long term goals and break up the company; the Revlon duties are triggered and the corporation has a duty to get the best price for its shareholders. Getting the best price for the corporation's shareholders means that the corporaiton must create an equal playing field, expand competition and treat all bidders equally. The Shareholders will argue that the Revlon Duties were triggered when they decided sell their solar car division to Lucky. The Solar power division was the company's "Crown Jewels" and the sale effectively "locked up" the corporation by making it undesirable to the Fast and other bidders. This was evident when Fast cancelled its tender offer in response to learning of the deal with Lucky. Once Innovative decided to sell, It had a duty to try and get shareholders the highest price. Shareholders will claim that such defensive measures ultimately destroyed any competition and resulted in the price of its stock to fall.

Good argument

Innovative can argue that the Revlon duties were never in fact triggered. That Innovative never intendend to sell and thus there was no duty to get rid of any defensive measures. The fact that the agreeement did not include a "fiduciary out" however locked Innovative into the deal and thus likely triggered the Revlon Duties.

The Shareholders could bring a direct action as opposed to a derivative action. In a direct action the shareholders individually have been harmed. Here Innovative's actions resulted in the holder's losing money

when the shares plummeted.

Duty of Loyalty and Duty of Care

Does the advice from attorneys and Bankers suggest they at least made an effort and therefore may not have breached the duty of loyalty?

Under Ritter v. Stone an exculpation clause will not protect directors if they "consciously disregarded" their duties as directors. Here the shareholders can argue that the directors of Innovative made false representations, acted in bad faith and made irrational decisions in deciding to sell its crown jewels to Fast. This is especially true when Innovative could have initially sought an injunction against Fast for failing to make disclosures. The shareholders could make an argument that the directors of innovative breached both their duty of loyalty and their duty of care. Claims of breaches of the Duty of Loyalty and the Duty of Care are usually brought as derivative actions on behalf of the company. Here shareholders would have no trouble meeting the burden required in Delware to obtain a "Demand Excused".

Insider Trading

Rule 10b-5 prohibits any deception, fraud or manipulation in connection with the sale or purchase of securities. Rule 10b-5 covers insider trading and affirmative misreprsentations. Here Innovative may be liable for insider trading. Insider trading is the sale of shares based on non-public information. Innovative decided to sell a large block of stocks to Lucky based on the fact that Fast was planning to acquire innovative. Such information is material if a reasonable investor would find it important in their decision to buy or sell the stock. The SEC will be able to bring a claim against Innovative howeve shareholders will likely not since they did not buy

or sell in conneciton with the misrepresentation.

END OF EXAM