

BUSINESS ORGANIZATIONS COURSE MATERIALS

PART 2: PUBLIC CORPORATIONS

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UNDERSTANDING THE FINANCIAL CRISIS (1/09)

Professor Johnson

I. Banks (e.g. Bank of America) vs. Investment Companies (IC) (e.g. Merrill Lynch, Lehman Brothers)

Banks and investment companies make money by taking money deposited in their accounts by depositors (consumers for banks) or investors (investment companies) and then lending it to others and or investing it in different markets and/or businesses.

Banks charge fees and interest on loans; IC charge commissions for investment and seek a return on the investment (ROI) for investors. Depositors earn a nominal interest to keep their money in the bank and debtors are charged a higher interest to borrow. Usually, the loans banks make have limited risk because they have to protect the depositors. To help them the FDIC will insure the deposits up to \$100,000. IC will ensure their accounts too, but they assume more risk for the possibility of a greater return.

Banks are liquid in that depositors are always depositing money in or taking money out. If you leave your money in, you earn interest paid by the bank. If you take it out prematurely, CD, you are charged a prepayment penalty. Banks use the cash to keep their operations flowing.

Investment co. don't have depositor accounts so if their investments don't make money, or their investments are nonperforming, e.g. company default on loans, then the company doesn't have cash to operate. Many of them will engage in short term borrowing to cover any shortfall in their operations.

Because of the defaults in the mortgage loans and persons withdrawing money from their accounts or not investing, investment companies are in a money crunch. In addition, to the extent foreclosures are on the rise, banks are not being repaid their obligations. As a result, IC are not liquid.

If you are insolvent, you have more liabilities than income so cannot borrow because you become a bad risk. As a result, people lack money to buy goods and services because credit is unavailable.

Proposal: Allow IC to have depositor accounts to increase cash flow.

II. Role of Confidence in Performance in the Stock Market

Stock market rises and falls based upon person's perceptions of whether the market will rise or fall. When persons lack faith in the market, then they do not invest and they don't buy, companies don't have people buying their stock or goods, companies start laying off persons, who become unemployed so they can't afford to buy anything and economy goes down because there is no circulation of money.

Investment typically follows a herd mentality. If a few key persons invest, e.g. Warren Buffett, then people will follow suit because they want to jump on the band wagon. However, Ponzi schemes designed to use money from new investors to pay off earlier investors until the scheme collapses have resulted in investors losing billions of dollars worth of savings, retirement portfolios and discretionary income. Massive layoffs of entry level and mid-level workers, coupled with investment losses means that many people aren't spending money,

investing, or making charitable contributions, which has strained most markets and sent a ripple effect to other industries.

Assumption: Government purchasing the bad debt will restore confidence in the market and people will begin investing again.

III. Buying Assets vs. Stock

You can buy the assets of a company or buy the stock. If you buy the assets then you use them for their intended purpose but have no interest in the company. If you buy the stock, then you become an investor and are entitled to share in the profits and losses. There are no guarantees, but if it does well, then you make money. If not, then you lose your investment. The key issue is the level of risk.

Proposal: In the first bailout, President Bush proposed to have the government buy the nonperforming assets (bad mortgage debt). The problem was that it is similar to purchasing the assets, but in this case, the government was purchasing nonperforming assets, reducing the likelihood that the government could recover. Congress wanted the government to invest in the troubled companies so that when the companies became profitable, the government would receive the money invested back.

IV. Executive Compensation (e.g. severance and retirement pay as deferred income)

Executives are paid salaries and can get fringe benefits, e.g., bonuses and deferred, retirement, severance compensation that can often exceed their salary. Ideally, their entitlement to receive these benefits is tied to their performance, although it does not have to be. If the company does not have the money to pay, then it becomes an obligation of the company and the executive becomes the creditor.

Proposal: Eliminate additional compensation to executives whose actions may have caused the problem in the first place.

V. Impact on Global Markets

Foreign companies and governments invest in US markets, just as US invests in other markets. These companies may buy stock or buy assets, e.g. mortgage loans in bulk at a discount. They can foreclose on these obligations if they become nonperforming, or if they have invested, can take over the company and dictate policy on how the company will go forward. That means foreign companies having a greater say in US economy. US has traditionally resisted such attempts.

US economy in global markets is based upon the strength of the dollar and exchange rates as compared to other currencies, e.g., euro-European countries, peso-Mexico and many Spanish companies, and yen-Japan. When the dollar is strong, a US person can buy more; when it is weak, then it costs more to buy goods. That is why when you vacation in a country that has a better exchange rate, it costs more to buy the same goods.

Proposal: Congress wants to add some protection to mortgage loans so that people don't lose their homes or forced into bad positions.

CORPORATE ACCOUNTABILITY

I. Factors Creating an Atmosphere of Greed and Fraud

1. Buzz of Dot coms led to tremendous investment by institutions and individuals without the earnings or assets to back it up.
2. Perceived growth of the internet caused telecommunication industry to invest in infrastructure where demand never materialized.
3. Investment community devalued the risk of new ventures, which increased perceived value.
4. Deregulation of public utilities that allowed unbundling of services, raising cost of services.
5. Masking of liabilities through Special Purpose Entities that did not appear on balance sheet as a debt. (Enron)
6. Deregulation of securities which allowed audit and consulting to be provided by the same firm, causing audit business to be leveraged to get consulting fees.
7. Analysts were promoting IPOs to high stake investors to get financial business of companies.

II. Players and Motivations

1. Issuing companies-overstated earnings to get investment.
2. Underwriters-invested money for fees with assurance of a buy-back if there was not sufficient demand.
3. Dealers and Brokers-present favorable recommendations for companies for fees.
4. Auditors/Accountants- provide favorable audits for consulting fees.
5. Attorneys-Created the legal entities that allowed masking of liabilities.
6. Executives- Took over special companies to hide company losses and received bonuses, personal loans, and windfalls from selling before market (insider trading).
7. Inside Boards- rubberstamping management decisions w/o independent investigation. Minutes being altered or changed to hide irregularities or lie by omitting critical info. e.g. in Enron, traced what happened through hand written notes taken by corp. secretary.

III. Causes of Actions

1. Self-dealing
2. Usurping corporate opportunities
3. Misrepresentation or omissions of material information
4. Insider trading
5. Misappropriation of assets for personal use

OVERVIEW OF SARBANES-OXLEY

I. WHAT ARE THE NEW REQUIREMENTS

A. Overview

1. Additional disclosure requirements on companies
2. Expands financial responsibility of CEO, CFO, and attorneys
3. New Security-related crimes
4. Increase the penalties for SEC violations
5. Increased oversight and enforcement
6. Establishes an Accounting Oversight Board to oversee and prosecute accounting firms and conduct audits of public companies

B. Officers must certify annual or quarterly reports that they have

- reviewed the report, does not contain any untrue statement of material fact or omission
- company has established internal controls to ensure material information is made known to the officers
- officers have evaluated effectiveness of internal controls w/in 90 days and included conclusions
- there are no material changes that could affect controls.

C. Prohibits executives and directors from receiving most personal loans, except home improvement, purchase, and consumer credit.

D. Create Audit Committee independent from co management to oversee and direct audit process. Will be delisted on the exchange if fail to comply

1. Title II prohibits accountants from providing consulting services simultaneously, i.e., valuation services, management functions, broker-dealer services, investment banking or legal services. Can provide tax services if approved in advance.

E. Attorneys must report evidence of a material violation of securities laws or breach of fiduciary duty to chief legal counsel or CEO. If action is not taken by attorney, then must inform audit committee. There is a proposed rule before the SEC requiring a "noisy withdrawal," i.e., if no action is taken, then the attorney must withdraw from representation and report the withdrawal to the SEC.

F. New Security-related crimes

1. Violation to alter, destroy any record to impede or obstruct or influence investigation. SEC may impose a fine + up to 20 years in prison
2. Attempts to commit criminal fraud under mail fraud, wire fraud, bank fraud, health care fraud is a violation—5 years in prison
3. Felony to retaliate vs. whistleblowers (have to disclose to a member of Congress and action has to be taken—limits imposed by Bush via EO)

Three Basic Points re Public Corporations

- 1) Major differences between close corp or C corps and public corporations relate to the size, revenues, secondary market for the shares, and the respective roles of directors and officers over shareholders, who play a nominal role. The SEC provides greater oversight of public corporations.

- 2) The registration requirements for taking a company public are governed by the SEA of 1933. The intent of SEA of 1933 is to provide potential investors (who are not insiders) with full and detailed disclosure of information. Exemptions apply based upon the qualifications of the investors, the amount of the offering, or the residence of the persons to whom the offering is made.

- 3) Public corporations must comply with both federal securities regulation and state blue sky laws.

Securities Act of 1933
Securities Act of 1933 - General Provisions

Requires full disclosure in offering documents.

Relates to purchase and sale of securities through interstate commerce or mails via offering or solicitation. Applies only to initial offerings.

- 1) Must file registration statement prior to solicitation. Sect. 5
- 2) Violation to make misrepresentations or omissions in the offering statement (includes fraud) Sect.12, 17
 - Imposes liability on the issuer in favor of the purchaser for consideration paid less any income received
- 3) Issuer must disclose the consideration to be paid in any offering
- 4) Sect. 5 applies only to issuers, underwriters, or dealers involved in a public offering
 - N/A if fall within the exceptions under Regulation D or Intrastate exemptions and no solicitation, file notice with the SEC, and transaction involves offers solely to one or more accredited investors.

Definitions Under Securities Act of 1933

- 1) Underwriter: Any person who has purchased shares with a view toward further distribution.
- 2) Issuer: Corporation whose shares are being offered or any person controlled by the corporation or acting on its behalf.
- 3) Dealer: Person who acts as an agent, broker, or principal part or full time in the business of offering, buying, selling, or dealing in securities issued by another.
- 4) Accredited investors: Banks, Insurance Companies, Investment Companies, Business Development Companies, Employee Benefit Plans are usually subject to statutory requirements.

REGULATION D :

Regulation D is a private offering safe harbor exemption to the registration requirement under Section 5 of the Securities Act of 1933 (SA). And although an issuer that satisfies one or more of the exemptions provided by Regulation D, the issuer remains subject to all of the anti-fraud provisions of other federal and state securities (“blue sky”) laws. As a result, the following is a very simplified overview of certain of the applicable exemptions.

Regulation D was adopted by the Commission in 1982 as a safe harbor for “private placements.” It provides an issuer of securities three possible exemptions from the registration requirement. The exemptions provided under Regulation D are:

Rule 504	- offerings of up to \$1 million in any 12 month period
Rule 505	- offerings of up to \$5 million in any 12 month period
Rule 506	- offerings with no dollar limitation

Before undertaking an exempt offering of securities, the issuer will need to examine which one or more of the three exemptions provided by Regulation D can be utilized for the planned offering and sale of the issuer’s securities. Section 502 provides the factors to consider to determine if two or more offerings will be integrated and considered one offering.

- 1) Accredited investors include banks, Savings and Loan, directors or officers of the issuing company; and persons with a net worth that exceeds \$1,000,000; or an individual with an individual income of \$200,000 for the last 2 years, or a joint income of \$300,000. (Accredited investors are defined in Rule 501(a) of Regulation D and specifically excluded from being counted in any offering conducted under a claim of exemption pursuant to Rule 504, 505, or 506 of Regulation D.)
- 2) Offerings of less than \$1,000,000 during any 12 month period¹ and where the issuer need not comply with any disclosure requirements. (Rule 504).
- 3) Offerings to up to 35 persons AND the total offering* does not exceed \$5,000,000 in any 12 month period (Rule 505) provided that no officer, director, affiliate, or agent of the issuer is a “bad boy” within the meaning of Rule 262 of Regulation A.
- 4) Offerings to up to 35 investors with no dollar limit so long as all of the investors are sophisticated, i.e. knowledge and experience capable of evaluating the merits and risks. (Rule 506)

An issuer that claims that an offering is exempt from Section 5, has the burden of proof. All of the securities sold in offerings under Rules 505 and 506 must contain a restricted securities legend restricting their resale. Securities sold in a Rule 504 offering may be issued without a restricted securities legend provided that certain state registration requirements are met. Even if an offering fails to meet any of the above exemptions, it may still meet the requirements of the statutory Section 4(2) exemption. The latter is today widely used primarily

¹ The Commission amended Rule 504 in 1999 such that a claim of exemption under Rule 504 can be undertaken in any one of three different formats depending upon the type of offerees and whether the offering is registered under state securities law in the state or jurisdictions wherein the offering is conducted. Both Rule 504 and Rule 505 were adopted pursuant to Section 3(b) of the Securities Act of 1933 and thus they are subject to aggregation rules.

in venture capital transactions and as a “residual claim of exemption” where an issuer has otherwise failed to fully comply with one or more other exemptions.

*Note that the total offering limitation will be affected by whether the transactions are construed as part of the same integrated plan or different transactions.

FEDERAL INTRASTATE EXEMPTION

There is also an Intrastate Offering Exemption. Section 3(a)(11) of the Securities Act of 1933 is a statutory intrastate offering exemption which was part of the original provisions of the Securities Act of 1933 so as to allow offerings that are “purely local” in character to be conducted without the burdens of Section 5 being imposed on the issuer. Subsequently and to bring greater certainty to claims made by issuers that their offering was an intrastate offering, the Commission adopted Rule 147 which is a “safe harbor” for the intrastate offering exemption.

While both Section 3(a)(11) and Rule 147 offer an issuer an exemption from the registration requirements imposed by Section 5, if an issuer complies with Rule 147 (and the specific requirements thereunder), the issuer will automatically meet the more uncertain contours of the Section 3(a)(11) statutory exemption.

Under Rule 147 and as a summary, the issuer claiming an exemption under Rule 147, has the burden of showing that all of the following exist:

1. Residency/Business of Issuer: The issuer must be a resident of and doing business within the state or territory in which all of the offers to sell, offers for sale, and sales are made. The issuer will be deemed to be a resident of the state in which it is incorporated and it will be deemed to be doing business within the state in which at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis are derived.

2. Offering Proceeds. At least 80% of the net proceeds received from the offering must be used within the state.

3. Principal Office. The issuer’s principal office must be within the same state as the offering.

4. Residency of Offerees & Purchasers. All offerees and purchasers must be residents of the same state as the issuer.

5. Resale Limitations. All of the securities sold “must come to rest” within the state wherein the offering is conducted and no resales can be made within the nine month period following the close of the offering. A restricted securities legend must be imposed on each certificate representing securities sold in the offering.

If the issuer is mistaken in its belief, however innocent and unintended the mistake, the issuer loses the claim of exemption. However, unlike offerings under Section 4(2) and Rules 505 and 506 of Regulation D and subject to compatible state “blue sky” laws, the issuer may conduct advertising and general solicitation within the state in connection with an offering conducted under Section 3(a)(11) and Rule 147. This can be a significant advantage for an issuer. Further, neither Section 3(a)(11) nor Rule 147 impose any dollar or investor head count limitations.

STEPS IN DETERMINING IF A TRANSACTION IS EXEMPT FROM REGISTRATION

- 1) Determine if it is a private offering under SA Section 4(2). Look at the use of interstate commerce, the number and type of the proposed investors, and the total dollar amount of the offering. See Question 1 of practice problems. If not, then the issuer may be found to have violated Section 5 and thereby Section 12(a)(1).
- 2) Determine if the transaction is exempt under one of the federal exemptions. Remember that an issuer bears the burden of pleading and proving that the offering met the requirements of at least one exemption. Many offerings can be conducted under more than one claim of exemption.
- 3) If an issuer conducts two or more offerings in any 12 month period, examine whether the offerings may be deemed to be one offering. Regulation D has specific aggregation rules for offerings conducted under Rule 504 and Rule 505. Where offerings are aggregated, the issuer may lose the claim of exemption for the second offering if the dollar limits or head count limitations exceed those allowed.
- 4) Offerings conducted within a 6-month period may be aggregated. Again, if the amounts are not allowed under the applicable exemption, the issuer could lose the claim of exemption.
- 5) Each offering, solicitation, and sale of a security must also meet applicable provisions of state "blue sky" laws in each state or jurisdiction where such activity occurs. Thus, even if an offering is conducted under a valid claim of exemption under federal law, it must still meet the independent tests of validity under applicable state securities laws.
- 6) Finally, even if an issuer can demonstrate that it successfully satisfied the requirements for one or more exemptions under the Securities Act of 1933 and similarly for exemptions under applicable state securities laws, the issuer's offering and sale of securities may still be successfully attacked because it violated the anti-fraud provisions of federal and state securities laws.

The above comments are only a brief and very limited summary of the general principles of the federal securities cited. There are many other provisions which deserve further examination.

GOING PUBLIC

AB Software, Inc.: A contributes \$100,000 in IP
(closely held corp) B contributes \$75,000 in IP
C contributes \$100,000
E contributes \$225,000

Total Cash= \$325,000

Assets= \$175,000

Total Capitalization = \$510,000

Cash Flow = Gross Income generated annually

What would have to happen for AB Software to consider going public?

To determine how much money they need to raise, need to consider a variety of factors, e.g., salaries, benefits, cost of goods, marketing. How long will they have to carry the business before it is profitable.

To go public, need to have \$5 million or more in assets.

Consider Exemptions: Up to \$1,000,000 w/in 12 mo.

Up to \$5,000,000 w/ 35 investors

Any amount from 35 sophisticated investors

Intrastate offering

Accredited Investors, \$1 million net worth or \$200,000 salary/yr

Assess risk, annual cash flow

Critical Terms

-Capitalization-Amount received from selling securities

-Valuation- projected cash flow

-Earnings-Net cash flow or profits

-Assets-Tangible and intangible personal and real property (book, resale or liquidation value)

-Minimum market capitalization-cash flow x valuation factor =future income stream

**-Valuation factor- income potential discounted in present value by the risk; varies depending upon perceived value of the assets and future income potential
(highly speculative) (>risk >discount rate <value of cash flow)**

Types of Securities

Private equity, which are private investors who invest while it is private to ride it until it goes public;

Public markets (publicly held companies);

Small-mid-large cap stocks (tied to capitalization requirements);

Fixed income like treasury shares and bonds; and

Hedge funds-exotic issues, such as futures, options, warrants.

Valuation Examples

Underwriter sets the valuation of the company. There are several methods for computing including a capitalization rate tied to cash flow, or some growth factor.

Under the cash flow valuation, assume that AB Software is likely to have a consistent permanent stream of cash flow. The present value of the stream is equal to the reciprocal of the interest rate multiplied by the payment: Present value = Payment x 1/discount rate (See Table Below)

RULE OF THUMB: The higher the risk, the higher the discount rate, the smaller the multiplier and the lower the value placed on cash flow. As a practical reality, it is hard to determine a reliable discount rate.

Discount Rate	Capitalization Rate
100%	1
50%	2
33.33%	3
25%	4
20%	5
16.66%	6
12.5%	8
10%	10
8%	12.5
7%	14
6%	16.7
5%	20

AB Software estimates that future cash flow is \$120,000/year with a discounted rate of 10% then the business is worth \$1.2 million (120K x 10).

AB Software estimates that future cash flow is \$90,000/year with a discounted rate of 10% then the business is worth \$900,000 (90K x 10).

If the business is considered riskier, and the discount rate is 20%, then company is worth half as much, (5 x \$100,000) \$500,000.

QUESTIONS RELATED TO SECURITIES EXCHANGE ACT OF 1933

Over the last five years, AB Software Store has diversified and grown into a full service office computer hardware and software store (similar to Fryes). Andrew and Bob are still involved with the C corporation that was ultimately formed to run the business. They are now interested in franchising their stores across the country. George, Henry and Ivan are friends of Andrew and spend the weekends playing golf. They decide to create a new corporation in the state of Somewhere as their corporate headquarters. George, Henry and Ivan each decide to invest \$150,000 in the new company for a total of 75,000 shares at no par. George will oversee the franchises; Henry and Ivan will be passive investors. All are experienced investors and have had moderate success.

QUESTION 1: Has AB Software Store violated Section 5 of the SEA of 1933 in failing to register when issuing stock to George, Henry and Ivan.

QUESTION 2: Henry and Ivan are residents of Somewhere. George is a resident of Nowhere, although he promises that he will be subject to the jurisdiction of Somewhere. Is the issuance of stock to Henry, Ivan and George exempt under 3(a) governing intrastate offerings?

QUESTION 3: If, as a way to avoid the SEC requirements, Henry and Ivan agreed to buy the shares and then resell a portion of the shares to George, Will exemption 3(a) apply?

QUESTION 4: After 5 years of operation, AB Software Store becomes a huge success? They now want to expand to allow persons to purchase their products on-line through international distribution networks. They need to raise \$3 million, by selling 300,000 new shares at \$10/share to friends and a group of venture capitalists who are interested in this kind of business. Many of the investors will be from different parts of the country.

a. AB Software expects to raise \$3 million by selling to 40 investors: 10 of whom have a net worth of over \$1 million; another 10 have incomes of over \$200,000; another 10 are experienced software programmers and equipment vendors; and the last 10 are family and friends. Will Regulation D apply to exempt the transaction from SEC registration?

b. AB wants to use Rule 505 to avoid SEC registration. It places a solicitation in a computer trade publication. The only respondents are institutional investors. Is the solicitation exempt?

c. AB wants to use Rule 505 to avoid SEC registration. It sends out letters to 50 investors that it knows who have in the past expressed an interest. Some of the respondents are not accredited investors. Is the solicitation exempt?

QUESTION 5: After 10 years of operation, AB Software wants to acquire several existing competitors and consolidate its operations. Over the next 3 years, it proposes to raise \$3,000,000 in round 1 during year 1, \$3,000,000 in round 2 during year 2, and \$2,000,000 in round 3 during year 3. During year 1 the corporation raises the \$3,000,000 from accredited investors; in year 2 the corporation raises the \$3 million from 35 persons; in year 3, the corporation raises \$2,000,000 from 100 members of the general public. Is this offering exempt under Regulation D?

QUESTION 6: If the corporation raised the money in three separate transactions that were authorized at the beginning of each year, would your answer change.

BASIC CONCEPTS

DUTIES OF DIRECTORS AND OFFICERS TO THE CORPORATION AND SHAREHOLDERS

Duty of Care	Obligation	Violation
Care	Reasonable investigation; Reliance; and honest error	Negligence, Waste Recklessness-Insider trading
Loyalty	Full and complete disclosures; non compete	Self-dealing Usurping corporate opportunity Interested transaction Insider trading
Good faith	Absence of ill-intent; Reasonable care, prudence	Bad faith, Fraud, Insider trading

DIRECT VS DERIVATIVE ACTIONS

Direct action: Action brought by a shareholder against the corporation or a purchaser or seller. Remedy goes to the individual.

Derivative action: Action by a director or shareholder on behalf of a corporation against a director or board for breach of duty. Corporation is named as a defendant, but the remedy goes to the corporation, not an individual.

BUSINESS JUDGMENT RULE

Insulates directors from liability for their business decisions. BJR does not apply to interested or self-dealing transactions unless the decision is made by directors who are disinterested after full and complete disclosure. If all directors are interested, then board can appoint a committee or go to shareholders.

Arises in four situations:

- 1) Exercising reasonable care in performance of duty of care, loyalty and good faith. Includes reasonable reliance on experts such as lawyers, accountants, and honest error. Full disclosure and investigation required.
- 2) To approve or ratify the transaction after the fact.
- 3) Whether to pursue a derivative action against a director for actions or inactions that may be harmful to the corporation. Directors must be disinterested and given full and complete disclosure. If all directors are interested, then can appoint a committee or go to shareholders.
- 4) Whether to dismiss a derivative action brought by a shareholder without demand (on the basis that demand is futile).

Disinterest is presumed by directors even though they may incur liability as directors, may be related or affiliated with the decision maker, own stock or have a financial interest in the corporation. There must be a personal stake in the particular transaction.

THREE POINTS REGARDING DIRECTOR'S DUTY

1. A derivative action can be brought by a shareholder or director on behalf of the corporation for a breach of duty to the corporation. To bring a derivative action, a shareholder must first make a demand of the board of directors, who must investigate and make a reasonable decision to consent or refuse. If the directors are interested then demand may be excused and a suit filed, or a disinterested committee appointed to investigate. The decision to bring or not to bring an action will be protected by the business judgment rule so long as the board is disinterested.
2. Interested or self-dealing transactions are not per se illegal, but do require that they be authorized, fair and/or ratified by disinterested board or shareholders after full disclosure.
3. Directors cannot usurp a corporate opportunity without first offering it to the corporation if the opportunity was discovered while working for the corporation, in the same or competing business, or in which the corporation would have an interest.

Director's Duty of Care

I. Duty: General duty of care and loyalty to refrain from negligence or imprudence.

A. Exception: Reasonable business judgment if the director acts in good faith and commits honest error, taking prudent steps to be informed.

1. π has burden re duty
2. D has burden re loyalty

II. Liability: Director is personally liable for direct and proximate losses suffered by corporation and extends to all directors who have knowledge of, participate, acquiesce or ratify the action.

A director is liable if it is an illegal action, despite good faith or if negligent (should know & don't).

III. Defenses:

1. Reliance on expert advice, or excused or nonhabitual absence from meeting.
2. Age, experience, industry are considered to establish reasonable standard.
3. Unanimous shareholder ratification.

IV. Interested Directors: Director is liable to corporation if there exists a conflict of interest or personal interest, and transaction is not authorized, disclosed or fair.

1. If a majority of directors are interested, shareholders may authorize action.

2. Interested directors are not counted in quorum or vote unless the bylaws state to the contrary.

3. Remedies

a. Void K if no disclosure

b. Recover damage for unfair profit

V. Self Dealing: Where shareholder or director is personally involved in a transaction with the corporation and benefits at the expense of corp. or minority shareholders. Interested transaction

Test: Apply intrinsic fairness test

1) If a disinterested board or shareholders ratify then apply the business judgment rule. Burden on π to show transaction is unfair. Usually will not involve fraud, waste or serious over-reaching.

2) If the transaction is fair to the corporation based on motives of director and effect on corporation, then transaction may be valid. Burden on Δ to show fair. (Usually there has not been ratification by the board or shareholders) Marciano

3) If interested director is required for quorum and participates in meeting but does not vote, then apply intrinsic fairness test. (Usu. where all directors are interested).

Self-Dealing Rules of Thumb

- 1) If a court believes the transaction is fair, it will be upheld.
- 2) If the transaction involves fraud, overreaching or waste of corp. assets, it will be set aside.
- 3) If it doesn't involve elements in (2) but court is not sure it is fair, then it will be upheld only where Δ can show transaction was approved or ratified by a truly disinterested board without participation by interested party after full disclosure of material facts.

Review Questions on the Business Judgment Rule in Derivative Actions and Self-Dealing

Question 1: AB Auto Corp is a publicly held corporation under the laws of Somewhere, that follows the MBCA. The company manufactures automotive parts. Last year, AB's board approved a \$5 million loan to Auto Interests Committee, a lobbying entity whose interests are to protect the rights of auto makers. The committee was organized by Andrew Jr., nephew of Andrew, who is a majority shareholder of AB Auto Corp. Andrew controls the board, even though Bob has a guaranteed seat on the board. There are currently two vacancies on the board. A meeting is scheduled to elect new directors. An accounting showed that a lot of the money was used to pay the organizers and for travel expenses. The loan is now delinquent and Bob's wife, Carla, who is now a minority shareholder wants the corporation to take action to collect on the debt.

- a) Does Carla have to make a demand of the shareholders of AB Auto Corp?
- b) Does Carla have to make a demand of the board of directors?
- c) Advise Carla on whether she should make a demand first or file suit.
- d) Assume that Carla does not make a demand on the board but files a derivative action. What must the corporation do in response?
- e) If they elect to appoint an independent committee to investigate, and the committee in consultation with outside counsel votes not to proceed with the litigation, what should they do and what will be the likely response from the court?

QUESTION 2: If Andrew owns 95% of the shares of a corp. (disregard if it is publicly held or close 'cause the rules are the same), and the remaining 5% is owned by family members.

- a) Can Andrew elect himself president?
- b) Is it a breach of fiduciary duty?
- c) Can Andrew decide to pay himself a \$500,000 salary? What test will be applied?
- d) What if Andrew was not a majority shareholder and the board approved the compensation plan? What test will be applied?
- e) What if he redeems his shares at slightly above the market (but reasonable) but does not allow the 5% shareholders to do so? What test will be applied?
- f) What if a dividend is paid proportionately to everyone but the amount is based upon the money lost by Andrew in gambling debts?

QUESTION 3: Directors of AB Corp. offer to sell to the corporation a piece of land owned by a family trust for a high price. What standards are applicable?

Corporate Opportunity Doctrine

Director can't take an opportunity that should be offered first to corporation if the

1. Opportunity is discovered while working for the corporation (can't compete, take employees or divulge corporate information);
2. Opportunity is in the same or competing business; or
3. Corporation has an interest in opportunity.

Remedies:

1. Recover profits or force director to convey property to the corporation at cost;
2. Corporation gets a constructive trust if director has converted property to cash (profits-cost); or
3. Damages if corporate business is injured.

Defenses:

1. Disclosure to the corporation.
2. Corporation can't afford to take advantage and the director got the opportunity on same terms.
3. Opportunity is beyond scope of corporate powers (ultra vires).

Overview of Tests for Corporate Opportunity

1. Earliest test: Expectancy test focuses on use of corporation position or information to pursue an opportunity. Unless corp. has an existing expectancy or an interest based upon pre-existing plans the manager does not have to disclose the opportunity. Ask the question, but for manager's action, would the corporation have pursued the opportunity. If no expectancy, no disclosure required. Misappropriation will also apply.

2. Line of business: broader test and compare the existing and new opportunity--is the opportunity significantly related to current business that would take advantage if aware of it.

3. ALI Test combines narrow and broader test to include opportunities closely related to the corporation business. ALI encourages informed, internal decision making. Must offer to corporation and disclose conflicting interest, and board must reject via disinterested vote. If disinterested directors then apply business judgment rule, and if not disinterested, apply fairness test.

Under the ALI a corporate opportunity means

1) director becomes aware either in connection with performance as a director and should reasonably lead to believe that person offering opportunity expects it to be offered to corporation, or through the use of corporation property, OR

2) Opportunity is one that he should reasonably believe that it will be of interest to corporation ;OR

3) Opportunity becomes aware and executive knows is closely related to corporation business.

Challenging party has the burden of proof, but director must show rejection and that the taking was fair. Good faith but defective disclosure may be cured by ratification following disclosure by the board, shareholders, or decision maker who originally approved the rejection.

Application of Rules Regarding Usurping the Corporate Opportunity:

a. If there is no logical relation to the business, or corporation lacks both the financial and technical capability to pursue, then it is a non corporation opportunity as a matter of law.

b. If no fraud or breach of fiduciary duty (because full disclosure) and found not to be corporation opportunity, officer is not liable

c. If it is a corporation opportunity but no breach of duty of loyalty, good faith, and fair dealing, officer should not be liable—If the corporation votes not to take advantage after disclosure then officer or director can.

d. Presence or absence of good faith, loyalty is not an absolute defense if it is closely related.

e. Burden of proof is on D/officers or director

REVIEW QUESTIONS

CORPORATE OPPORTUNITY DOCTRINE

- 1) Director learns that the company is going to expand the plant, so he goes out and buys the adjoining land. Is that a breach under any of the tests?

- 2) If he secretly sells it back to the corporation at a profit, is that a breach?

- 3) If he is aware that the company is interested in drilling oil and leases land adjoining to the property, is this a breach?

- 4) If the director buys land adjoining the company knowing that the property values will increase as a result of the company's activities, is this a breach?

THREE BASIC POINTS RELATED TO INSIDE INFORMATION

- 1) Any person is liable under 10b5 for **intentional** use of any means of interstate commerce to **defraud**, make **material omissions or misrepresentations** or acts which tend to defraud another in the **purchase or sale of securities** in **close or public corporations**. An action may be private or under the federal statute and can result in damages that include rescission, out of pocket, and conversion.
- 2) Directors, officers, shareholders or a fiduciary who, by virtue of their position have access to confidential information, have a **fiduciary duty** to refrain from trading based upon it or will be liable for **insider trading**. Directors have an **affirmative duty** to **correct misleading information** that may be attributed to the corporation, if they have reason to know that **people are trading** based upon the information.
- 3) **Outside persons**, who, by virtue of some **special relationship**, e.g, contract (but who may not owe any duty to the corporation) get access to confidential information about a corporation and who trade on it may be liable under the **misappropriation theory**.

RULE 10 (b) 5

IN CONNECTION WITH THE PURCHASE AND SALE OF STOCK, A PERSON IS LIABLE FOR USING INTERSTATE COMMERCE OR THE MAILES TO

1) DEFRAUD;

2) MAKE UNTRUE STATEMENTS OF MATERIAL FACTS OR OMIT TO STATE MATERIAL FACTS; OR

3) ENGAGE IN ANY PRACTICE WHICH OPERATES AS A FRAUD OR DECEIT UPON ANY PERSON.

"MATERIALITY" IS BASED ON THE REASONABLE PERSON STANDARD: WHETHER A REASONABLE PERSON WOULD ATTACH IMPORTANCE OR SIGNIFICANCE TO THE INFORMATION SO AS TO INFLUENCE HIS OR HER DECISION REGARDING THE VALUE OF THE STOCK AND WHETHER TO BUY OR SELL HIS OR HER SHARES.

SUMMARY OF RULE 10 (b) 5

1) APPLIES TO PUBLIC AND CLOSE CORPORATIONS

2) DUTY TO DISCLOSE: TIMING IS KEY

--APPLIES WHERE THE PERSON SOLICITING OR USING AN INTERMEDIARY MISLEADS OR DECEIVES BY OMISSION OR MISSTATEMENT

--AFFIRMATIVE DUTY TO CORRECT A MISUNDERSTANDING

--HARM TO THE CORPORATION IS NOT REQUIRED

3) THERE IS AN AFFIRMATIVE DUTY TO DISCLOSE REQUIRED:

a) IF UNDISCLOSED INFORMATION RENDERS PREVIOUSLY DISCLOSED PUBLIC STATEMENTS BY CORPORATION MISLEADING (E.G., PROPOSED MERGER)

b) IF CORPORATION HAS REASON TO BELIEVE INDIVIDUALS ARE TRADING BASED ON MATERIAL INFORMATION NOT DISCLOSED (E.G., DROP IN NET EARNINGS)

c) WHERE RUMORS ARE CIRCULATED IN THE BROKER COMMUNITY THAT ALTHOUGH INCORRECT, ARE ATTRIBUTABLE TO THE ISSUING CORPORATION

UNDERSTANDING THE CONTEXT OF 10b5 REGULATION

Anti-fraud statutes have evolved over the years to respond to specific facts raised by case law. Securities and Exchange Act of 1934 is the general statute under which actions are brought pursuant to authority under 10b. The theories of liabilities have been expanded by federal and state case law to include common law theories of insider trading (liable to corporation per derivative action Diamond- no harm to the corporation is required) and misappropriation (common law doctrine codified by state law). Apply the theory and elements that best suit the facts.

Anti-fraud statutes include Federal laws, i.e., 10b5, 16b, 14e-a (tender offers), Wire and Mail Fraud, RICO; State laws, i.e., blue sky, trade secret laws, anti fraud laws; and common law doctrine, i.e., fraud and misappropriation.

1) COMMON LAW TORT OF FRAUD OR DECEIT-Still in effect. Elements include 1) material misrepresentation of material fact; 2) that insider knows is false or is reckless; 3) and intends that the other person rely upon it; 4) actual reliance; and 5) actual damages.

2) SEC ACT OF 1934-Anti-fraud statute-applied to sales of stock only.

3) 10B5- enacted in 1942 to cover presidents buying stock in their companies. It is applied to buying and selling and authorized the SEC to act. This gave rise to a duty to act.

--Elements developed via case law: in connection with a purchase and sale (Blue Chip), intent to deceive or defraud (Ernst), material fact or omission (Basic), and manipulative practices (Sante Fe)

--Most common facts are when information is disclosed to the public that impacts on value of stock--10b5 violation gives rise to an affirmative duty to disclose, refrain from trading, or damages if have traded.

--10b5 implies a private right of action to bring an action, so it is not just limited to SEC.

--Fraud on the Market-created a rebuttable presumption that if information is material, reliance is presumed; focus on reasonable significance placed on the information. Basic

4) Insider Trading is an outgrowth of 10b5. Arises in two contexts:

a) CLASSIC INSIDER TRADING: where an insider uses trades based upon nonpublic information about his or her corporation which is obtained in their corporate capacity. Arises out of the relationship to the corporation. Tipper/Tippee

b) OUTSIDER TRADING: where an outsider is trading on misappropriated information about another corporation. There may or may not be a relationship but there is access.

10 (b) 5 REMEDIES

- 1) RESCIND CONTRACT: IF STOCK WAS NOT RESOLD; USUALLY IN FACE TO FACE ENCOUNTERS.
- 2) RESCISSION DAMAGES: IF STOCK IS RESOLD; DAMAGES = BUYER'S PROFIT (PRICE BOUGHT STOCK - PRICE SOLD STOCK).
- 3) OUT OF POCKET DAMAGES: DIFFERENCE BETWEEN PRICE YOU BOUGHT OR SOLD STOCK FOR AND WHAT STOCK IS WORTH.
- 4) COVER OR CONVERSION: DIFFERENCE BETWEEN THE PRICE PURCHASED AND THE MARKET PRICE AT WHICH YOU COULD SALE OR REPURCHASE ONE FRAUD IS REVEALED; DUTY TO MITIGATE.
- 5) NO PUNITIVE DAMAGES IN 10 (b) 5; MAY BE AVAILABLE IN STATE STATUTES

EXAMPLE OF 10(b)5 DAMAGES

Lizzy publicly reports that the sales of a new product produced by a corporation will be disappointing. At the time the stock is trading at \$25/share, although the stock would normally trade at \$27/share if the potential were known.

After the bad news, the stock falls to \$20/share and Gullible sells to Lizzy. Later, rumors circulate that Lizzy's announcement is overly pessimistic and the stock rises. Lizzy sells at \$28. Eventually, Lizzy's prognosis is determined to be false and the stock jumps to \$31/share.

Gullible sues Lizzy. At the time of the suit, the market price is \$33/share.

What are the remedies?

IN RE ENRON (SD TEXAS 2002)
Summary

ALLEGATIONS: Enron made misrepresentations about firms manipulations by:

1. Not consolidating illicit special purpose entities into the statements in financials to properly reflect reduced earnings;
2. Improperly accounting for stock issued to a related-party that should reduce shareholder equity, but was identified as a note receivable;
3. Characterizing loans as forward contracts to conceal debt;
4. Improperly accounting for long-term debt;
5. Failing to record write-downs for impairment of value in investments;
6. Failing to record \$92 million in proposed audit adjustments from 1997-2001;
7. Failing to disclose related third party action;
8. Misstating debt-to-equity ratio relied upon by rating entities.

HOLDING: Court found sufficient grounds to establish intent under 10b5 against:

- 1) Citigroup and other banks as primary violators of 10b5;
- 2) Law firm (Vinson & Elkins) for participating in an ongoing Ponzi scheme and deliberately and with severe recklessness directed public statements that were designed to keep the scheme alive; and
- 3) Arthur Andersen, accounting firm for being intimately privy to the smallest details of Enron's alleged fraudulent activity and audits.

RULE: A private action under Rule 10b and 105 can be made against parties as primary violators who engage in a Ponzi scheme, pyramid scheme to use money from new investors to pay off earlier investors until the scheme collapses, or repeated practices that show intent to defraud or recklessness of action in exchange for personal or monetary gain.

EFFECT: Suggests that while there is no private action for aiding and abetting, a private action does exist under 10b5 as a primary violator where the requisite intent to deceive is found.

TEXAS GULF CHRONOLOGY

Trading was at \$11

- Oct 1963 TCG discovered anomaly. Stephens said keep quiet
- Nov. 8 When drilling began, stock closed at \$17 3/8
- Nov 12 K-55-1 completed and samples sent out for analysis; closed at 18
Decided to acquire more land.

INFORMATION WAS DEEMED MATERIAL AS OF THIS POINT. CO ACQUIRED MORE LAND SO RELIANCE, AND DIRECTORS STARTED BUYING STOCK.

- Nov-March Stephens, Fogarty, Clayton, Mollison, Fogarty, Hoyk, Darke, purchased TGS stock or calls totaling 8235 shares and 12,300 calls. Prior to that time owned only 1135 and no calls*.

*Call is a negotiable option contract where bearer has a right to buy a certain number of shares for a fixed price before certain date. E.G. buy call for \$1 to buy at strike price of \$26/ share. Liquidate at \$58

- Dec. 1963 Results received re analysis. Stock went to 20 7/8
- Feb 1964 Stock options issued to S,F (CEO of TG- later killed w/ 4 others),M-became president after deaths, H, K (K knew nothing) Neither options committee or board knew nothing about it. All accepted
Closed at 24 1/8
- March 1964 Resumed drilling and land acquisition
Darke traded and told others it was a good buy so he was a tipper
- March 31 Reached 26 after land acquisition program completed
- April 12 Press release downplaying results, Closed at 30 1/8 and then dipped.
- April 16 Corrective announcement of Timmins discovery, price went to 37
- May Stock was selling at 58 1/4.

DISTINGUISHING INSIDER TRADING, MISAPPROPRIATION AND WILLIAMS ACT

10b5- Reaches any activity involving the purchase and sale of stock in a close or public corporation where intent to deceive or recklessness and materiality is established

Insider Trading-Type of 10b5 action that relies on breach of a fiduciary duty of an insider or tipper. Duty to disclose, correct, and refrain from trading. Includes agents, employees, directors, shareholders, attorneys, accountants, underwriters, or consultants

--Tipper/Tippee liability: Arises when an insider tells someone else. Breach of fiduciary duty and personal benefit to the tipper, both of which are known or should be known to the tippee.

Misappropriation-Type of 10b5 action that relies on a breach of a duty to the source of the information, often an employer (not the corporation).

Williams Act 14e- Any trade related to a tender offer where confidential information is used and includes conversations between tippers and tippees, a person who steals, misappropriates material non-public information, statements made by offeror to any person or 3rd person who knows information is confidential. No need to prove breach of duty for personal benefit.

Rules re Director and Officer Investments

- 1) Ok if periodic investment program already approved and simply making investments as part of plan.
- 2) OK to buy stock 1 week after annual report is issued for 30 days
- 3) May be ok for trades if contact CEO before trade to see if any info needs to be made public in the following circumstances:
 - a) after quarterly reports issued;
 - b) making wide information dissemination regarding the status of company, e.g. proxy statement re merger or action;
 - c) when relative stability in market.
- 4) Avoid 3-4 months before an announcement; prior to release of earnings, dividends - Must wait until after release of information and dissemination.
- 5) Same thing applies to stock options.
- 6) If by disclosing the information to board would jeopardize corporate security, need not reject the options but refrain from exercising them until full disclosure. Ratification after the fact may be ok.

Williams Act 14e

Imposes a duty to disclose on any person who trades in stock sought for tender offer while in possession of material information which he knows or should know is nonpublic and has acquired it directly or indirectly from an offering person, issuer, officer, partner, or employee; No duty if don't purchase or sale. 14e imposes broader liability because no breach is required.

-Establishes a specific duty to disclose or refrain from trading

-14e-3a applies to

- 1) conversations re tender offer which are nonpublic for tippers and tippees; and
- 2) extends to offering person who sends nonpublic letter to subject co. noticing a proposed tender offer at specified terms and price--management cannot purchase or sell or cause the purchase or sale per a tender offer nor can unaffiliated persons who are told by management purchase or sell;
- 3) a person who steals, converts or misappropriates material, nonpublic information (Chiarella overruled); and
- 4) if offeror tells another of intent to make a tender offer and person tells 3rd person that offer will be made and 3rd person knows or should know information is nonpublic.

TIPPER-TIPPEE LIABILITY

TIPPER LIABILITY: LIABLE ONLY IF THE TIP BREACHES A FIDUCIARY DUTY TO CORPORATION OR SHAREHOLDERS; NO BREACH IF NO PERSONAL BENEFIT IS RECEIVED

[NOTE: YOU CAN RECEIVE A BENEFIT IF YOU SPLIT THE PROFITS WITH ANOTHER OR YOUR REPUTATION IS ENHANCED].

TIPPEE LIABILITY: LIABLE IF THE TIPPER HAS A FIDUCIARY DUTY TO SHAREHOLDER NOT TO TRADE: 1) IF TIPPER HAS BREACHED FIDUCIARY DUTY BY DISCLOSING INFORMATION TO TIPPEE; AND 2) TIPPEE KNOWS OR SHOULD KNOW OF BREACH.

POST O'HAGAN RULES

1. Post O'Hagan: A relation with any fiduciary falls w/in the misappropriation and includes atty/client, executor/heir; guardian/ward; principal/agent; trustee/trust beneficiary; doctor/patient; priest/parishioner; family members in a special relation to one another (presumes person is acting as an insider/tipper, not a tippee);

2. Open questions unanswered by the case: a) if fiduciary knows the info is confidential then it creates an inference that any trading is based upon it; however, can overcome the inference by showing the absence of a causal connection (SEC v Adler-- 11th Cir 1998)

3. Safe harbor exists if the purchaser or seller has a binding contract or plan entered into before he or she is aware of the information, and the terms of the contract include the amount, price and date or some formula and no influence or discretion and demonstrates that it is pursuant to a plan whose terms have not changed.

TIPPER-TIPPEE QUESTIONS

Is there a Rule 10(b)5 or Williams Act 14e violation in any of the following scenarios?

1) Secretary or messenger overhears snippets of conversation from their superiors, while in the office and infers that a favorable development is about to occur and buys shares of his employer.

2) Person sitting in restaurant who overhears conversations at the next table, from which she infers favorable development is about to occur, and buys XX stock.

3) Reporter who attends a press conference at which a favorable development is announced and then immediately after and before the news appears on the ticker services, telephones his broker and places an order to purchase.

4) A subtippee who believes his tipper has "connections" with employees of the corporation, but is not himself employed by the corporation.

5) Is a manager who has made public comments in favor of stock, which are relied upon by public, but who has sold millions of his own, in violation of 10b5?

6. Wife of a fiduciary passes confidential information from her husband to her hairdresser.

7. Reporter gets a tip, asks their editor if they can trade, and the editor (who has the authority to make the call) says okay.

8. Director and father regularly tells son of internal actions; the son regularly trades on the information.

9. An airline steward hangs up a coat and sees papers suggesting some activity relating to a corporation. She calls her broker and buys stock. Would it matter if the papers were in a briefcase?

10. Same facts as in 9, but what if the information relates to a tender offer.

FOUR BASIC POINTS RE 16 b

1. Every 10% beneficial owner, director, or officer of a public corporation who purchases and sells their shares within a six month period will be liable under Section 16b and must disgorge any profits. The 10% owner must have a minimum of 10% before each transaction; the officers and directors must be officers or directors before the purchase and the sale.
2. To determine the damages, offset the highest sell with the lowest purchase. Losses need not be offset.
3. Section 21 allows the SEC to impose civil penalties not exceeding three times the profit or \$1,000,000 (for controlling persons) on persons who purchase and sell a security while in possession of confidential information.
4. The purchase and sale of an option is matchable for purposes of looking at the 6 months time frame, not when the option is exercised. For example, you acquire the option in Month 1, exercise in Month 10 and then sell in Month 12. The transaction is not matchable.

GENERAL RULE ON SECTION 16 (b)

ANY BENEFICIAL OWNER OF 10 PERCENT OR MORE OF THE STOCK, DIRECTOR, OFFICER, WHO BY REASON OF HIS OR HER POSITION, PURCHASES AND SALES STOCK IN THE CORPORATION MUST DISGORGE ANY PROFITS RECEIVED FROM THE TRANSACTION.

-ACTION IS BROUGHT BY DERIVATIVE SUIT OR BREACH OF FIDUCIARY DUTY SUIT.

-STATUTE OF LIMITATIONS IS 2 YEARS FROM THE DATE PROFIT REALIZED.

-MATCH THE LOWEST IN AND HIGHEST PRICE PAID OUT WITHIN A SIX MONTHS PERIOD (NOT APPLICABLE TO LOSSES).

DISTINCTIONS BETWEEN SECTIONS 16(b) AND 10(b)5

16(b)

-APPLIES ONLY TO REGISTERED CORP.

-APPLIES ONLY TO 10% SHAREHOLDERS, DIRECTORS, OR OFFICERS

-REQUIRES PURCHASE AND SALE (OFFSETTING PROFITS)

-INTENT TO USE INSIDE INFO. NOT REQUIRED (AUTOMATIC LIABILITY)

-PROFITS PAID TO THE CORPORATION VIA A DERIVATIVE ACTION

-EXEMPTION AVAILABLE

-FEDERAL ACTION

10(b)5

-APPLIES TO ALL CORPORATIONS

-APPLIES TO ANY PERSON (PURCHASER OR SELLER)

-APPLIES TO PURCHASE OR SALE

-INTENT REQUIRED

-PRIVATE ACTION OR DERIVATIVE ACTION

-NO EXEMPTION

-FEDERAL ACTION

QUESTIONS ON RULE 16b

1. AB Corporation has one class of stock and is publicly traded and registered under Section 14 of the 1934 Act. David is a director of AB. For each of the following, what is the liability under Section 16b.

a. David purchases 100 shares of AB Corp. on Feb 1 at \$10/share and sells on August 3 at \$15. AB Corp's stock price rose because it was awarded a large contract on April 1, which David knew about when he made the purchases.

b. David buys 200 shares on July 1 at \$5, sells 200 shares on February 1 of the next year at \$15/share, and then purchases 300 shares on May 1 at \$10/share.

c. David buys 100 shares on February 1 at \$10, buys another 100 shares at \$20 on March 1, sells 100 shares at \$12 on April 1, and sells another 100 shares at \$15 on May 1.

d. David buys 180 shares on February 1 at \$10, sells 150 shares on May 1 at \$15, and then sells another 100 shares at \$18 on June 1.

e. David becomes a director on March 1. Prior to this, on February 1, he had purchased 100 shares at \$10 /share. He purchases 100 shares at \$12 on April 1 and sells 100 shares at \$15/share on June 1.

f. David purchases 100 shares at \$10/share on February 1. He becomes a director on March 1 and resigns as director on May 1. He sells 100 shares at \$15/share on May 2. David had purchased in February at \$10 knowing of confidential, nonpublic developments that would raise the price in May.

2. Cheryl is an investor with a keen interest in AB Corp. She is neither a director nor officer of AB Corp.

a. Over 4 years, Cheryl accumulates 9 million (9%) of AB Corp. On February 1 she buys 5 million additional shares at \$15/share, bringing her holdings to 14%. On May 1 she sells all of her 14 million shares at \$20/share. What is her 16b liability?

b. After selling all her AB Corp. stock last year, Cheryl decides to acquire control of the company by making open-market purchases and a tender offer. She is prepared, however, to sell her holdings if another bidder offers a good price. Advise Cheryl on how to purchase and, if the opportunity presents itself, sell her stock without becoming subject to 16b liability.

Summary of Actions Against Directors

A. Actions vs. Directors, officers by corp.

- 1) If the facts pertain to taking advantage of an opportunity to the disadvantage of minority shareholders, then the principles that may apply are
 - a. Self-dealing-interested transaction
 - b. Corporate opportunity: ALI test re line of business, expectancy
 - c. Sale of control-premium
 - d. Waste of corporate assets or overreaching

2) The breach may arise out of a breach of duty of loyalty, care and good faith to the corp. The obligations will be judged based upon extent of disclosure, and disinterested approval or ratification. Apply either the intrinsic fairness or business judgment rule. Factors to be considered (defenses) are reasonableness of investigation and information provided, extent of waste, looting, or fraud and if authorized in the by-laws.

3) If the remedy is for the benefit of corporation, file a shareholder derivative action where demand must be made, or if futile-facts alleged to support. Both actions to bring an action and underlying transaction may be judged by business judgment rule. Damages are constructive trust or disgorge profits, rescission

B. Actions regarding shares-misappropriations, 10b5, 14e (Williams Act-tender offer) and 16b

1) 10b, 10b5 apply to fraud or deception per a purchase or sale of securities: intent to defraud, purchase or sale, and materiality. Reliance may be presumed if information is material or reasonable person attach importance (fraud on the market)

2) William Act applies to use of nonpublic information related to trades in a tender offer. The existence of a relationship to the source or the corporation is not required to impose liability.

3) 16b applies to officers, directors, and 10 % shareholders-purchase and sale w/in 6 months is presumed to be based on insider information. Imposes strict liability. Match the highest sale with the lowest purchase, then the next etc.

4) Action can be brought in Federal court by SEC for violation of securities laws, private person who bought or sold, the corp. under a derivative action (by a shareholder); or in state court under state blue sky laws (actions have been narrowed)

5) Remedies are rescission, rescission charge (price bought-price resold), out of pocket (purchase or sale price and what was worth), cover (purchase price - market price once disclosed); no punitive damages but penalties may be imposed by SEC

Securities Act of 1934

THREE BASIC POINTS RE PROXY REGULATION

1. Proxy solicitations and statements for public corporations relate to such matters as electing the board, approving compensation plan for directors, agree to merger, consolidation or some fundamental change in corp. structure. Solicitation must be registered with the SEC. Cannot make material misrepresentations or misleading statements, e.g.,

- 1) predictions of future market values;
- 2) impugn the character, integrity or personal reputation or makes charges regarding illegal or immoral conduct w/o factual foundation;
- 3) failure to identify document as a proxy statement, form of proxy or other soliciting material;
- 4) claims regarding the results of a solicitation.

2. In proxy fights, insurgents must disclose their identity, interest in company; securities financing arrangement, participation in other contests and understandings regarding future employment, source of funds used, purpose for which the offer is made, plans of aggressor if successful and any contracts have regarding target company.

3. Defensive tactics in a typical proxy fight include: 1) move up or postpone meeting at which board will consider the offer; 2) change the record date to minimize insurgents voting power; 3) amend bylaws to make it more difficult by increasing minimum vote required to pass.

Proxy Regulation

Relates to the use of interstate commerce to solicit proxies or consent or authorization.

- 1) Must file a registration before the broker can effect transaction on national exchange.
- 2) Prohibits false or misleading information in proxy solicitations and statement.
- 3) Proxy must be for specific: notice of the meeting and fully disclose the proposed action and options regarding voting.

Proxy Solicitation Rules

It is a violation of SEA 14a to include false or misleading material facts or omit material facts in proxy statement. The rule applies, for example, in the following circumstances.

- 1) Predictions about future market values;
- 2) Impugn character, integrity, or personal reputation; or make charges regarding illegal and immoral conduct without factual foundation;
- 3) Failing to identify a proxy statement, form of proxy or other soliciting materials; or
- 4) Claims regarding results of a solicitation.

SHAREHOLDER PROPOSALS: Governed primarily by state law, SEC 1934 implies a private action but has higher standard to overcome. Can request no action letters.

There are three categories of shareholders proposals that are submitted for inclusion: Often shareholders seek to include proposals that are designed to change policies of the corporation indirectly w/o going through the board. There is an implied private action re proxies and request from SEC for whether action is proper.

1) Corporate Governance-structure and composition of the board, poison pills (i.e. special class of stock created for a bidder that requires that the corporation redeem at a higher price if unsuccessful, or allows shareholders to acquire additional shares at a discount to dilute the value)-generally favorably treated by SEC in recent years (2001-2002 @ 55.7% approve) though management tends to exclude by 47% during the same period

2) Operational-executive compensation, production/business matters, company communications (2001-2002 @49% of proposals SEC has found includable)

3) Social/political: environmental, political, military and labor (2001-2002 @ 41.4 % included by SEC which says that most are excludable)

If management excludes proposal, then board must give shareholder opportunity to cure any defect.

General Rules:

Notice requirements are defined by Bylaws for annual and special meetings.

Proxy can allow person to vote in a specific way for or against a proposal, leave to the discretion of the board to vote shares. You can show up and defeat proxy submitted.

Expenses for proxy fight have to be borne by the person submitting the proposal. If they are successful, and take over the board, then can request reimbursement.

Can request no action letter from the SEC that the request was properly excluded.

Submit proposals within 120 days of mailing. Proposal has to be registered with SEC and identified as proxy. All of the pertinent information needs to be included.

There are word limits 500 words (2 pp)

If management collects proxies that give them authority to vote on matters within their discretion, then if a motion from the floor is made and supported by shareholders, then the board can use its discretion whether to approve or not.

Reasons to exclude Board is not required to include any proposal in a proxy re:

1. Violate state law,
2. Contrary to proxy rules,
3. Redress a personal claim or grievance,
4. Relates to operations of less than 5% of total assets,- Unrelated to co business-
5. Deals with ordinary business operations,
6. Relates to election of office,
7. Counter to proposal submitted by majority board- not required to submit conflicting proposals or duplicative,
8. Similar to previous proposals- that have failed in the past
9. Relates to specific cash or stock dividend.
10. Not a proper subject- asks that a study be conducted without compelling specific action
11. Beyond the authority of the corporation
12. Moot because the board is already doing it.

QUESTIONS RE SHAREHOLDER PROPOSALS

George presents a liquidation proposal to GPI's board and shareholders that is soundly defeated at the shareholder meeting. As the next annual meeting approaches, he wants to shake up the way in which GPI does business. Which of the following would be includable under the shareholder proposal rule?

- 1) A proposal that shareholders elect George as a new director to the board.
- 2) A resolution stating the shareholders' desire that management nominate at least two women to the board.
- 3) A resolution stating that the shareholders' desire that management nominate more women to the board.
- 4) A resolution requiring the board to prepare a report on affirmative action in the company's management training program.
- 5) A resolution urging the board to adopt a policy that GPI not sell products from countries that rely upon child labor. Although such products account for a small part of GPI's business George feels that it is immoral.

Proxy Fights

A. Usually occurs between management vs. nonmanagement where latter tries to get sufficient proxies to elect the board and gain control.

1. Management has leverage since
 - a) It has a copy of shareholder list;
 - b) It can finance the cost of solicitation from the corporate assets; and
 - c) Shareholders often have management bias.
2. Insurgents must have deep pockets since they
 - a) Must go to court to get shareholder list;
 - b) Must finance cost of solicitation from outside funds; and
 - c) Usually buy up sufficient number of shares at premium to sway vote.

B. Process - Conventional Proxy Fight

- 1) Insurgent secretly buys up block of stock
- 2) Insurgent goes to court to get shareholder list
 - usu. gets it at the time management mails out its solicitation
- 3) Solicit votes from large individual or institutional shareholders

Proxy Fight Requirements

Filing Requirements

Insurgent must disclose

- 1) Identity
- 2) Interest in corporate securities
- 3) Financing arrangement
- 4) Participation in other contests
- 5) Future employment with corporation

Defensive Tactics

- 1) Move up or postpone meeting
- 2) Change record date
- 3) Amend bylaws relating to the terms, voting, and the number of directors

ELEMENTS FOR PROXY FRAUD-SEC 14 a-9

1. Misrepresentation or omissions, include opinions, motives and reasons are actionable unless you can show speaker believes the opinion is correct, or there is a basis for making the opinion, and speaker knows nothing to contradict. (Va. Bankshare)
2. Materiality establishes reliance, so reliance need not be specifically proved. (TSC) Materiality is an objective standard that a reasonable person believes that the event will likely occur and attaches importance to it.
3. Loss Causation- “Essential link in the transaction,” so vote is necessary and transaction has harmed the shareholders. (Va. Bankshare)
4. Intent- not required. Negligence is enough if the transaction has resulted in a loss.

TYPES OF TENDER OFFERS

TENDER OFFERS/TAKEOVERS: Uses proxy solicitation and statements in addition to tender offer to gain control. (Williams Act 14e, SEA of 1934, 10b, 16b)

1. Cash Tender Offer- Buy shares at a premium, usu. 15-20% above market

2. Two-tier acquisition or front end loaded-partial cash offer with subsequent offer to buy at less favorable rates, 2nd offer is to mop up and set up to compel shareholder to accept the terms, e.g. offer securities; Not used widely.

3. Exchange offer--offer includes a stock swap, i.e. exchange of stock in one company for stock in another or includes case and stock swap package of its own securities--cash debt and equity

4. Leveraged buyout-purchase with borrowed money. It is a variation on two-tier offer where acquirer (mgmt., another corporation, or raider) buys all or most of outstanding stock of the target at a premium for an amount that is financed through short-term bridge loans, or low-grade high interest debt such as junk bonds; with a "cash out" or mop-up for the remaining. Repayment of the debt becomes the obligation of the target company and is paid off over time.

--The new debt may be satisfied by selling off divisions of the old company, reserves, or cash flow. If can cover debt, then the corporation has successfully leveraged debt to buy, if not then it goes into bankruptcy as overextended (insufficient cash to cover debt). All transactions must be made at arms length and subject to rules on self-dealing, corporate opportunity, and 10b.

Remedies for Various Actions

1. Regulation D: register for IPO, exemptions: SEC can deregister a company, require amended S1 form with corrected information; cancel or terminate the offering; and impose fines on co or principal persons where trading has occurred = to 3 times the profit or \$1,000,000.

S1: registration is effective 20 days after it is filed

-Regulation 230.502 Requires that securities must be registered before they can be resold after initial purchase.

2. Preemptive right of the company to acquire shares does not apply to stock given as compensations per MBCA Section 6.30 (b)(3). Does apply to options as well as stock purchases.

3. Violations of fiduciary duty: Fired if officer, removed from board; turn over profits or constructive trust on assets.

4. Insider trading: Civil penalties under 10 b, private direct action for damages; derivative action for breach of duty, Section 21 provides SEC can impose penalties can be 3 times profit or loss avoided OR vs controlling persons \$1,000,000 or 3 times profit. Removed from the board

-duty to disclose or correct public statements

5. Proxy regulation: Failure to comply with the rules can result in excluding the proposal, or request No action Letter, i.e., SEC will take no action vs the company. Enjoin meeting, file corrected statement, invalidate vote.

-request for proxy list- response w/in 5 days and include list of no. holders, type and class of stock, and cost of mailing.

-(if hostile action) or board refuses to include then can sue for the list and send out information to shareholders. Must front the cost but if successful, will control the board and can seek reimbursement.

6. Shareholder proposals- Only 1 proposal/shareholder. Proposals have to be received within 4 mo OR if the date has moved by more than 30 days then within a reasonable time.

7. Exclude proposals that include false or misleading information.

8. Regulation FD (Fair Disclosure)- if make selective disclosure to analysts privately, then must publicly disclose the information. Disclosure via press release, wire service, email is required if intentional then simultaneously, or unintentional then make prompt disclosure. Can also file statement with SEC.

-if the information was included in a public statement, e.g. annual report then not material non-public, BUT if you change what was included in statement so private info would change then may require disclosure.

-will not alone result in a 10b5 violation

-innocent snippets that aren't material but allow a professional to figure it out may not be a violation.

9. Sarbanes-Oxley- Outside auditors must disclose non audit services rendered and that cannot provide audit and other non-audit services.

-Services must be pre-approved by corporate management and audit committee. Accounting firms cannot provide book-keeping, accounting, and financial statements, fairness opinions, management functions, legal services and expert services.

10. Audit committee must have procedures for protection of whistleblowers and engage independent legal counsel. Sect 301.

11. CFO and CEO must certify financial statements that contain no material false statements or omissions. That would render financial statements to be misleading.