BUSINESS ORGANIZATIONS
Statutes, Problems, and Cases (Second Edition)
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ELECTRONIC SUPPLEMENT

EXPLANATION

This electronic supplement (PDF document) contains the following parts:

- An entirely rewritten version of **Chapter 15: The Securities Act of 1933**, beginning on page 5 of this supplement. This chapter entirely replaces the chapter 15 that is in the physical textbook. A lot of developments in securities law happened between 2017 and 2021, so I thought it best to give you a rewritten version of the entire chapter.

- A supplement to **Chapter 16: Insider Trading**, beginning on page 109. This supplement contains a new U.S. Supreme Court case concerning insider trading.

- A chapter that is not in the physical textbook, **Chapter 17: Publicly Traded Corporations**, beginning on page 116. Please note that the information in this chapter is only current through 2016. My next project is to update this chapter!

- A **Practice-Question Appendix,** beginning on page 188. This appendix contains more than 350 practice multiple-choice problems and detailed explanations.

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CHAPTER 15
THE SECURITIES ACT OF 1933

This chapter primarily concerns the federal Securities Act of 1933 (the "Securities Act" or the "1933 Act"). It is important to remember that each state also has a securities statute and that federal law only partially pre-empts these state "blue sky" laws. Nonetheless, we will be spending the bulk of our time in this chapter discussing federal law, for two reasons. First, federal law obviously applies everywhere in the United States. Second, with some notable exceptions, most state securities laws are modeled, at least in part, on the federal laws. Thus, understanding federal securities laws will give you a good foundation for understanding most of the state securities laws that you may encounter in practice.

§ 15.01 WHAT IS A "SECURITY"?

The logical place to start our discussion of securities law is with the question: what is a "security"? Clearly, if an item is a "security" then the securities laws will apply to it, whereas if something is not a "security" then the securities laws will not apply to it. That was not something that you needed a textbook to tell you, but it is important because if a lawyer gives advice with respect to something without realizing that it is a "security," then she not only will have an unhappy client (who may be in a great deal of trouble) but she could be looking at malpractice liability as well. In short, the stakes can be high with securities laws; they are very "plaintiff friendly" and non-compliance with them could even send your client to jail in an extreme case.

What do you think of when you think of a "security"? (No, this has nothing to do with your Secured Transactions course.) The two items that are most likely to spring to mind are found in the common phrase "stocks and bonds." Certainly, stocks and bonds are considered securities, but there is a much longer list of things that are securities. Let's start by taking a look at how the statute defines a "security."

Section 2(a)(1) of the Securities Act provides that, "unless the context otherwise requires,"

> [t]he term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security",

> or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

That is a pretty long list, but you should note that, to allow the statute to respond to developments in the financial world, Section 2(a)(1) provides that "any interest or instrument commonly known as a 'security'" will be considered a security. Wall Street is nothing if not creative; it is continually inventing new financial products, many of which could not have been imagined in 1933.

A. STOCK

One of the things on the statute's list of securities that should be familiar to you is "stock." After all, we've spent several chapters of this textbook discussing stock and the rights of shareholders. But does the statute's inclusion of "stock" mean that something that is called "stock" is *always* a security? Not necessarily. In *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), the Supreme Court considered whether shares of "stock" in a nonprofit housing cooperative in New York City called Co-op City (technically named Riverbay Corporation) were "securities."

As the Court explained the facts of the case:

> To acquire an apartment in Co-op City, an eligible prospective purchaser must buy 18 shares of stock in Riverbay for each room desired. The cost per share is $25, making the total cost $450 per room, or $1,800 for a four-room apartment. The sole purpose of acquiring these shares is to enable the purchaser to occupy an apartment in Co-op City; in effect, their purchase is a recoverable deposit on an apartment. The shares are explicitly tied to the apartment: they cannot be transferred to a nontenant; nor can they be pledged or encumbered; and they descend, along with the apartment, only to a surviving spouse. No voting rights attach to the shares as such: participation in the affairs of the cooperative appertains to the apartment, with the residents of each apartment being entitled to one vote irrespective of the number of shares owned.

Id. at 842. The Court found that these characteristics meant that the "stock" in the case was not really "stock" within the meaning of the federal securities laws. As the Court wrote:

> We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any ... stock." ***
> ***
>
> In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision

> whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.
>
> In the present case respondents do not contend, nor could they, that they were misled by use of the word "stock" into believing that the federal securities laws governed their purchase. Common sense suggests that people who intend to acquire only a residential apartment in a state-subsidized cooperative, for their personal use, are not likely to believe that in reality they are purchasing investment securities simply because the transaction is evidenced by something called a share of stock. These shares have none of the characteristics "that in our commercial world fall within the ordinary concept of a security." [Citation omitted.] Despite their name, they lack what the Court in [a prior case] deemed the most common feature of stock: the right to receive "dividends contingent upon an apportionment of profits." [Citation omitted.] Nor do they possess the other characteristics traditionally associated with stock: they are not negotiable; they cannot be pledged or hypothecated; they confer no voting rights in proportion to the number of shares owned; and they cannot appreciate in value. In short, the inducement to purchase was solely to acquire subsidized low-cost living space; it was not to invest for profit.

Id. at 848-51.

Admittedly, *Forman* is a very unusual case. As such, it is usually a safe bet that "stock" is "stock" within the meaning of Section 2(a)(1) and therefore something to which the securities laws apply. In other words, if you have a client that is a corporation and that wants to do an offering of its common or preferred stock, rest assured that the securities laws will apply to that stock offering.

B. "INVESTMENT CONTRACTS"

In General. One mysterious entry in the list of "securities" in Section 2(a)(1) is the phrase "investment contract." Unfortunately, the Securities Act did not (and still does not) contain a separate definition of "investment contract," which meant that the courts were left with the task of interpreting it. In *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court provided a definition that is still used today. Under the *Howey* test, an "investment contract" involves (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) solely from the efforts of others (that is, persons other than the investor). All four parts of this definition must be satisfied in order to find that something is an "investment contract." Of course, not all "securities" are "investment contracts." An investment contract is merely one example of a security.

Over the years, the *Howey* test has resulted in a number of unusual things being labeled as "investment contracts" and therefore subject to the federal securities laws. One example that may surprise you is found in the following case, which is the Supreme Court's most recent application of the *Howey* test.

Securities and Exchange Commission v. Edwards
United States Supreme Court
540 U.S. 389 (2004)

JUSTICE O'CONNOR delivered the opinion of the Court.

"Opportunity doesn't always knock ... sometimes it rings." [Citing ETS Payphones promotional brochure]. And sometimes it hangs up. So it did for the 10,000 people who invested a total of $300 million in the payphone sale-and-leaseback arrangements touted by respondent under that slogan.

The Securities and Exchange Commission (SEC) argues that the arrangements were investment contracts, and thus were subject to regulation under the federal securities laws. In this case, we must decide whether a moneymaking scheme is excluded from the term "investment contract" simply because the scheme offered a contractual entitlement to a fixed, rather than a variable, return.

[I] Respondent Charles Edwards was the chairman, chief executive officer, and sole shareholder of ETS Payphones, Inc. (ETS). ETS, acting partly through a subsidiary also controlled by respondent, sold payphones to the public via independent distributors. The payphones were offered packaged with a site lease, a [five]-year leaseback and management agreement, and a buyback agreement. All but a tiny fraction of purchasers chose this package, although other management options were offered. The purchase price for the payphone packages was approximately $7,000. Under the leaseback and management agreement, purchasers received $82 per month, a 14% annual return. Purchasers were not involved in the day-to-day operation of the payphones they owned. ETS selected the site for the phone, installed the equipment, arranged for connection and long-distance service, collected coin revenues, and maintained and repaired the phones. Under the buyback agreement, ETS promised to refund the full purchase price of the package at the end of the lease or within 180 days of a purchaser's request.

In its marketing materials and on its website, ETS trumpeted the "incomparable pay phone" as "an exciting business opportunity," in which recent deregulation had "open[ed] the door for profits for individual pay phone owners and operators." According to ETS, "[v]ery few business opportunities can offer the potential for ongoing revenue generation that is available in today's pay telephone industry." [Citations omitted.]

The payphones did not generate enough revenue for ETS to make the payments required by the leaseback agreements, so the company depended on funds from new investors to meet its obligations. In September 2000, ETS filed for bankruptcy protection. The SEC brought this civil enforcement action the same month. It alleged that respondent and ETS had violated the registration requirements of §§ 5(a) and (c) of the Securities Act of 1933, [15 U.S.C. §§ 77e(a), (c)], the antifraud provisions of both § 17(a) of the Securities Act of 1933, [15 U.S.C. § 77q(a)], and § 10(b) of the Securities Exchange Act of 1934, [15 U.S.C. § 78j(b)], and Rule 10b-5 thereunder, [17 C.F.R. § 240.10b-5]. The District Court concluded that the payphone sale-and-leaseback arrangement was an investment contract within the meaning of, and therefore was subject to, the federal securities laws. [Citation omitted.] The Court of Appeals reversed. [Citation omitted.] It held that respondent's scheme was not an investment contract, on two grounds. First, it read this Court's opinions to require that an investment contract offer either capital appreciation or a participation in the earnings of the enterprise, and thus to exclude schemes, such as respondent's, offering a fixed rate of return. [Citation omitted.] Second, it held that our opinions' requirement that the return on the investment be "derived solely from the efforts of others" was not satisfied when the purchasers had a contractual entitlement to the return. [Citation omitted.] We conclude that it erred on both grounds.

[II] "Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called." [Citation omitted.] To that end, it enacted a broad definition of "security," sufficient "to encompass virtually any instrument that might be sold as an investment." [Citation omitted.] Section 2(a)(1) of the 1933 Act, [15 U.S.C. § 77b(a)(1)], and § 3(a)(10) of the 1934 Act, [15 U.S.C. § 78c(a)(10)], in slightly different formulations which we have treated as essentially identical in meaning, [citation omitted], define "security" to include "any note, stock, treasury stock, security future, bond, debenture, ... investment contract, ... [or any] instrument commonly known as a 'security.'" "Investment contract" is not itself defined.

The test for whether a particular scheme is an investment contract was established in our decision in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946). We look to "whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." [Citation omitted.] This definition "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." [Citation omitted.]

In reaching that result, we first observed that when Congress included "investment contract" in the definition of security, it "was using a term the meaning of which had been crystallized" by the state courts' interpretation of their "'blue sky'" laws. [Citation omitted.] (Those laws were the precursors to federal securities regulation and were so named, it seems, because they were "aimed at promoters who 'would sell building lots in the blue sky in fee simple.'" [Citation omitted.] The state courts had defined an investment contract as "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment,'" and had "uniformly applied" that definition to "a variety of situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or [a third party]." [Citation omitted.] Thus, when we held that "profits" must "come solely from the efforts of others," we were speaking of the profits that investors seek on their investment, not the profits of the scheme in which they invest. We used "profits" in the sense of income or return, to include, for example, dividends, other periodic payments, or the increased value of the investment.

There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test, so understood. In both cases, the investing public is attracted by representations of investment income, as purchasers were in this case by ETS' invitation to "'watch the profits add up.'" [Citation omitted.] Moreover, investments pitched as low risk (such as those offering a "guaranteed" fixed return) are particularly attractive to individuals more vulnerable to investment fraud, including older and less sophisticated investors. [Citation omitted.] Under the reading respondent advances, unscrupulous marketers of investments could evade the securities laws by picking a rate of return to promise. We will not read into the securities laws a limitation not compelled by the language that would so undermine the laws' purposes.

Respondent protests that including investment schemes promising a fixed return among investment contracts conflicts with our precedent. We disagree. No distinction between fixed and variable returns was drawn in the blue sky law cases that the *Howey* Court used, in formulating the test, as its evidence of Congress' understanding of the term. [Citation omitted.] Indeed, two of those cases involved an investment contract in which a fixed return was promised. [Citations omitted.]

None of our post-*Howey* decisions is to the contrary. In *United Housing Foundation v. Forman*, 421 U.S. 837 (1975), we considered whether "shares" in a nonprofit housing cooperative were investment contracts under the securities laws. We identified the "touchstone" of an investment contract as "the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," and then laid out two examples of investor interests that we had previously found to be "profits." [Citation omitted.] Those were "capital appreciation resulting from the development of the initial investment" and "participation in earnings resulting from the use of investors' funds." [Citation omitted.] We contrasted those examples, in which "the investor is 'attracted solely by the prospects of a return'" on the investment, with housing cooperative shares, regarding which the purchaser "is motivated by a desire to use or consume the item purchased." [Citation omitted.] Thus, *Forman* supports the commonsense understanding of "profits" in the *Howey* test as simply "financial returns on ... investments." [Citation omitted.]

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Given that respondent's position is supported neither by the purposes of the securities laws nor by our precedents, it is no surprise that the SEC has consistently taken the opposite position, and maintained that a promise of a fixed return does not preclude a scheme from being an investment contract. It has done so in formal adjudications, [citations omitted], and in enforcement actions, [citations omitted].

The Eleventh Circuit's perfunctory alternative holding, that respondent's scheme falls outside the definition because purchasers had a contractual entitlement to a return, is incorrect and inconsistent with our precedent. We are considering investment contracts. The fact that investors have bargained for a return on their investment does not mean that the return is not also expected to come solely from the efforts of others. Any other conclusion would conflict with our holding that an investment contract was offered in *Howey* itself. [Citation omitted].

We hold that an investment scheme promising a fixed rate of return can be an "investment contract" and thus a "security" subject to the federal securities laws. The judgment of the United States Court of Appeals for the Eleventh Circuit is reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

More Detail About the Requirements of the* Howey *Test. Many other cases have fleshed out the meanings of the four parts of the *Howey* test for "investment contracts." For example, the word "money" in the first part of the test (an "investment of money") simply means anything that has value, which should not be terribly surprising. An "investment" is basically the opposite of consumption. Thus, the *Forman* Court noted that "when a purchaser is motivated by a desire to use or consume the item purchased—'to occupy the land or to develop it themselves,' as the *Howey* court put it—the securities laws do not apply." *Forman*, 421 U.S. at 852 (citing *Howey*). In *Forman*, residents of Co-op City bought the stock to have an apartment to live in, not as an investment.[*]

The phrase "common enterprise" has resulted in a split of authority in the federal circuit courts. All courts will accept what is called the "horizontal" formulation of the common-enterprise test. In addition, some courts will also accept the "vertical" formulation of the common-enterprise test. (To date, the Supreme Court has not weighed in on this issue.) The horizontal test requires multiple investors who are similarly situated, that is, who are similarly affected by the success or failure of the enterprise. Thus, if there is only one investor, the enterprise will not be deemed to be a "common enterprise" under the horizontal formulation of the test. If a court accepts the vertical version of the test, however, all that would be necessary to prove that a "common enterprise" is present would be to show a link between the investor's fortunes (that is, how much money the investor will make) and the promoter of the program or a third party.[**]

Litigation over the meaning of the phrase "expectation of profits" has centered on what types of "profits" are needed. As discussed in the *Edwards* case, the Supreme Court in *Forman* identified two types of "profits": "capital appreciation resulting from the development of the initial investment" and "participation in earnings resulting from the

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[*] In addition to arguing that the shares of Co-Op City were "stock," the residents of Co-Op City also argued in the *Forman* case that they were "investment contracts." They lost both arguments.

[**] Some courts have further refined the vertical formulation of the common-enterprise test into two strands: the *strict* version and the *broad* version. Under the strict version, the fortunes of the investor must be linked to the *fortunes* of the promoter or a third party. Under broad vertical commonality, the fortunes of the investor must be linked to the *efforts* of the promoter or a third party (that is, how hard or effectively the promoter or a third party works). To make things even more confusing, it is possible to conceive of examples of investments that would simultaneously satisfy the horizontal, the strict vertical, and the broad vertical versions of the common-enterprise test

use of investors' funds." In other words, capital appreciation (the hope that the value of the security will rise) and dividends or other periodic payments are both considered "profits." And of course *Edwards* itself held that a contractually fixed rate of return also qualifies as a "profit" under the *Howey* test.

As for the "solely from the efforts of others" part of the *Howey* test, courts have not interpreted it literally. In other words, "solely" doesn't really mean "solely." (If it did, it would be easy to avoid something being an investment contract by having the investors do some nominal work like licking stamps and then arguing that the profits generated by the enterprise arose, at least partly, from their efforts!) Instead, the court in *Securities and Exchange Commission v. Koscot Interplanetary, Inc.,* 497 F.2d 473 (5th Cir. 1974),* stated that "the critical inquiry is 'whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'" *Id*. at 483 (citation omitted).

Cryptocurrencies and Other Digital Assets. The twenty-first century has seen a great many technological innovations, including blockchain and cryptocurrencies such as Bitcoin. This has resulted in a great deal of legal and regulatory confusion, as lawyers, courts, and regulators have struggled to apply existing legal concepts to these new innovations. Indeed, the law is evolving so fast in this area that anything in a textbook (this section was written in early June 2021) risks becoming outdated, or maybe even obsolete, very quickly. We thus will not engage here in a detailed and exhaustive discussion of the many legal issues that could arise in connection with cryptocurrencies and other digital assets. However, we should at least examine a few important SEC releases that struggle with whether (and if so, how) to apply the 1940s *Howey* test to these strange new digital assets.

The first is a speech by a high-ranking SEC official in which he draws a distinction between Bitcoin and Ethereum on the one hand, and most types of initial coin offerings ("ICOs") on the other.

Digital Asset Transactions: When *Howey* Met *Gary* (Plastic)
William Hinman, Director, Division of Corporation Finance
Remarks at the Yahoo Finance All Markets Summit: Crypto
San Francisco, CA
June 14, 2018**

*** This event provides a great opportunity to address a topic that is the subject of considerable debate in the press and in the crypto-community – whether a digital asset offered as a security can, over time, become something other than a security.

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* It is probably not a good idea to invest in a company that has "Interplanetary" in its name.

** *Available at* https://www.sec.gov/news/speech/speech-hinman-061418. [Author's note: I have deleted all of the footnotes from this document, but please note that footnote 1 stated: "The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners or other members of the staff."]

To start, we should frame the question differently and focus not on the digital asset itself, but on the circumstances surrounding the digital asset and the manner in which it is sold. To that end, a better line of inquiry is: "Can a digital asset that was originally offered in a securities offering ever be later sold in a manner that does not constitute an offering of a security?" In cases where the digital asset represents a set of rights that gives the holder a financial interest in an enterprise, the answer is likely "no." In these cases, calling the transaction an initial coin offering, or "ICO," or a sale of a "token," will not take it out of the purview of the U.S. securities laws.

But what about cases where there is no longer any central enterprise being invested in or where the digital asset is sold only to be used to purchase a good or service available through the network on which it was created? I believe in these cases the answer is a qualified "yes." I would like to share my thinking with you today about the circumstances under which that could occur.

Before I turn to the securities law analysis, let me share what I believe may be most exciting about distributed ledger technology – that is, the potential to share information, transfer value, and record transactions in a decentralized digital environment. ***

*** I would like to focus on the application of the federal securities laws to digital asset transactions – that is how tokens and coins are being issued, distributed and sold. While perhaps a bit dryer than the promise of the blockchain, this topic is critical to the broader acceptance and use of these novel instruments.

I will begin by describing what I often see. Promoters, in order to raise money to develop networks on which digital assets will operate, often sell the tokens or coins rather than sell shares, issue notes or obtain bank financing. But, in many cases, the economic substance is the same as a conventional securities offering. Funds are raised with the expectation that the promoters will build their system and investors can earn a return on the instrument – usually by selling their tokens in the secondary market once the promoters create something of value with the proceeds and the value of the digital enterprise increases.

When we see that kind of economic transaction, it is easy to apply the Supreme Court's "investment contract" test first announced in *SEC v. Howey*. That test requires an investment of money in a common enterprise with an expectation of profit derived from the efforts of others. And it is important to reflect on the facts of *Howey*. *** In articulating the test for an investment contract, the Supreme Court stressed: "Form [is] disregarded for substance and the emphasis [is] placed upon economic reality." So the purported real estate purchase was found to be an investment contract – an investment in orange groves was in these circumstances an investment in a security.

Just as in the *Howey* case, tokens and coins are often touted as assets that have a use in their own right, coupled with a promise that the assets will be cultivated in a way that will cause them to grow in value, to be sold later at a profit. And, as in *Howey* – where interests in the groves were sold to hotel guests, not farmers – tokens and coins typically are sold to a wide audience rather than to persons who are likely to use them on the network.

In the ICOs I have seen, overwhelmingly, promoters tout their ability to create an innovative application of blockchain technology. Like in *Howey*, the investors are passive. Marketing efforts are rarely narrowly targeted to token users. And typically at the outset, the business model and very viability of the application is still uncertain. The purchaser usually has no choice but to rely on the efforts of the promoter to build the network and make the enterprise a success. At that stage, the purchase of a token looks a lot like a bet on the success of the enterprise and not the purchase of something used to exchange for goods or services on the network.

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Some may be attracted to a blockchain-mediated crowdfunding process. Digital assets can represent an efficient way to reach a global audience where initial purchasers have a stake in the success of the network and become part of a network where their participation adds value beyond their investment contributions. The digital assets are then exchanged – for some, to help find the market price for the new application; for others, to speculate on the venture. As I will discuss, whether a transaction in a coin or token on the secondary market amounts to an offer or sale of a security requires a careful and fact-sensitive legal analysis.

I believe some industry participants are beginning to realize that, in some circumstances, it might be easier to start a blockchain-based enterprise in a more conventional way. In other words, conduct the initial funding through a registered or exempt equity or debt offering and, once the network is up and running, distribute or offer blockchain-based tokens or coins to participants who need the functionality the network and the digital assets offer. This allows the tokens or coins to be structured and offered in a way where it is evident that purchasers are not making an investment in the development of the enterprise.

Returning to the ICOs I am seeing, strictly speaking, the token – or coin or whatever the digital information packet is called – all by itself is not a security, just as the orange groves in *Howey* were not. Central to determining whether a security is being sold is how it is being sold and the reasonable expectations of purchasers. When someone buys a housing unit to live in, it is probably not a security. But under certain circumstances, the same asset can be offered and sold in a way that causes investors to have a reasonable expectation of profits based on the efforts of others. For example, if the housing unit is offered with a management contract or other services, it can be a security. Similarly, when a CD, exempt from being treated as a security under Section 3 of the Securities Act, is sold as a part of a program organized by a broker who offers retail investors promises of liquidity and the potential to profit from changes in interest rates, the *Gary Plastic* case teaches us that the instrument can be part of an investment contract that is a security.

The same reasoning applies to digital assets. The digital asset itself is simply code. But the way it is sold – as part of an investment; to non-users; by promoters to develop the enterprise – can be, and, in that context, most often is, a security – because it evidences an investment contract. And regulating these transactions as securities transactions makes sense. The impetus of the Securities Act is to remove the information asymmetry between promoters and investors. In a public distribution, the Securities Act prescribes the information investors need to make an informed investment decision, and the promoter is liable for material misstatements in the offering materials. These are important safeguards, and they are appropriate for most ICOs. The disclosures required under the federal securities laws nicely complement the *Howey* investment contract element about the efforts of others. As an investor, the success of the enterprise – and the ability to realize a profit on the investment – turns on the efforts of the third party. So learning material information about the third party – its background, financing, plans, financial stake and so forth – is a prerequisite to making an informed investment decision. Without a regulatory framework that promotes disclosure of what the third party alone knows of these topics and the risks associated with the venture, investors will be uninformed and are at risk.

But this also points the way to when a digital asset transaction may no longer represent a security offering. If the network on which the token or coin is to function is sufficiently decentralized – where purchasers would no longer reasonably expect a person or group to carry out essential managerial or entrepreneurial efforts – the assets may not represent an investment contract. Moreover, when the efforts of the third party are no longer a key factor for determining the enterprise's success, material information asymmetries recede. As a network becomes truly decentralized, the ability to identify an issuer or promoter to make the requisite disclosures becomes difficult, and less meaningful.

And so, when I look at Bitcoin today, I do not see a central third party whose efforts are a key determining factor in the enterprise. The network on which Bitcoin functions is operational and appears to have been decentralized for some time, perhaps from inception. Applying the disclosure regime of the federal securities laws to the offer and resale of Bitcoin would seem to add little value. And putting aside the fundraising that accompanied the creation of Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions. And, as with Bitcoin, applying the disclosure regime of the federal securities laws to current transactions in Ether would seem to add little value. Over time, there may be other sufficiently decentralized networks and systems where regulating the tokens or coins that function on them as securities may not be required. And of course there will continue to be systems that rely on central actors whose efforts are a key to the success of the enterprise. In those cases, application of the securities laws protects the investors who purchase the tokens or coins.

I would like to emphasize that the analysis of whether something is a security is not static and does not strictly inhere to the instrument. Even digital assets with utility that function solely as a means of exchange in a decentralized network could be packaged and sold as an investment strategy that can be a security. If a promoter were to place Bitcoin in a fund or trust and sell interests, it would create a new security. Similarly, investment contracts can be made out of virtually any asset (including virtual assets), provided the investor is reasonably expecting profits from the promoter's efforts.

Let me emphasize an earlier point: simply labeling a digital asset a “utility token” does not turn the asset into something that is not a security. I recognize that the Supreme Court has acknowledged that if someone is purchasing an asset for consumption only, it is likely not a security. But, the economic substance of the transaction always determines the legal analysis, not the labels. The oranges in *Howey* had utility. Or in my favorite example, the Commission warned in the late 1960s about investment contracts sold in the form of whisky warehouse receipts. Promoters sold the receipts to U.S. investors to finance the aging and blending processes of Scotch whisky. The whisky was real – and, for some, had exquisite utility. But Howey was not selling oranges and the warehouse receipts promoters were not selling whisky for consumption. They were selling investments, and the purchasers were expecting a return from the promoters’ efforts.

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What are some of the factors to consider in assessing whether a digital asset is offered as an investment contract and is thus a security? Primarily, consider whether a third party – be it a person, entity or coordinated group of actors – drives the expectation of a return. That question will always depend on the particular facts and circumstances, and this list is illustrative, not exhaustive:

1. Is there a person or group that has sponsored or promoted the creation and sale of the digital asset, the efforts of whom play a significant role in the development and maintenance of the asset and its potential increase in value?

2. Has this person or group retained a stake or other interest in the digital asset such that it would be motivated to expend efforts to cause an increase in value in the digital asset? Would purchasers reasonably believe such efforts will be undertaken and may result in a return on their investment in the digital asset?

3. Has the promoter raised an amount of funds in excess of what may be needed to establish a functional network, and, if so, has it indicated how those funds may be used to support the value of the tokens or to increase the value of the enterprise? Does the promoter continue to expend funds from proceeds or operations to enhance the functionality and/or value of the system within which the tokens operate?

4. Are purchasers “investing,” that is seeking a return? In that regard, is the instrument marketed and sold to the general public instead of to potential users of the network for a price that reasonably correlates with the market value of the good or service in the network?

5. Does application of the Securities Act protections make sense? Is there a person or entity others are relying on that plays a key role in the profit-making of the enterprise such that disclosure of their activities and plans would be important to investors? Do informational asymmetries exist between the promoters and potential purchasers/investors in the digital asset?

6. Do persons or entities other than the promoter exercise governance rights or meaningful influence?

While these factors are important in analyzing the role of any third party, there are contractual or technical ways to structure digital assets so they function more like a consumer item and less like a security. Again, we would look to the economic substance of the transaction, but promoters and their counsels should consider these, and other, possible features. This list is not intended to be exhaustive and by no means do I believe each and every one of these factors needs to be present to establish a case that a token is not being offered as a security. This list is meant to prompt thinking by promoters and their counsel, and start the dialogue with the staff – it is not meant to be a list of all necessary factors in a legal analysis.

1. Is token creation commensurate with meeting the needs of users or, rather, with feeding speculation?

2. Are independent actors setting the price or is the promoter supporting the secondary market for the asset or otherwise influencing trading?

3. Is it clear that the primary motivation for purchasing the digital asset is for personal use or consumption, as compared to investment? Have purchasers made representations as to their consumptive, as opposed to their investment, intent? Are the tokens available in increments that correlate with a consumptive versus investment intent?

4. Are the tokens distributed in ways to meet users' needs? For example, can the tokens be held or transferred only in amounts that correspond to a purchaser's expected use? Are there built-in incentives that compel using the tokens promptly on the network, such as having the tokens degrade in value over time, or can the tokens be held for extended periods for investment?

5. Is the asset marketed and distributed to potential users or the general public?

6. Are the assets dispersed across a diverse user base or concentrated in the hands of a few that can exert influence over the application?

7. Is the application fully functioning or in early stages of development?

These are exciting legal times and I am pleased to be part of a process that can help promoters of this new technology and their counsel navigate and comply with the federal securities laws.

Another SEC material in this area is the "DAO Report," which concerned whether a decentralized autonomous organization (think about that phrase for a minute!) was engaged in a securities offering when it offered and sold "DAO Tokens."

United States Securities and Exchange Commission
Securities Exchange Act Release No. 81207
Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO
July 25, 2017

I. Introduction and Summary

The United States Securities and Exchange Commission's ("Commission") Division of Enforcement ("Division") has investigated whether The DAO, an unincorporated organization; Slock.it UG ("Slock.it"), a German corporation; Slock.it's co-founders; and intermediaries may have violated the federal securities laws. The Commission has determined not to pursue an enforcement action in this matter based on the conduct and activities known to the Commission at this time.

As described more fully below, The DAO is one example of a Decentralized Autonomous Organization, which is a term used to describe a "virtual" organization embodied in computer code and executed on a distributed ledger or blockchain. The DAO was created by Slock.it and Slock.it's co-founders, with the objective of operating as a for-profit entity that would create and hold a corpus of assets through the sale of DAO Tokens to investors, which assets would then be used to fund "projects." The holders of DAO Tokens stood to share in the anticipated earnings from these projects as a return on their investment in DAO Tokens. In addition, DAO Token holders could monetize their investments in DAO Tokens by re-selling DAO Tokens on a number of web-based platforms ("Platforms") that supported secondary trading in the DAO Tokens.

After DAO Tokens were sold, but before The DAO was able to commence funding projects, an attacker used a flaw in The DAO's code to steal approximately one-third of The DAO's assets. Slock.it's co-founders and others responded by creating a work-around whereby DAO Token holders could opt to have their investment returned to them, as described in more detail below.

The investigation raised questions regarding the application of the U.S. federal securities laws to the offer and sale of DAO Tokens, including the threshold question whether DAO Tokens are securities. Based on the investigation, and under the facts presented, the Commission has determined that DAO Tokens are securities under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The Commission deems it appropriate and in the public interest to issue this report of investigation ("Report") pursuant to Section 21(a) of the Exchange Act to advise those who would use a Decentralized Autonomous Organization ("DAO Entity"), or other distributed ledger or blockchain-enabled means for capital raising, to take appropriate steps to ensure compliance with the U.S. federal securities laws. All securities offered and sold in the United States must be registered with the Commission or must qualify for an exemption from the registration requirements. In addition, any entity or person engaging in the activities of an exchange must register as a national securities exchange or operate pursuant to an exemption from such registration.

This Report reiterates these fundamental principles of the U.S. federal securities laws and describes their applicability to a new paradigm—virtual organizations or capital raising entities that use distributed ledger or blockchain technology to facilitate capital raising and/or investment and the related offer and sale of securities. The automation of certain functions through this technology, "smart contracts,"* or computer code, does not remove conduct from the purview of the U.S. federal securities laws. This Report also serves to stress the obligation to comply with the registration provisions of the federal securities laws with respect to products and platforms involving emerging technologies and new investor interfaces.

II. Facts

A. Background

From April 30, 2016 through May 28, 2016, The DAO offered and sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million Ether ("ETH"), a virtual currency* used on the Ethereum Blockchain. As of the time the offering closed, the total ETH raised by The DAO was valued in U.S. Dollars ("USD") at approximately $150 million.

The concept of a DAO Entity is memorialized in a document (the "White Paper"), authored by Christoph Jentzsch, the Chief Technology Officer of Slock.it, a "Blockchain and IoT [(internet-of-things)] solution company," incorporated in Germany and co-

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* Computer scientist Nick Szabo described a "smart contract" as:

> a computerized transaction protocol that executes terms of a contract. The general objectives of smart contract design are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.

See Nick Szabo, *Smart Contracts*, 1994, [citation omitted].

* The Financial Action Task Force defines "virtual currency" as:

> a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction, and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from fiat currency (a.k.a. "real currency," "real money," or "national currency"), which is the coin and paper money of a country that is designated as its legal tender; circulates; and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from e-money, which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency.

[Citation omitted.]

founded by Christoph Jentzsch, Simon Jentzsch (Christoph Jentzsch's brother), and Stephan Tual ("Tual"). The White Paper purports to describe "the first implementation of a [DAO Entity] code to automate organizational governance and decision making." The White Paper posits that a DAO Entity "can be used by individuals working together collaboratively outside of a traditional corporate form. It can also be used by a registered corporate entity to automate formal governance rules contained in corporate bylaws or imposed by law." The White Paper proposes an entity—a DAO Entity—that would use smart contracts to attempt to solve governance issues it described as inherent in traditional corporations. As described, a DAO Entity purportedly would supplant traditional mechanisms of corporate governance and management with a blockchain such that contractual terms are "formalized, automated and enforced using software."

B. The DAO

"The DAO" is the "first generation" implementation of the White Paper concept of a DAO Entity, and it began as an effort to create a "crowdfunding contract" to raise "funds to grow [a] company in the crypto space." In November 2015, at an Ethereum Developer Conference in London, Christoph Jentzsch described his proposal for The DAO as a "for-profit DAO [Entity]," where participants would send ETH (a virtual currency) to The DAO to purchase DAO Tokens, which would permit the participant to vote and entitle the participant to "rewards." Christoph Jentzsch likened this to "buying shares in a company and getting … dividends. The DAO was to be "decentralized" in that it would allow for voting by investors holding DAO Tokens. All funds raised were to be held at an Ethereum Blockchain "address" associated with The DAO and DAO Token holders were to vote on contract proposals, including proposals to The DAO to fund projects and distribute The DAO's anticipated earnings from the projects it funded. The DAO was intended to be "autonomous" in that project proposals were in the form of smart contracts that exist on the Ethereum Blockchain and the votes were administered by the code of The DAO.

On or about April 29, 2016, Slock.it deployed The DAO code on the Ethereum Blockchain, as a set of pre-programmed instructions. This code was to govern how The DAO was to operate.

To promote The DAO, Slock.it's co- founders launched a website ("The DAO Website"). The DAO Website included a description of The DAO's intended purpose: "To blaze a new path in business for the betterment of its members, existing simultaneously nowhere and everywhere and operating solely with the steadfast iron will of unstoppable code." The DAO Website also described how The DAO operated, and included a link through which DAO Tokens could be purchased. The DAO Website also included a link to the White Paper, which provided detailed information about a DAO Entity's structure and its source code and, together with The DAO Website, served as the primary source of promotional materials for The DAO. On The DAO Website and elsewhere, Slock.it represented that The DAO's source code had been reviewed by "one of the world's leading security audit companies" and "no stone was left unturned during those five whole days of security analysis."

Slock.it's co- founders also promoted The DAO by soliciting media attention and by posting almost daily updates on The DAO's status on The DAO and Slock.it websites and numerous online forums relating to blockchain technology. Slock.it's co-founders used these posts to communicate to the public information about how to participate in The DAO, including: how to create and acquire DAO Tokens; the framework for submitting proposals for projects; and how to vote on proposals. Slock.it also created an online forum on The DAO Website, as well as administered "The DAO Slack" channel, an online messaging platform in which over 5,000 invited "team members" could discuss and exchange ideas about The DAO in real time.

1. DAO Tokens

In exchange for ETH, The DAO created DAO Tokens (proportional to the amount of ETH paid) that were then assigned to the Ethereum Blockchain address of the person or entity remitting the ETH. A DAO Token granted the DAO Token holder certain voting and ownership rights. According to promotional materials, The DAO would earn profits by funding projects that would provide DAO Token holders a return on investment. The various promotional materials disseminated by Slock.it's co-founders touted that DAO Token holders would receive "rewards," which the White Paper defined as, "any [ETH] received by a DAO [Entity] generated from projects the DAO [Entity] funded." DAO Token holders would then vote to either use the rewards to fund new projects or to distribute the ETH to DAO Token holders.

From April 30, 2016 through May 28, 2016 (the "Offering Period"), The DAO offered and sold DAO Tokens. Investments in The DAO were made "pseudonymously" (i.e., an individual's or entity's pseudonym was their Ethereum Blockchain address). To purchase a DAO Token offered for sale by The DAO, an individual or entity sent ETH from their Ethereum Blockchain address to an Ethereum Blockchain address associated with The DAO. All of the ETH raised in the offering as well as any future profits earned by The DAO were to be pooled and held in The DAO's Ethereum Blockchain address. The token price fluctuated in a range of approximately 1 to 1.5 ETH per 100 DAO Tokens, depending on when the tokens were purchased during the Offering Period. Anyone was eligible to purchase DAO Tokens (as long as they paid ETH). There were no limitations placed on the number of DAO Tokens offered for sale, the number of purchasers of DAO Tokens, or the level of sophistication of such purchasers.

DAO Token holders were not restricted from re-selling DAO Tokens acquired in the offering, and DAO Token holders could sell their DAO Tokens in a variety of ways in the secondary market and thereby monetize their investment as discussed below. Prior to the Offering Period, Slock.it solicited at least one U.S. web-based platform to trade DAO Tokens on its system and, at the time of the offering, The DAO Website and other promotional materials disseminated by Slock.it included representations that DAO Tokens would be available for secondary market trading after the Offering Period via several platforms. During the Offering Period and afterwards, the Platforms posted notices on their own websites and on social media that each planned to support secondary market trading of DAO Tokens.

In addition to secondary market trading on the Platforms, after the Offering Period, DAO Tokens were to be freely transferable on the Ethereum Blockchain. DAO Token holders would also be permitted to redeem their DAO Tokens for ETH through a complicated, multi-week (approximately 46-day) process referred to as a DAO Entity "split."

2. Participants in The DAO

According to the White Paper, in order for a project to be considered for funding with "a DAO [Entity]'s [ETH]," a "Contractor" first must submit a proposal to the DAO Entity. Specifically, DAO Token holders expected Contractors to submit proposals for projects that could provide DAO Token holders returns on their investments. Submitting a proposal to The DAO involved: (1) writing a smart contract, and then deploying and publishing it on the Ethereum Blockchain; and (2) posting details about the proposal on The DAO Website, including the Ethereum Blockchain address of the deployed contract and a link to its source code. Proposals could be viewed on The DAO Website as well as other publicly-accessible websites. Per the White Paper, there were two prerequisites for submitting a proposal. An individual or entity must: (1) own at least one DAO Token; and (2) pay a deposit in the form of ETH that would be forfeited to the DAO Entity if the proposal was put up for a vote and failed to achieve a quorum of DAO Token holders. It was publicized that Slock.it would be the first to submit a proposal for funding.

ETH raised by The DAO was to be distributed to a Contractor to fund a proposal only on a majority vote of DAO Token holders. DAO Token holders were to cast votes, which would be weighted by the number of tokens they controlled, for or against the funding of a specific proposal. The voting process, however, was publicly criticized in that it could incentivize distorted voting behavior and, as a result, would not accurately reflect the consensus of the majority of DAO Token holders. ***

Before any proposal was put to a vote by DAO Token holders, it was required to be reviewed by one or more of The DAO's "Curators." At the time of the formation of The DAO, the Curators were a group of individuals chosen by Slock.it. According to the White Paper, the Curators of a DAO Entity had "considerable power." The Curators performed crucial security functions and maintained ultimate control over which proposals could be submitted to, voted on, and funded by The DAO. As stated on The DAO Website during the Offering Period, The DAO relied on its Curators for "failsafe protection" and for protecting The DAO from "malicous [sic] actors." Specifically, per The DAO Website, a Curator was responsible for: (1) confirming that any proposal for funding originated from an identifiable person or organization; and (2) confirming that smart contracts associated with any such proposal properly reflected the code the Contractor claims to have deployed on the Ethereum Blockchain. If a Curator determined that the proposal met these criteria, the Curator could add the proposal to the "whitelist," which was a list of Ethereum Blockchain addresses that could receive ETH from The DAO if the majority of DAO Token holders voted for the proposal.

Curators of The DAO had ultimate discretion as to whether or not to submit a proposal for voting by DAO Token holders. Curators also determined the order and frequency of proposals, and could impose subjective criteria for whether the proposal should be whitelisted. One member of the group chosen by Slock.it to serve collectively as the Curator stated publicly that the Curator had "complete control over the whitelist … the order in which things get whitelisted, the duration for which [proposals] get whitelisted, when things get unwhitelisted … [and] clear ability to control the order and frequency of proposals," noting that "curators have tremendous power." Another Curator publicly announced his subjective criteria for determining whether to whitelist a proposal, which included his personal ethics. Per the White Paper, a Curator also had the power to reduce the voting quorum requirement by 50% every other week. Absent action by a Curator, the quorum could be reduced by 50% only if no proposal had reached the required quorum for 52 weeks.

3. Secondary Market Trading on the Platforms

During the period from May 28, 2016 through early September 2016, the Platforms became the preferred vehicle for DAO Token holders to buy and sell DAO Tokens in the secondary market using virtual or fiat currencies. Specifically, the Platforms used electronic systems that allowed their respective customers to post orders for DAO Tokens on an anonymous basis. For example, customers of each Platform could buy or sell DAO Tokens by entering a market order on the Platform's system, which would then match with orders from other customers residing on the system. Each Platform's system would automatically execute these orders based on pre-programmed order interaction protocols established by the Platform.

None of the Platforms received orders for DAO Tokens from non-Platform customers or routed its respective customers' orders to any other trading destinations. The Platforms publicly displayed all their quotes, trades, and daily trading volume in DAO Tokens on their respective websites. During the period from May 28, 2016 through September 6, 2016, one such Platform executed more than 557,378 buy and sell transactions in DAO Tokens by more than 15,000 of its U.S. and foreign customers. During the period from May 28, 2016 through August 1, 2016, another such Platform executed more than 22,207 buy and sell transactions in DAO Tokens by more than 700 of its U.S. customers.

4. Security Concerns, The "Attack" on The DAO, and The Hard Fork

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III. Discussion

The Commission is aware that virtual organizations and associated individuals and entities increasingly are using distributed ledger technology to offer and sell instruments such as DAO Tokens to raise capital. These offers and sales have been referred to, among other things, as "Initial Coin Offerings" or "Token Sales." Accordingly, the Commission deems it appropriate and in the public interest to issue this Report in order to stress that the U.S. federal securities law may apply to various activities, including distributed ledger technology, depending on the particular facts and circumstances, without regard to the form of the organization or technology used to effectuate a particular offer or sale. In this Report, the Commission considers the particular facts and circumstances of the offer and sale of DAO Tokens to demonstrate the application of existing U.S. federal securities laws to this new paradigm.

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B. DAO Tokens Are Securities

1. *Foundational Principles of the Securities Laws Apply to Virtual Organizations or Capital Raising Entities Making Use of Distributed Ledger Technology*

Under Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act, a security includes "an investment contract." *See* 15 U.S.C. §§ 77b-77c. An investment contract is an investment of money in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *See SEC v. Edwards*, 540 U.S. 389, 393 (2004); *SEC v. W.J. Howey Co.,* 328 U.S. 293, 301 (1946); *see also United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852-53 (1975) (The "touchstone" of an investment contract "is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."). This definition embodies a "*flexible rather than a static principle*, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Howey*, 328 U.S. at 299 (emphasis added). The test "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Id.* In analyzing whether something is a security, "form should be disregarded for substance," *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967), "and the emphasis should be on economic realities underlying a transaction, and not on the name appended thereto." *United Housing Found.*, 421 U.S. at 849.

2. *Investors in The DAO Invested Money*

In determining whether an investment contract exists, the investment of "money" need not take the form of cash. [Citation omitted.]

Investors in The DAO used ETH to make their investments, and DAO Tokens were received in exchange for ETH. Such investment is the type of contribution of value that can create an investment contract under *Howey*. *See SEC v. Shavers*, No. 4:13-CV-416, 2014 WL 4652121, at *1 (E.D. Tex. Sept. 18, 2014) (holding that an investment of Bitcoin, a virtual currency, meets the first prong of *Howey*); *Uselton*, 940 F.2d at 574 ("[T]he 'investment' may take the form of 'goods and services,' or some other 'exchange of value'.") (citations omitted).

3. *With a Reasonable Expectation of Profits*

Investors who purchased DAO Tokens were investing in a common enterprise and reasonably expected to earn profits through that enterprise when they sent ETH to The DAO's Ethereum Blockchain address in exchange for DAO Tokens. "[P]rofits" include "dividends, other periodic payments, or the increased value of the investment." *Edwards*, 540 U.S. at 394. As described above, the various promotional materials disseminated by Slock.it and its co-founders informed investors that The DAO was a for-profit entity whose objective was to fund projects in exchange for a return on investment. The ETH was pooled and available to The DAO to fund projects. The projects (or "contracts") would be proposed by Contractors. If the proposed contracts were whitelisted by Curators, DAO Token holders could vote on whether The DAO should fund the proposed contracts. Depending on the terms of each particular contract, DAO Token holders stood to share in potential profits from the contracts. Thus, a reasonable investor would have been motivated, at least in part, by the prospect of profits on their investment of ETH in The DAO.

4. *Derived from the Managerial Efforts of Others*

a. *The Efforts of Slock.it, Slock.it's Co-Founders, and The DAO's Curators Were Essential to the Enterprise*

Investors' profits were to be derived from the managerial efforts of others—specifically, Slock.it and its co-founders, and The DAO's Curators. The central issue is "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *SEC v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476, 482 (9th Cir. 1973). The DAO's investors relied on the managerial and entrepreneurial efforts of Slock.it and its co-founders, and The DAO's Curators, to manage The DAO and put forth project proposals that could generate profits for The DAO's investors.

Investors' expectations were primed by the marketing of The DAO and active engagement between Slock.it and its co-founders with The DAO and DAO Token holders. To market The DAO and DAO Tokens, Slock.it created The DAO Website on which it published the White Paper explaining how a DAO Entity would work and describing their vision for a DAO Entity. Slock.it also created and maintained other online forums that it used to provide information to DAO Token holders about how to vote and perform other tasks related to their investment. Slock.it appears to have closely monitored these forums, answering questions from DAO Token holders about a variety of topics, including the future of The DAO, security concerns, ground rules for how The DAO would work, and the anticipated role of DAO Token holders. The creators of The DAO held themselves out to investors as experts in Ethereum, the blockchain protocol on which The DAO operated, and told investors that they had selected persons to serve as Curators based on their expertise and credentials. Additionally, Slock.it told investors that it expected to put forth the first substantive profit-making contract proposal—a blockchain venture in its area of expertise. Through their conduct and marketing materials, Slock.it and its co-founders led investors to believe that they could be relied on to provide the significant managerial efforts required to make The DAO a success.

Investors in The DAO reasonably expected Slock.it and its co-founders, and The DAO's Curators, to provide significant managerial efforts after The DAO's launch. The expertise of The DAO's creators and Curators was critical in monitoring the operation of The DAO, safeguarding investor funds, and determining whether proposed contracts should be put for a vote. Investors had little choice but to rely on their expertise. At the time of the offering, The DAO's protocols had already been pre-determined by Slock.it and its co-founders, including the control that could be exercised by the Curators. Slock.it and its co-founders chose the Curators, whose function it was to: (1) vet Contractors; (2) determine whether and when to submit proposals for votes; (3) determine the order and frequency of proposals that were submitted for a vote; and (4) determine whether to halve the default quorum necessary for a successful vote on certain proposals. Thus, the Curators exercised significant control over the order and frequency of proposals, and could impose their own subjective criteria for whether the proposal should be whitelisted for a vote by DAO Token holders. DAO Token holders' votes were limited to proposals whitelisted by the Curators, and, although any DAO Token holder could put forth a proposal, each proposal would follow the same protocol, which included vetting and control by the current Curators. While DAO Token holders could put forth proposals to replace a Curator, such proposals were subject to control by the current Curators, including whitelisting and approval of the new address to which the tokens would be directed for such a proposal. In essence, Curators had the power to determine whether a proposal to remove a Curator was put to a vote.

And, Slock.it and its co-founders did, in fact, actively oversee The DAO. They monitored The DAO closely and addressed issues as they arose, proposing a moratorium on all proposals until vulnerabilities in The DAO's code had been addressed and a security expert to monitor potential attacks on The DAO had been appointed. When the Attacker exploited a weakness in the code and removed investor funds, Slock.it and its co-founders stepped in to help resolve the situation.

b. *DAO Token Holders' Voting Rights Were Limited*

Although DAO Token holders were afforded voting rights, these voting rights were limited. DAO Token holders were substantially reliant on the managerial efforts of Slock.it, its co-founders, and the Curators. Even if an investor's efforts help to make an enterprise profitable, those efforts do not necessarily equate with a promoter's significant managerial efforts or control over the enterprise. *See, e.g.*, *Glenn W. Turner*, 474 F.2d at 482 (finding that a multi-level marketing scheme was an investment contract and that investors relied on the promoter's managerial efforts, despite the fact that investors put forth the majority of the labor that made the enterprise profitable, because the promoter dictated the terms and controlled the scheme itself); *Long v. Shultz*, 881 F.2d 129, 137 (5th Cir. 1989) ("An investor may authorize the assumption of particular risks that would create the possibility of greater profits or losses but still depend on a third party for all of the essential managerial efforts without which the risk could not pay off."). *See also generally SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (finding an investment contract even where voting rights were provided to purported general partners, noting that the voting process provided limited information for investors to make informed decisions, and the purported general partners lacked control over the information in the ballots).

The voting rights afforded DAO Token holders did not provide them with meaningful control over the enterprise, because (1) DAO Token holders' ability to vote for contracts was a largely perfunctory one; and (2) DAO Token holders were widely dispersed and limited in their ability to communicate with one another.

First, as discussed above, DAO Token holders could only vote on proposals that had been cleared by the Curators. And that clearance process did not include any mechanism to provide DAO Token holders with sufficient information to permit them to make informed voting decisions. ***

Second, the pseudonymity and dispersion of the DAO Token holders made it difficult for them to join together to effect change or to exercise meaningful control. ***

These facts diminished the ability of DAO Token holders to exercise meaningful control over the enterprise through the voting process, rendering the voting rights of DAO Token holders akin to those of a corporate shareholder. [Citations omitted.]

By contract and in reality, DAO Token holders relied on the significant managerial efforts provided by Slock.it and its co-founders, and The DAO's Curators, as described above. Their efforts, not those of DAO Token holders, were the "undeniably significant" ones, essential to the overall success and profitability of any investment into The DAO. *See Glenn W. Turner*, 474 F.2d at 482.

C. <u>Issuers Must Register Offers and Sales of Securities Unless a Valid Exemption Applies</u>

The definition of "issuer" is broadly defined to include "every person who issues or proposes to issue any security" and "person" includes "any unincorporated organization." 15 U.S.C. § 77b(a)(4). ***

The DAO, an unincorporated organization, was an issuer of securities, and information about The DAO was "crucial" to the DAO Token holders' investment decision. ***

During the Offering Period, The DAO offered and sold DAO Tokens in exchange for ETH through The DAO Website, which was publicly- accessible, including to individuals in the United States. During the Offering Period, The DAO sold approximately 1.15 billion DAO Tokens in exchange for a total of approximately 12 million ETH, which was valued in USD, at the time, at approximately $150 million. Because DAO Tokens were securities, The DAO was required to register the offer and sale of DAO Tokens, unless a valid exemption from such registration applied.

Moreover, those who participate in an unregistered offer and sale of securities not subject to a valid exemption are liable for violating Section 5. [Citations omitted.]

D. A System that Meets the Definition of an Exchange Must Register as a National Securities Exchange or Operate Pursuant to an Exemption from Such Registration

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The Platforms that traded DAO Tokens appear to have satisfied the criteria of Rule 3b-16(a) and do not appear to have been excluded from Rule 3b-16(b). As described above, the Platforms provided users with an electronic system that matched orders from multiple parties to buy and sell DAO Tokens for execution based on non-discretionary methods.

IV. Conclusion and References for Additional Guidance

Whether or not a particular transaction involves the offer and sale of a security— regardless of the terminology used—will depend on the facts and circumstances, including the economic realities of the transaction. Those who offer and sell securities in the United States must comply with the federal securities laws, including the requirement to register with the Commission or to qualify for an exemption from the registration requirements of the federal securities laws. The registration requirements are designed to provide investors with procedural protections and material information necessary to make informed investment decisions. These requirements apply to those who offer and sell securities in the United States, regardless whether the issuing entity is a traditional company or a decentralized autonomous organization, regardless whether those securities are purchased using U.S. dollars or virtual currencies, and regardless whether they are distributed in certificated form or through distributed ledger technology. In addition, any entity or person engaging in the activities of an exchange, such as bringing together the orders for securities of multiple buyers and sellers using established non-discretionary methods under which such orders interact with each other and buyers and sellers entering such orders agree upon the terms of the trade, must register as a national securities exchange or operate pursuant to an exemption from such registration.

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For additional guidance, please see the following Commission enforcement actions involving virtual currencies:

- *SEC v. Trendon T. Shavers and Bitcoin Savings and Trust*, Civil Action No. 4:13-CV-416 (E.D. Tex., complaint filed July 23, 2013)

- *In re Erik T. Voorhees*, Rel. No. 33-9592 (June 3, 2014)

- *In re BTC Trading, Corp. and Ethan Burnside*, Rel. No. 33-9685 (Dec. 8, 2014)

- *SEC v. Homero Joshua Garza, Gaw Miners, LLC, and ZenMiner, LLC (d/b/a Zen Cloud)*, Civil Action No. 3:15-CV-01760 (D. Conn., complaint filed Dec. 1, 2015)

- *In re Bitcoin Investment Trust and SecondMarket, Inc.*, Rel. No. 34-78282 (July 11, 2016)

- *In re Sunshine Capital, Inc*., File No. 500-1 (Apr. 11, 2017)

And please see the following investor alerts:

- *Bitcoin and Other Virtual Currency-Related Investments* (May 7, 2014)

- *Ponzi Schemes Using Virtual Currencies* (July 2013)

By the Commission.

The SEC continues to rely on the *Howey* test to evaluate digital assets, as shown in the following reading, a release from 2019:

United States Securities and Exchange Commission
Strategic Hub for Innovation and Financial Technology
Framework for "Investment Contract" Analysis of Digital Assets

April 3, 2019*

I. Introduction

If you are considering an Initial Coin Offering, sometimes referred to as an "ICO," or otherwise engaging in the offer, sale, or distribution of a digital asset,** you need to consider whether the U.S. federal securities laws apply. A threshold issue is whether the digital asset is a "security" under those laws. The term "security" includes an "investment contract," as well as other instruments such as stocks, bonds, and transferable shares. A digital asset should be analyzed to determine whether it has the characteristics of any product that meets the definition of "security" under the federal securities laws. In this guidance, we provide a framework for analyzing whether a digital asset has the characteristics of one particular type of security—an "investment contract." Both the Commission and the federal courts frequently use the "investment contract" analysis to determine whether unique or novel instruments or arrangements, such as digital assets, are securities subject to the federal securities laws.

The U.S. Supreme Court's *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. The so-called "*Howey* test" applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of typical securities. The focus of the *Howey* analysis is not only on the form and terms of the instrument itself (in this case, the digital

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* Available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets#_edn1.

A footnote at the beginning of this document states: "This framework represents the views of the Strategic Hub for Innovation and Financial Technology ("FinHub," the "Staff," or "we") of the Securities and Exchange Commission (the "Commission"). It is not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved its content. Further, this framework does not replace or supersede existing case law, legal requirements, or statements or guidance from the Commission or Staff. Rather, the framework provides additional guidance in the areas that the Commission or Staff has previously addressed. *See, e.g., Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Act Rel. No. 81207) (July 25, 2017) ("*The DAO Report*"); William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Remarks at the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

** The term "digital asset," as used in this framework, refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called "virtual currencies," "coins," and "tokens."

asset) but also on the circumstances surrounding the digital asset and the manner in which it is offered, sold, or resold (which includes secondary market sales). Therefore, issuers and other persons and entities engaged in the marketing, offer, sale, resale, or distribution of any digital asset will need to analyze the relevant transactions to determine if the federal securities laws apply.

The federal securities laws require all offers and sales of securities, including those involving a digital asset, to either be registered under its provisions or to qualify for an exemption from registration. The registration provisions require persons to disclose certain information to investors, and that information must be complete and not materially misleading. *** Absent the disclosures required by law about those efforts and the progress and prospects of the enterprise, significant informational asymmetries may exist between the management and promoters of the enterprise on the one hand, and investors and prospective investors on the other hand. The reduction of these information asymmetries through required disclosures protects investors and is one of the primary purposes of the federal securities laws.

II. Application of *Howey* to Digital Assets

In this guidance, we provide a framework for analyzing whether a digital asset is an investment contract and whether offers and sales of a digital asset are securities transactions. As noted above, under the *Howey* test, an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others. Whether a particular digital asset at the time of its offer or sale satisfies the *Howey* test depends on the specific facts and circumstances. We address each of the elements of the *Howey* test below.

A. The Investment of Money

The first prong of the *Howey* test is typically satisfied in an offer and sale of a digital asset because the digital asset is purchased or otherwise acquired in exchange for value, whether in the form of real (or fiat) currency, another digital asset, or other type of consideration.[*]

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[*] The lack of monetary consideration for digital assets, such as those distributed via a so-called "bounty program" does not mean that the investment of money prong is not satisfied. As the Commission explained in *The DAO Report*, "[i]n determining whether an investment contract exists, the investment of 'money' need not take the form of cash" and "in spite of *Howey's* reference to an 'investment of money,' it is well established that cash is not the only form of contribution or investment that will create an investment contract." *The DAO Report* at 11 (citation omitted). *See In re Tomahawk Exploration LLC*, Securities Act Rel. 10530 (Aug. 14, 2018) (issuance of tokens under a so-called "bounty program" constituted an offer and sale of securities because the issuer provided tokens to investors in exchange for services designed to advance the issuer's economic interests and foster a trading market for its securities). Further, the lack of monetary consideration for digital assets, such as those distributed via a so-called "air drop," does not mean that the investment of money prong is not satisfied; therefore, an airdrop may constitute a sale or distribution of securities. In a so-called

B. Common Enterprise

Courts generally have analyzed a "common enterprise" as a distinct element of an investment contract.* In evaluating digital assets, we have found that a "common enterprise" typically exists.

C. Reasonable Expectation of Profits Derived from Efforts of Others

Usually, the main issue in analyzing a digital asset under the *Howey* test is whether a purchaser has a reasonable expectation of profits (or other financial returns) derived from the efforts of others. A purchaser may expect to realize a return through participating in distributions or through other methods of realizing appreciation on the asset, such as selling at a gain in a secondary market. When a promoter, sponsor, or other third party (or affiliated group of third parties) (each, an "Active Participant" or "AP") provides essential managerial efforts that affect the success of the enterprise, and investors reasonably expect to derive profit from those efforts, then this prong of the test is met. Relevant to this inquiry is the "economic reality" of the transaction and "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." [Citations omitted.] The inquiry, therefore, is an objective one, focused on the transaction itself and the manner in which the digital asset is offered and sold.

The following characteristics are especially relevant in an analysis of whether the third prong of the *Howey* test is satisfied.

1. Reliance on the Efforts of Others

The inquiry into whether a purchaser is relying on the efforts of others focuses on two key issues:

- Does the purchaser reasonably expect to rely on the efforts of an AP?

"airdrop," a digital asset is distributed to holders of another digital asset, typically to promote its circulation.

* In order to satisfy the "common enterprise" aspect of the *Howey* test, federal courts require that there be either "horizontal commonality" or "vertical commonality." *See Revak v. SEC Realty Corp*., 18 F.3d. 81, 87-88 (2d Cir. 1994) (discussing horizontal commonality as "the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits" and two variants of vertical commonality, which focus "on the relationship between the promoter and the body of investors"). The Commission, on the other hand, does not require vertical or horizontal commonality *per se*, nor does it view a "common enterprise" as a distinct element of the term "investment contract." *In re Barkate*, 57 S.E.C. 488, 496 n.13 (Apr. 8, 2004); *see also* the Commission's Supplemental Brief at 14 in *SEC v. Edwards*, 540 U.S. 389 (2004) (on remand to the 11th Circuit).

● Are those efforts "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise," [citation omitted] as opposed to efforts that are more ministerial in nature?

Although no one of the following characteristics is necessarily determinative, the stronger their presence, the more likely it is that a purchaser of a digital asset is relying on the "efforts of others":

● An AP is responsible for the development, improvement (or enhancement), operation, or promotion of the network, particularly if purchasers of the digital asset expect an AP to be performing or overseeing tasks that are necessary for the network or digital asset to achieve or retain its intended purpose or functionality.*

○ Where the network or the digital asset is still in development and the network or digital asset is not fully functional at the time of the offer or sale, purchasers would reasonably expect an AP to further develop the functionality of the network or digital asset (directly or indirectly). This particularly would be the case where an AP promises further developmental efforts in order for the digital asset to attain or grow in value.

● There are essential tasks or responsibilities performed and expected to be performed by an AP, rather than an unaffiliated, dispersed community of network users (commonly known as a "decentralized" network).

● An AP creates or supports a market for, or the price of, the digital asset. This can include, for example, an AP that: (1) controls the creation and issuance of the digital asset; or (2) takes other actions to support a market price of the digital asset, such as by limiting supply or ensuring scarcity, through, for example, buybacks, "burning," or other activities.

● An AP has a lead or central role in the direction of the ongoing development of the network or the digital asset. In particular, an AP plays a lead or central role in deciding governance issues, code updates, or how third parties participate in the validation of transactions that occur with respect to the digital asset.

● An AP has a continuing managerial role in making decisions about or exercising judgment concerning the network or the characteristics or rights the digital asset represents including, for example: ***

* We recognize that holders of digital assets may put forth some effort in the operations of the network, but those efforts do not negate the fact that the holders of digital assets are relying on the efforts of the AP. ***

● Purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset, such as where:

○ The AP has the ability to realize capital appreciation from the value of the digital asset. This can be demonstrated, for example, if the AP retains a stake or interest in the digital asset. In these instances, purchasers would reasonably expect the AP to undertake efforts to promote its own interests and enhance the value of the network or digital asset.

○ The AP distributes the digital asset as compensation to management or the AP's compensation is tied to the price of the digital asset in the secondary market. To the extent these facts are present, the compensated individuals can be expected to take steps to build the value of the digital asset.

○ The AP owns or controls ownership of intellectual property rights of the network or digital asset, directly or indirectly.

○ The AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "efforts of others," including but not limited to: ***

2. Reasonable Expectation of Profits

An evaluation of the digital asset should also consider whether there is a reasonable expectation of profits. Profits can be, among other things, capital appreciation resulting from the development of the initial investment or business enterprise or a participation in earnings resulting from the use of purchasers' funds. Price appreciation resulting ***solely*** from external market forces (such as general inflationary trends or the economy) impacting the supply and demand for an underlying asset generally is not considered "profit" under the *Howey* test.

The more the following characteristics are present, the more likely it is that there is a reasonable expectation of profit:

● The digital asset gives the holder rights to share in the enterprise's income or profits or to realize gain from capital appreciation of the digital asset.

○ The opportunity may result from appreciation in the value of the digital asset that comes, at least in part, from the operation, promotion, improvement, or other positive developments in the network, particularly if there is a secondary trading market that enables digital asset holders to resell their digital assets and realize gains.

○ This also can be the case where the digital asset gives the holder rights to dividends or distributions.

● The digital asset is transferable or traded on or through a secondary market or platform, or is expected to be in the future.*

● Purchasers reasonably would expect that an AP's efforts will result in capital appreciation of the digital asset and therefore be able to earn a return on their purchase.

● The digital asset is offered broadly to potential purchasers as compared to being targeted to expected users of the goods or services or those who have a need for the functionality of the network.

○ The digital asset is offered and purchased in quantities indicative of investment intent instead of quantities indicative of a user of the network. For example, it is offered and purchased in quantities significantly greater than any likely user would reasonably need, or so small as to make actual use of the asset in the network impractical.

● There is little apparent correlation between the purchase/offering price of the digital asset and the market price of the particular goods or services that can be acquired in exchange for the digital asset.

● There is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption.

● The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset.

● The AP is able to benefit from its efforts as a result of holding the same class of digital assets as those being distributed to the public.

● The AP continues to expend funds from proceeds or operations to enhance the functionality or value of the network or digital asset.

● The digital asset is marketed, directly or indirectly, using any of the following:

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* Situations where the digital asset is exchangeable or redeemable solely for goods or services within the network or on a platform, and may not otherwise be transferred or sold, may more likely be a payment for a good or service in which the purchaser is motivated to use or consume the digital asset. *See* discussion of "Other Relevant Considerations."

- The expertise of an AP or its ability to build or grow the value of the network or digital asset.

- The digital asset is marketed in terms that indicate it is an investment or that the solicited holders are investors.

- The intended use of the proceeds from the sale of the digital asset is to develop the network or digital asset.

- The future (and not present) functionality of the network or digital asset, and the prospect that an AP will deliver that functionality.

- The promise (implied or explicit) to build a business or operation as opposed to delivering currently available goods or services for use on an existing network.

- The ready transferability of the digital asset is a key selling feature.

- The potential profitability of the operations of the network, or the potential appreciation in the value of the digital asset, is emphasized in marketing or other promotional materials.

- The availability of a market for the trading of the digital asset, particularly where the AP implicitly or explicitly promises to create or otherwise support a trading market for the digital asset.

In evaluating whether a digital asset previously sold as a security should be reevaluated at the time of later offers or sales, there would be additional considerations as they relate to the "reasonable expectation of profits," including but not limited to:

- Purchasers of the digital asset no longer reasonably expect that continued development efforts of an AP will be a key factor for determining the value of the digital asset.

- The value of the digital asset has shown a direct and stable correlation to the value of the good or service for which it may be exchanged or redeemed.

- The trading volume for the digital asset corresponds to the level of demand for the good or service for which it may be exchanged or redeemed.

- Whether holders are then able to use the digital asset for its intended functionality, such as to acquire goods and services on or through the network or platform.

- Whether any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.

- No AP has access to material, non-public information or could otherwise be deemed to hold material inside information about the digital asset.

3. Other Relevant Considerations

When assessing whether there is a reasonable expectation of profit derived from the efforts of others, federal courts look to the economic reality of the transaction. In doing so, the courts also have considered whether the instrument is offered and sold for use or consumption by purchasers.

Although no one of the following characteristics of use or consumption is necessarily determinative, the stronger their presence, the less likely the *Howey* test is met:

- The distributed ledger network and digital asset are fully developed and operational.

- Holders of the digital asset are immediately able to use it for its intended functionality on the network, particularly where there are built-in incentives to encourage such use.

- The digital assets' creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network. For example, the digital asset can only be used on the network and generally can be held or transferred only in amounts that correspond to a purchaser's expected use.

- Prospects for appreciation in the value of the digital asset are limited. For example, the design of the digital asset provides that its value will remain constant or even degrade over time, and, therefore, a reasonable purchaser would not be expected to hold the digital asset for extended periods as an investment.

- With respect to a digital asset referred to as a virtual currency, it can immediately be used to make payments in a wide variety of contexts, or acts as a substitute for real(or fiat) currency.

    - This means that it is possible to pay for goods or services with the digital asset without first having to convert it to another digital asset or real currency.

○ If it is characterized as a virtual currency, the digital asset actually operates as a store of value that can be saved, retrieved, and exchanged for something of value at a later time.

● With respect to a digital asset that represents rights to a good or service, it currently can be redeemed within a developed network or platform to acquire or otherwise use those goods or services. Relevant factors may include:

○ There is a correlation between the purchase price of the digital asset and a market price of the particular good or service for which it may be redeemed or exchanged.

○ The digital asset is available in increments that correlate with a consumptive intent versus an investment or speculative purpose.

○ An intent to consume the digital asset may also be more evident if the good or service underlying the digital asset can only be acquired, or more efficiently acquired, through the use of the digital asset on the network.

● Any economic benefit that may be derived from appreciation in the value of the digital asset is incidental to obtaining the right to use it for its intended functionality.

● The digital asset is marketed in a manner that emphasizes the functionality of the digital asset, and not the potential for the increase in market value of the digital asset.

● Potential purchasers have the ability to use the network and use (or have used) the digital asset for its intended functionality.

● Restrictions on the transferability of the digital asset are consistent with the asset's use and not facilitating a speculative market.

● If the AP facilitates the creation of a secondary market, transfers of the digital asset may only be made by and among users of the platform.

Digital assets with these types of use or consumption characteristics are less likely to be investment contracts. For example, take the case of an online retailer with a fully-developed operating business. The retailer creates a digital asset to be used by consumers to purchase products only on the retailer's network, offers the digital asset for sale in exchange for real currency, and the digital asset is redeemable for products commensurately priced in that real currency. The retailer continues to market its products to its existing customer base, advertises its digital asset payment method as part of those efforts, and may "reward" customers with digital assets based on product purchases. Upon receipt of the digital asset, consumers immediately are able to purchase products on the network using the digital asset. The digital assets are not transferable; rather, consumers can only use them to purchase products from the retailer or sell them back to the retailer at a discount to the original purchase price. Under these facts, the digital asset would not be an investment contract.

Even in cases where a digital asset can be used to purchase goods or services on a network, where that network's or digital asset's functionality is being developed or improved, there may be securities transactions if, among other factors, the following is present: the digital asset is offered or sold to purchasers at a discount to the value of the goods or services; the digital asset is offered or sold to purchasers in quantities that exceed reasonable use; and/or there are limited or no restrictions on reselling those digital assets, particularly where an AP is continuing in its efforts to increase the value of the digital assets or has facilitated a secondary market.

III. Conclusion

The discussion above identifies some of the factors market participants should consider in assessing whether a digital asset is offered or sold as an investment contract and, therefore, is a security. It also identifies some of the factors to be considered in determining whether and when a digital asset may no longer be a security. These factors are not intended to be exhaustive in evaluating whether a digital asset is an investment contract or any other type of security, and no single factor is determinative; rather, we are providing them to assist those engaging in the offer, sale, or distribution of a digital asset, and their counsel, as they consider these issues. We encourage market participants to seek the advice of securities counsel and engage with the Staff through www.sec.gov/finhub.

As noted at the start of this discussion of digital assets, the law is quickly evolving in this area. Thus, the foregoing materials—while helpful—will undoubtedly soon be supplemented or perhaps even supplanted by new cases and SEC guidance. Nonetheless, it is interesting that the *Howey* test, developed in the 1940s, is flexible and vital enough to apply to the brave new world of digital assets. The next section discusses the application of the *Howey* test to another legal innovation (albeit less recent): interests in limited liability companies.

C. LLC INTERESTS

Looking at Section 2(a)(1) of the Securities Act again, you will note that there is no reference to partnership interests, whereas (as discussed above), stock in a corporation is almost always considered a security. The reason for the exclusion of partnership interests from the statute is that, as you learned in Chapters 3 and 4, partners generally work at and make all of the decisions of a partnership. Thus, because the investors would be doing the work, not passive investors, partnership interests would not be considered "investment contracts" because the profits generated by the partnership would not be coming "solely from the efforts" of others (although there were some cases that found otherwise on specific facts).

But what about interests in an LLC? Obviously, LLCs were not around in 1933, but Congress hasn't amended Section 2(a)(1) of the Securities Act to address LLC interests since then. The following case contains a good discussion of whether LLC interests should be considered securities.

Great Lakes Chemical Corp. v. Monsanto Co.
United States District Court for the District of Delaware
96 F. Supp.2d 376 (2000)

McKELVIE, District Judge.

This is a securities case. Plaintiff Great Lakes Chemical Corporation is a Delaware corporation with its principal place of business in Indianapolis, Indiana. Defendants Monsanto Company and its wholly owned subsidiary, Sweet Technologies, Inc. ("STI"), are Delaware corporations with their principal places of business in St. Louis, Missouri.

On May 3, 1999, Great Lakes purchased NSC Technologies Company, LLC ("NSC"), from Monsanto and STI. NSC is a Delaware limited liability company with its principal place of business in Mount Prospect, Illinois.

On January 4, 2000, Great Lakes filed the complaint in this action, alleging that Monsanto and STI violated [Section 10(b) of, and Rule 10b-5 under, the Securities Exchange Act] by failing to disclose material information in conjunction with the sale of NSC. *** Great Lakes is seeking compensatory damages, punitive damages, indemnification, costs, fees, and rescission of the purchase agreement. ***

*** This is the court's decision on defendants' motion to dismiss.

I. FACTUAL AND PROCEDURAL BACKGROUND

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A. The Formation of NSC

1. Creation of the NSC Unit within Monsanto

Monsanto is the world's largest manufacturer and distributor of L-phenylalanine ("L-phe"), an amino acid that is a principal ingredient in the sweetener aspartame. Monsanto manufactures and sells aspartame as the product NutraSweet. L-phe is also useful in the production of numerous pharmaceutical products.

In approximately 1985, Monsanto created the NSC Unit within its NutraSweet division to develop specialized pharmaceutical intermediates and pharmaceutical active compounds derived from L-phe. In 1995, Monsanto reorganized its NutraSweet division and established the NSC Unit as a separate reporting division of Monsanto Growth Enterprises. Monsanto retained the commercial rights to manufacture and sell L-phe and aspartame to the sweetener market. Monsanto restricted the NSC Unit's sales of L-phe to the pharmaceutical market and to a single customer in the sweetener market, Enzymologa, a Mexican manufacturer of aspartame. By 1998, the NSC Unit's principal business was based on the development and sale of L-phe and Tic-D, a pharmaceutical intermediate derived from L-phe.

2. Creation of NSC as a Limited Liability Company

On September 25, 1998, Monsanto entered into an agreement (the "LLC Agreement") with STI to establish the NSC Unit as a limited liability company called NSC Technologies Company, LLC ("NSC"), pursuant to the Delaware Limited Liability Company Act [citation omitted]. The following terms of the LLC Agreement are relevant to the present dispute.

The LLC Agreement names Monsanto and STI as the Members of NSC, and provides that each Member shall have an Interest in NSC. The LLC Agreement defines "Interest" as "[a] Member's Percentage Interest, right to distributions under Section 4.1 of this Agreement, and any other rights which such Member has in the Company." A Member's Percentage Interest is determined according to the Member's capital contributions to NSC. Pursuant to the LLC Agreement, Monsanto contributed assets to NSC totaling $162.9 million, and STI contributed assets totaling $37.1 million, giving the firms an 81.5% and 18.5% Percentage Interest, respectively, in NSC. The LLC Agreement establishes procedures for Members to adjust their Percentage Interest in NSC.

The Members are entitled to receive distributions of Net Cash Flow and allocations of profits and losses. Net Cash Flow is defined, essentially, as all cash receipts of NSC, excluding members' capital contributions, less all cash expenditures, accrued expenses, and loan payments due. Section 4.1 of the LLC Agreement establishes the allocation mechanism by which Members receive distributions of Net Cash Flow ***. The LLC Agreement also provides that NSC's income, profits, gains, losses, deductions, and credits shall be allocated to the Members pro rata in accordance with their respective Percentage Interests.

The LLC Agreement provides that the business and affairs of NSC shall be managed by a Board of Managers. *** Except as otherwise provided for in the LLC Agreement, the Board of Managers has exclusive authority to bind NSC, and to manage and control NSC's business and affairs. The LLC Agreement states:

> Except as otherwise expressly set forth in this Agreement, the Members shall not have any authority, right, or power to bind the Company, or to manage or control, or to participate in the management or control of, the business and affairs of the Company in any manner whatsoever. Such

> management shall in every respect be the full and complete responsibility of the Board alone as provided in this Agreement.

The Members of NSC may remove the Managers with or without cause.

The Members of NSC are entitled to vote on certain matters, including on all incurrences of indebtedness or guarantees thereof. The LLC Agreement specifies that a Majority in Interest, which is defined as 51% of the Percentage Interests owned by the Members, is required to constitute a quorum, or to amend the LLC Agreement.

The LLC Agreement restricts the ability of Members to transfer or otherwise dispose of their Interests in NSC absent consent of the Board. Moreover, Members are prohibited from disposing of their Interests in NSC when the disposition would cause NSC to be taxable as a corporation, would violate federal or state securities laws, or would violate other laws or commitments binding on NSC. ***

B. The Sale of NSC

In October 1998, BancBoston Robertson Stephens, an investment bank, prepared a Confidential Descriptive Memorandum (the "Offering Memorandum") on behalf of Monsanto and STI to promote the sale of NSC. *** The Offering Memorandum recites that NSC's sales increased from $8.3 million in 1995 to $34.5 million in 1997, and projects that NSC's sales would increase to $93.2 million in 1999 and $192.2 million by 2002.

On November 10, 1998, Monsanto and STI presented the Offering Memorandum to Great Lakes, together with a letter from BancBoston Robertson Stephens proposing that final bids be submitted by year end. On November 12, 1998, Great Lakes responded to the solicitation with a letter indicating its interest in submitting a bid.

***

2. Changes in the Market for L-phe and Tic-D

In early 1999, as negotiations over the sale of NSC continued, a number of events were occurring that may have impacted the business prospects of NSC. ***

3. Great Lakes' Offer to Purchase NSC, and Monsanto's Revision of NSC's Financial Projections

On January 15, 1999, [Ian Wolpert, a Vice-President of Monsanto] provided representatives of Great Lakes with revised sales projections for NSC, reducing the forecast of $93.2 million originally stated in the Offering Memorandum to $78 million.

The following week, Great Lakes offered to acquire defendants' Interests in NSC for approximately $130 million.

During the months of January through April 1999, Great Lakes conducted due diligence concerning NSC's business, intellectual property, its product markets, and its actual and projected sales. ***

***

On March 15, 1999, during a teleconference call with Wolpert, representatives from Great Lakes raised concerns about defendants' sales projections for NSC. Wolpert allegedly replied that the reduced sales in 1999 were the result of temporary reductions in orders and the accelerated posting of 1999 sales in 1998, and that the shortfall in sales in the first quarter of 1999 would benefit Great Lakes because those deferred sales would be realized after Great Lakes acquired NSC.

On March 16, 1999, Monsanto and STI provided Great Lakes with revised financial projections, stating that NSC could realize total sales of approximately $68.2 million in 1999. Defendants allegedly assured Great Lakes that NSC's total sales would increase to $124.1 million in 2000, $149.9 million in 2001, and $184 million in 2002. At a meeting the same week between defendants and Great Lakes, Wolpert allegedly stated to Great Lakes' representative that defendants "stood by" these sales projections. After the meeting, [Fred Beyerlein, the Co-Chief Operating Officer of NSC] allegedly told Wolpert that he, Beyerlein, did not stand behind the projections. Defendants allegedly prohibited Beyerlein from advising Great Lakes of his opinions.

In early April 1999, the parties adjusted the purchase price for NSC from $130 million to $125 million. On April 8, 1999, the parties entered into an Ownership Interest Purchase Agreement (the "Purchase Agreement"). *** The parties closed the transaction on May 3, 1999.

4. The Purchase Agreement

*** [T]he Purchase Agreement refers to the Ownership Interests in NSC being transferred as "equity securities." ***

In § 4.6 of the Purchase Agreement, Monsanto and STI make the representation and warranty that, except as otherwise provided, the financial statements provided by defendants to Great Lakes "reflect all material items and present fairly in all material respects the financial position of the Company as of the dates thereof and the results of operations for the periods described therein."

In § 4.7(a) of the Purchase Agreement, Monsanto and STI make the representation and warranty that, since December 31, 1998, "there has been no change in the business of the Company," which would have a "negative effect or negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to $6,500,000 or more."

The Purchase Agreement includes a disclaimer which states that Great Lakes is to take full responsibility for evaluating the accuracy of all estimates and projections furnished to it by Monsanto and STI. ***

***

Section 11.1 of the Purchase Agreement states that, except as otherwise provided, Monsanto and STI "will indemnify and reimburse the Buyer for any and all claims, losses, liabilities, damages, penalties, fines, costs and expenses ... incurred by the Buyer and its Affiliates" as a result of, among other things, any breach or inaccuracy of any representation or warranty made by Monsanto or STI as set forth in the Purchase Agreement.

C. The Dissolution of NSC

On October 5, 1999, Great Lakes filed a Certificate of Cancellation with the State of Delaware, dissolving NSC as a separate entity. NSC's actual sales for 1999 were approximately $33 million, less than 50% of the projections provided by Monsanto and STI to Great Lakes in March 1999.

D. The Lawsuit

On January 20, 2000, Great Lakes filed an eight count complaint in this court. Count I asserts that Monsanto and STI violated § 10(b) of the Securities Exchange Act of 1934, [citation omitted], and Rule 10b-5 promulgated thereunder, [citation omitted], by making material misrepresentations and by failing to disclose material facts in connection with the sale of securities. ***

***

On March 9, 2000, Monsanto and STI moved to dismiss the complaint pursuant *** for failure to plead fraud with specificity and for failure to state a claim upon which relief may be granted. Monsanto and STI assert that Great Lakes' federal and state securities claims fail as a matter of law because the Interests in NSC transferred pursuant to the Purchase Agreement do not constitute "securities" under federal or state law, and because plaintiffs fail to adequately plead fraud. ***

II. DISCUSSION

A. What Is an LLC?

In Delaware, LLCs are formed pursuant to the Delaware Limited Liability Company Act, [citation omitted]. LLCs are hybrid entities that combine desirable characteristics of corporations, limited partnerships, and general partnerships. LLCs are entitled to partnership status for federal income tax purposes under certain circumstances, which permits LLC members to avoid double taxation, i.e., taxation of the entity as well as taxation of the members' incomes. [Citation omitted.] Moreover, LLCs members, unlike partners in general partnerships, may have limited liability, such that LLC members who are involved in managing the LLC may avoid becoming personally liable for its debts and obligations. [Citation omitted.] In addition, LLCs have greater flexibility than corporations in terms of organizational structure. The Delaware Limited Liability Company Act, for example, establishes the default rule that management of an LLC shall be vested in its members, but permits members to establish other forms of governance in their LLC agreements. [Citation omitted.]

***

B. Are the Interests in NSC That Were Transferred Pursuant to the Purchase Agreement "Securities" Under Federal Law?

To prevail in its claim that defendants engaged in securities fraud under § 10(b) of the Securities Exchange Act of 1934, Great Lakes must demonstrate that: (i) defendants made a misstatement or omission; (ii) of a material fact; (iii) with scienter; (iv) in connection with the purchase or sale of securities; (v) upon which plaintiffs relied; and (vi) that reliance proximately caused plaintiffs' losses. [Citation omitted.] A threshold question in this matter is whether defendants' alleged misconduct involved a purchase or sale of securities. Defendants contend that plaintiff's claim fails as a matter of law because the Interests in NSC do not constitute securities.

Section 2(a)(1) of the Securities Act of 1933 lists financial instruments that qualify as securities ***. Among the securities enumerated in § 2(a)(1) of the Securities Act, Great Lakes contends that the Interests in NSC constitute either "stock," an "investment contract," or "any interest or instrument commonly known as a 'security.'"

1. Key Cases Governing the Characterization of Novel Instruments

***

The Supreme Court defined the parameters of an "investment contract" for the purposes of federal securities law in the case of *SEC v. W.J. Howey, Co.*, [328 U.S. 293 (1946)]. ***

*** The Court stated that "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." [Citation omitted.] Thus, the three requirements for establishing an investment contract are: (1) "an investment of money," (2) "in a common enterprise," (3) "with profits to come solely from the efforts of others." [Citation omitted.] ***

The Supreme Court established guidelines for whether non-traditional instruments labeled "stock" constitute securities in *United Housing Foundation, Inc. v. Forman*, [421 U.S. 837 (1975)] ***

*** The Supreme Court held that the "stock" issued by the cooperative [in the case] did not constitute a security. The shares, the Court found, lacked the five most common features of stock: (1) the right to receive dividends contingent upon an apportionment of profits; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) voting rights in proportion to the number of shares owned; and (5) the ability to appreciate in value. [Citation omitted.] Finding that the purchasers obtained the shares in order to acquire subsidized low-cost living space, not to invest for profit, the Court ruled that the "stock" issued by the cooperative was not a security. [Citation omitted.]

Following the issuance of *Forman*, a number of lower courts began to apply the *Howey* test to distinguish between investment transactions, which were covered by the securities laws, and commercial transactions, which were not. See, e.g., *Landreth Timber Co. v. Landreth*, 731 F.2d 1348, 1352 (9th Cir. 1984) (citing cases). In *Landreth*, the Ninth Circuit addressed whether a single individual who purchased 100% of the stock in a lumber corporation, and who had the power to actively manage the acquired business, could state a claim under the securities laws for alleged fraud in the sale of the business. The Ninth Circuit found that the purchaser bought full control of the corporation, and that the economic reality of the transaction was the purchase of a business, and not an investment in a security. The court held that the sale of 100% of the stock of a closely held corporation was not a transaction involving a "security."

Reversing the Ninth Circuit, the Supreme Court reasoned that it would be burdensome to apply the *Howey* test to transactions involving traditional stock. [Citation omitted.] The Court held that, insofar as a transaction involves the sale of an instrument called "stock," and the stock bears the five common attributes of stock enumerated in *Forman*, the transaction is governed by the securities laws. The Court noted that stock is specifically enumerated in § 2(a)(1) of the Securities Act as a security, and that stock is so "quintessentially a security" that it is unnecessary to apply the *Howey* test to determine if it is a security. [Citation omitted.] *** The Court stated that the *Howey* test should only be applied to determine whether an instrument is an "investment contract," and should not be applied in the context of other instruments enumerated in § 2(a)(1) of the Securities Act. [Citation omitted.]

***

2. Prior Cases Concerning Whether Interests in LLCs are Securities

The present case raises novel issues regarding the regulation of transactions involving interests in LLCs. The court has identified three cases in which other courts have determined whether interests in LLCs constitute securities.

In *Keith v. Black Diamond Advisors, Inc.*, 48 F.Supp.2d 326 (S.D.N.Y. 1999), the plaintiff, Keith, founded a sub-prime mortgage lending firm, Eagle Corp., and brought it to profitability. Milton was an original investor in Eagle. Black Diamond, a venture capital firm, proposed a joint venture in which it would contribute $150,000 in cash, and Keith and Milton would each contribute their interests in Eagle, to form a New York limited liability company, Pace LLC. Through this transaction, Black Diamond acquired 50% of the interests in Pace, and Keith and Milton each received a 25% stake. Keith alleged that Black Diamond subsequently used its majority position to strip him of control of Pace. Keith sued Black Diamond for federal securities fraud.

The court applied the *Howey* test, and found that Keith had invested money in a common enterprise. The court, however, found that Keith had retained substantial control over the enterprise, such that he did not have an expectation of profits "solely from the efforts of others." As such, the court concluded that the LLC interests were not investment contracts. ***

SEC v. Parkersburg Wireless LLC, 991 F. Supp. 6 (D.D.C. 1997), involves [an] LLC that was established to provide wireless cable services. The promoters of the company sold "memberships" in the company to over 700 individuals in 43 states. The promoters targeted prospective investors who had Individual Retirement Accounts, and encouraged them to divert funds from their IRAs to buy membership units of the company.

The SEC sought to enjoin the sale of the membership interests. The court found that the interests sold in the LLC "easily satisfy" the *Howey* test for investment contracts. The investors' $10,000 minimum contribution constituted an "investment of money." Because the 700 individuals were to receive a pro rata share of the company's revenues, the court found there was a common enterprise. Moreover, the investors had little, if any, input into the company, so their profits were to come solely from the efforts of others.

SEC v. Shreveport Wireless Cable Television Partnership, 1998 WL 892948 (D.D.C. 1998), involves three entities: Reading Partnership and Shreveport Partnership, which are both general partnerships, and Baton Rouge LLC. All three entities were established to provide wireless cable services. Each entity engaged the services of a corporation to develop the telecommunications services and to solicit public investment in the enterprises. The promoters sold memberships in the three entities to approximately 2000 investors.

The SEC sought to enjoin the sale of interests in the ventures. In ruling upon defendants' motion for summary judgment that the interests were not securities, the court applied the *Howey* test to determine whether the interests were investment contracts. The court found that the purchasers of the interests had invested money in a common enterprise. The court found, however, that there was a question of fact as to whether the investors exercised significant control over the management of the corporation, and denied defendants' motion for summary judgment.

Having reviewed these other cases in which courts have considered whether LLC interests might constitute securities, the court will determine whether the Interests in NSC constitute "stock," an "investment contract," or "any interest or instrument commonly known as a security."

3. Are the Interests In NSC "Stock"?

Great Lakes contends that NSC is the functional equivalent of a corporation, and that the Interests in NSC should be treated as stock. Great Lakes notes that the LLC Agreement refers to the Interests as "equity securities," and that the LLC Agreement prohibits the transfer of the Interests in such a way as would "violate the provisions of any federal or state securities laws."

Monsanto and STI, on the other hand, contend that the Interests cannot be stock because NSC is not a corporation.

As discussed above, the Supreme Court has described the five most common characteristics of stock as follows: (1) the right to receive dividends contingent upon an apportionment of profit; (2) negotiability; (3) the ability to be pledged or hypothecated; (4) the conferring of voting rights in proportion to the number of shares owned; and (5) the capacity to appreciate in value. [Citation omitted.]

As noted by plaintiffs, these attributes of stock also characterize, at least to some degree, the Interests in NSC. NSC's Members are entitled to share, pro rata, in distributions of Net Cash Flow, contingent upon its distribution by the Board of Managers. The Interests are negotiable and may be pledged or hypothecated, subject to approval by the Board of Managers. [Citation omitted.] Members in NSC have voting rights in proportion to their Percentage Interest in the company. And, the Interests in NSC have the capacity to appreciate in value. The Interests in NSC are undoubtedly stock-like in character, but the question remains if the Interests can be characterized as "stock" for the purposes of the federal securities laws.

The primary goal of the securities laws is to regulate investments, and not commercial ventures. [Citations omitted.] In transactions involving traditional stock, lower courts had attempted to distinguish between investment transactions and commercial transactions. [Citation omitted.] The Supreme Court, as discussed above, held that it is unnecessary to attempt to distinguish between commercial and investment transactions when the financial instrument in question is traditional stock. [Citation omitted.] Because stock is listed in § 2(a)(1) of the Securities Act as a security, and because people trading in traditional stock are likely to have a high expectation that their activities are governed by the securities laws, the Court ruled that all transactions involving traditional stock are covered by the securities laws, regardless if the transaction is of an investment or commercial character. [Citation omitted.] The Court expressly limited this rule to transactions involving traditional stock. [Citation omitted.]

The Supreme Court suggested, prior to the issuance of *Landreth*, that certain stock-like instruments might be construed as "stock" for the purposes of the federal securities laws. In *Tcherepnin v. Knight*, [389 U.S. 332 (1967)], the Court considered whether purchasers of withdrawable capital shares in a savings and loan association could state a claim under the federal securities laws for allegedly misleading statements made in solicitation materials. Holders of the withdrawable capital shares were entitled to be members of the association and were granted voting rights in proportion to the number of shares they owned. The holders were entitled to dividends declared by the association's board of directors and based on the association's profits. Certain restrictions applied to the transferability of the instruments. The Court rejected the lower court's finding that the restrictions on negotiability precluded a finding that the shares were securities. The Court ruled that the instruments constituted "investment contracts" under *Howey*. [Citation omitted.] The Court continued, stating that the instruments could also be characterized as "certificates of interest or participation in any profitsharing agreement," as "transferable shares," or as "stock." [Citation omitted.] The Court held that the holders of withdrawable capital shares were entitled to the protections afforded by the securities laws.

In *Marine Bank v. Weaver*, [455 U.S. 551 (1982)], the Court reaffirmed its holding in *Tcherepnin* that the withdrawable capital shares in that case were "like ordinary shares of stock." This statement arose in the context of a suit brought by holders of certificates of deposit who were allegedly defrauded into pledging their certificates to guaranty a third party loan. The lower court held that the certificates of deposit were securities, as they were deemed to be the functional equivalent of the withdrawable capital shares at issue in *Tcherepnin*. [Citation omitted.] The Court found that the certificates of deposit had different characteristics than withdrawable capital shares, as they conferred upon their holders the right to a fixed rate of interest and did not entitle holders to voting rights. The Court found that the certificates of deposit were not securities.

Although, in *Tcherepnin*, the Supreme Court found that stock-like instruments could be deemed "stock" for the purposes of federal securities law, this court does not find *Tcherepnin* controlling in the present case. *Tcherepnin* preceded *Landreth*, which holds that the per se rule announced in that case should apply only to transactions involving traditional stock, because the name "stock" serves to put parties on notice that the transaction is governed by the securities laws. [Citation omitted.] Moreover, the withdrawable capital shares at issue in *Tcherepnin* were clearly investment instruments, and there is no indication that the holding in that case would apply to stock-like instruments used in commercial ventures. [Citation omitted.] Although the Court subsequently reiterated in *Marine Bank* that the withdrawable capital shares in *Tcherepnin* were "stock-like," [citation omitted], the Court did so in order to distinguish certificates of deposit from other instruments deemed to be securities, and did not appear to hold that all "stock-like" instruments should be regulated as securities.

In the present case, the LLC Interests, although they are "stock-like" in nature, are not traditional stock. *Landreth*, thus, is inapplicable to this case, and the court must determine whether the sale of NSC was essentially an investment transaction, in which case the securities laws apply, or whether it was a commercial transaction, in which case they do not. To make this determination, the court will apply the *Howey* test for investment contracts. [Citations omitted.] The court will also consider whether the Interests can be characterized as "any interest or instrument commonly known as a security."

4. Are the Interests in NSC an "Investment Contract"?

*** The parties do not dispute that the first prong of the *Howey* test—an investment of money—is satisfied by the facts of this case. The court will now consider whether Great Lakes invested in a "common enterprise," and whether Great Lakes' profits in NSC were to come "solely from the efforts of others."

[*Common Enterprise*] Monsanto and STI argue that Great Lakes' purchase of the Interests in NSC fails the second prong of the *Howey* test, which requires that an investor invest its money in a "common enterprise." According to defendants, Great Lakes bought the entirety of NSC without pooling its contributions with those of other investors.

Great Lakes, on the other hand, contends that when Monsanto and STI created NSC, they pooled their resources and established NSC as a common enterprise. At the time of sale of the membership Interests, Great Lakes contends, the Interests were securities, and they did not cease to be securities when they were transferred to Great Lakes.

To determine whether a party has invested funds in a common enterprise, courts look to whether there is horizontal commonality between investors, or vertical commonality between a promoter and an investor. Horizontal commonality requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors. [Citation omitted.] The vertical commonality test is less stringent, and requires that an investor and promoter be engaged in a common enterprise, with the "fortunes of the investors linked with those of the promoters." [Citations omitted.] The Third Circuit has applied the horizontal commonality approach, [citation omitted], but has subsequently indicated that the vertical commonality test might be applicable in other cases, [citation omitted].

In this case, Great Lakes bought 100% of the Interests of NSC from Monsanto and STI. Great Lakes, accordingly, did not pool its contributions with those of other investors, as is required for horizontal commonality. After the sale, Monsanto and STI retained no interest in NSC, so it cannot be said that the fortunes of Great Lakes were linked to those of defendants, as is required for vertical commonality.

Great Lakes urges that when the Interests in NSC were created, Monsanto and STI pooled their contributions in a common enterprise. Great Lakes contends that Monsanto's and STI's Interests were securities when they were created, and that they did not cease to be securities when conveyed to Great Lakes. ***
***

In this case, the challenged transaction is the sale of NSC by defendants to Great Lakes, and not the formation of NSC. Thus, the fact that Monsanto and STI pooled their contributions in the formation of NSC does not change the character of the sale of NSC to Great Lakes. The court concludes that Great Lakes did not invest in a common enterprise.

[*Solely From the Efforts of Others.*] Monsanto and STI argue that the profits in NSC did not come solely from the efforts of others, as would support a finding that the Interests in NSC were securities. [Citation omitted.] Rather, defendants contend that Great Lakes had the power to control NSC through its authority to remove managers with or without cause, and to dissolve the entity.

Great Lakes argues, on the other hand, that it depended solely on the efforts of others to profit from NSC, as the LLC Agreement provides that the Members would retain no authority, right, or power to manage or control the operations of the company. In the alternative, Great Lakes contends that the Howey test does not apply to the sale of 100% of a business over which the purchaser intended to exercise control.

There is little case law establishing guidelines for determining whether a member in an LLC is sufficiently passive that he is dependent solely on the efforts of others for profits. In the context of general partnerships and limited partnerships, by contrast, there has been extensive litigation on whether partnership interests may qualify as securities. An analogy to partnership law is convenient for analyzing interests in LLCs, but there are important differences between general partnerships, limited partnerships, and LLCs.

General partnerships in Delaware are formed pursuant to the Delaware Revised Uniform Partnership Act, [citation omitted]. Each partner has equal rights in the management and conduct of the partnership business and affairs. [Citation omitted.] In general, all partners are liable jointly and severally for all obligations of the partnership. [Citation omitted.] Because partners have equal rights in the management of general partnerships, and because they are not protected by limited liability, courts consistently state that partners in general partnerships are unlikely to be passive investors who profit solely on the efforts of others. Some courts have adopted per se rules that partnership interests are not securities. [Citation omitted.] Other courts have adopted a presumption that partnership interests are not securities, but permit a finding that partnership interests are securities when a partner has so little control over the management as to be a passive investor. [Citation omitted.]

*** Limited partnerships are comprised of general partners and limited partners. General partners in limited partnerships have all the powers and duties of general partners in general partnerships, and are liable for the debts of the partnership. [Citation omitted.] Limited partners have limited liability, but become liable as general partners if they take part in the control of the business. [Citations omitted.] A limited partner may advise a general partner with respect to the business of the limited partnership, or cause a general partner to take action by voting or otherwise, without losing his limited liability. [Citation omitted.] In cases involving transactions of interests in limited partnerships, wherein the limited partners exercised no managerial role in the partnership's affairs, courts treat the limited partners as passive investors, and find that the membership interests of limited partners constitute securities under federal law. [Citation omitted.] Where, however, a limited partner is found to have exercised substantial control over the management of the partnership, courts find that the limited partner has not profited solely from the efforts of others, and rule that the interest in the partnership is not a security. [Citation omitted.]

Membership interests in LLCs are distinct from interests in general partnerships and limited partnerships. The primary differences between LLCs and general partnerships are that members of LLCs are entitled to limited liability, and, depending on the terms of the operating agreement giving rise to the particular LLC at issue, the members of the LLC may be less involved in the management of the enterprise than partners in a general partnership. As such, the grounds for creating a per se rule, or at least a presumption, that interests in general partnerships are not securities are lacking in the context of LLCs.

In comparison with limited partnerships, the Delaware Limited Liability Company Act permits a member in an LLC to be an active participant in management and still to retain limited liability. [Citation omitted.] Thus, there is no statutory basis, as with limited partnerships, to presume that LLC members are passive investors entitled to protection under the federal securities laws.

The Delaware Limited Liability Company Act grants parties substantial flexibility in determining the character of an LLC. Accordingly, the terms of the operating agreement of each LLC will determine whether its membership interests constitute securities. The presumptions that courts have articulated with respect to general partnerships and limited partnerships do not apply to LLCs. Rather, to determine whether a member's profits are to come solely from the efforts of others, it is necessary to consider the structure of the particular LLC at issue, as provided in its operating agreement.

In the present case, the Members of NSC had no authority to directly manage NSC's business and affairs. Section 5.1(a) of the LLC Agreement states:

> Except as otherwise expressly set forth in this Agreement, the Members shall not have any authority, right or power to bind the Company, or to manage or control, or to participate in the management or control of, the business and affairs of the Company in any manner whatsoever. Such

> management shall in every respect be the full and complete responsibility of the Board alone as provided in this Agreement.

The Members, however, had the power to remove any Manager with or without cause, and to dissolve the company. Great Lakes exercised this authority on October 5, 1999, when it filed a Certificate of Cancellation with the State of Delaware, dissolving NSC as a separate entity. Moreover, Great Lakes' complaint avers that, prior to selling NSC, Monsanto and STI had the power to control the actions of the Managers, insofar as defendants allegedly prohibited NSC's management from speaking directly with Great Lakes regarding sales, sales forecasts, and customer orders.

The powers held by Great Lakes in NSC are comparable to those discussed in *Steinhardt* [citation omitted], wherein the Third Circuit considered whether a limited partner in a limited partnership could state a claim under the securities laws. The limited partner, Steinhardt, purchased a 98.8% interest in the limited partnership, which acquired title to non-performing mortgage loans. The court noted that limited partners generally are passive investors entitled to protection under federal securities law. Upon analyzing the governance of the limited partnership at issue, however, the court found that Steinhardt alone constituted a "Majority of the Partners," and that Steinhardt was free to remove and replace the general partner without notice if the general partner refused to carry out Steinhardt's proposals. [Citation omitted.] In light of this factor and others, the court found that the limited partnership agreement at issue gave Steinhardt significant powers that directly affected the profits it received from the partnership. Accordingly, the court concluded that Steinhardt was not a passive investor, and that Steinhardt's membership in the partnership did not qualify as an investment contract.

The powers held by Great Lakes were comparable to those of Steinhardt, in that Great Lakes had the authority to remove NSC's managers without cause. Because Great Lakes was the sole owner of NSC, its power to remove managers was not diluted by the presence of other ownership interests. [Citation omitted.] Great Lakes' authority to remove managers gave it the power to directly affect the profits it received from NSC. Thus, the court finds that Great Lakes' profits from NSC did not come solely from the efforts of others. [Citation omitted.]

Alternatively, Great Lakes argues that, even if it did exercise substantial control over NSC, the transfer of Interests in NSC is nonetheless covered by the securities laws, because it bought 100% of the Interests in NSC and intended to operate the business. Great Lakes relies on [*Landreth Timber*] in support of this proposition.

Under *Landreth*, as discussed above, a stock transaction is covered by the securities laws even though the purchaser exercises control over the acquired corporation. [Citation omitted.] *Landreth*, however, is applicable only to those cases involving stock, or other financial instruments which are listed in § 2(a)(1) of the Securities Act. [Citation omitted.] When the financial instrument in question is a less traditional instrument that is not enumerated in the statute, but that might qualify as an "investment contract," then the complainant must demonstrate that the instrument satisfies the *Howey* test. As discussed above, the Interests in NSC do not constitute stock, and so *Landreth* is inapplicable.

The court finds that Great Lakes did not invest in a common enterprise, and did not have an expectation of profits "solely from the efforts of others," as is required by *Howey*. The Interests in NSC, thus, are not investment contracts.

5. Are the Interests in NSC "Any Interest or Instrument Commonly Known as a Security"?

Great Lakes argues that, even if the Interests in NSC do not otherwise satisfy the *Howey* test for investment contracts, they should be deemed to be "any interest or instrument commonly known as a security," as provided for in § 2(a)(1) of the Securities Act. Great Lakes notes that the LLC Agreement refers to the Interests at issue as "equity securities," and that the LLC Agreement prohibits the transfer of the Interests in such a way as would "violate the provisions of any federal or state securities laws." Moreover, Great Lakes contends, ten states have defined interests in LLCs as securities, including Indiana, where NSC has its principal place of business.

***

The Supreme Court has indicated that the term "any interest or instrument commonly known as a security" covers the same financial instruments as referred to by the term "investment contract." In [*United Housing v. Forman*], the Court stated that "[w]e perceive no distinction, for present purposes, between an 'investment contract' and an 'instrument' commonly known as a 'security.'" In either case, the basic test for distinguishing the transaction from other commercial dealings is 'whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.'" [Citations omitted.] The *Howey* test, the Court explained, "embodies the essential attributes that run through all of the Court's decisions defining a security." [Citation omitted.]

When confronted with novel financial instruments, numerous courts have considered whether to distinguish between an "investment contract" and "any interest or instrument commonly known as a security," and have declined to do so. [Citations omitted.] In this case, too, the court finds that it would be improper to extend the definition of a security by reinterpreting the term "any interest or instrument commonly known as a security."

In sum, the court finds that the Interests in NSC constitute neither "stock," nor an "investment contract," nor "any interest or instrument commonly known as a security." The court will grant defendants' motion to dismiss Count I of Great Lakes' complaint.

***

D. "NOTES" AND "EVIDENCES OF INDEBTEDNESS"

Section 2(a)(1) of the Securities Act provides that some other types of securities are notes, bonds, debentures, and "evidences of indebtedness." As noted in a footnote in Chapter 8, bonds typically are secured by the corporation's assets as collateral, whereas debentures are typically unsecured. Further, bonds and debentures tend to have a longer duration than notes. Nevertheless, the use of all three terms, as well as "evidence of indebtedness," in Section 2(a)(1) seems like overkill because they are all types of debt instruments.

But more importantly, keep in mind that Section 2(a)(1) states that "any" note can be a security. Does this mean that when your roommate gave you an "IOU" when you paid for her lunch yesterday, that that "note" was a security and, if she doesn't repay it, you can sue her in federal court? Probably not, as you will learn from the following case.

Reves v. Ernst & Young
United States Supreme Court
494 U.S. 56 (1990)

JUSTICE MARSHALL delivered the opinion of the Court.

This case presents the question whether certain demand notes issued by the Farmers Cooperative of Arkansas and Oklahoma (Co-Op) are "securities" within the meaning of § 3(a)(10) of the Securities Exchange Act of 1934. We conclude that they are.

[I] The Co-Op is an agricultural cooperative that, at the time relevant here, has approximately 23,000 members. In order to raise money to support its general business operations, the Co-Op sold promissory notes payable on demand by the holder. Although the notes were uncollateralized and uninsured, they paid a variable rate of interest that was adjusted monthly to keep it higher than the rate paid by local financial institutions. The Co-Op offered the notes to both members and nonmembers, marketing the scheme as an "Investment Program." Advertisements for the notes, which appeared in each Co-Op newsletter, read in part: "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is ... Safe ... Secure ... and available when you need it." [Citation omitted.] Despite these assurances, the Co-Op filed for bankruptcy in 1984. At the time of the filing, over 1,600 people held notes worth a total of $10 million.

After the Co-Op filed for bankruptcy, petitioners, a class of holders of the notes, filed suit against Arthur Young & Co., the firm that had audited the Co-Op's financial statements (and the predecessor to respondent Ernst & Young). Petitioners alleged, *inter alia*, that Arthur Young had intentionally failed to follow generally accepted accounting principles in its audit, specifically with respect to the valuation of one of the Co-Op's major assets, a gasohol plant. Petitioners claimed that Arthur Young violated these principles in an effort to inflate the assets and net worth of the Co-Op. Petitioners maintained that, had Arthur Young properly treated the plant in its audits, they would not have purchased demand notes because the Co-Op's insolvency would have been apparent. On the basis of these allegations, petitioners claimed that Arthur Young had violated the antifraud provisions of the 1934 Act as well as Arkansas'[s] securities laws.

Petitioners prevailed at trial on both their federal and state claims, receiving a $6.1 million judgment. Arthur Young appealed, claiming that the demand notes were not "securities" under either the 1934 Act or Arkansas law, and that the statutes' antifraud provisions therefore did not apply. A panel of the Eighth Circuit, agreeing with Arthur Young on both the state and federal issues, reversed. [Citation omitted.] We granted certiorari to address the federal issue, [citation omitted], and now reverse the judgment of the Court of Appeals.

[II.A] This case requires us to decide whether the note issued by the Co-Op is a "security" within the meaning of the 1934 Act. Section 3(a)(10) of that Act is our starting point:

> The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is like-wise limited." [Citation omitted.]

The fundamental purpose undergirding the Securities Acts is "to eliminate serious abuses in a largely unregulated securities market." [Citation omitted.] In defining the scope of the market that it wished to regulate, Congress painted with a broad brush. It recognized the virtually limitless scope of human ingenuity, especially in the creation of "countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," [citation omitted], and determined that the best way to achieve its goal of protecting investors was "to define 'the term "security" in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" [Citation omitted.] Congress therefore did not attempt precisely to cabin the scope of the Securities

Acts. Rather, it enacted a definition of "security" sufficiently broad to encompass virtually any instrument that might be sold as an investment.

Congress did not, however, "intend to provide a broad federal remedy for all fraud." [Citation omitted.] Accordingly, "[t]he task has fallen to the Securities and Exchange Commission (SEC), the body charged with administering the Securities Acts, and ultimately to the federal courts to decide which of the myriad financial transactions in our society come within the coverage of these statutes." [Citation omitted.] In discharging our duty, we are not bound by legal formalisms, but instead take account of the economics of the transaction under investigation. [Citation omitted.] Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called.

A commitment to an examination of the economic realities of a transaction does not necessarily entail a case-by-case analysis of every instrument, however. Some instruments are obviously within the class Congress intended to regulate because they are by their nature investments. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), we held that an instrument bearing the name "stock" that, among other things, is negotiable, offers the possibility of capital appreciation, and carries the right to dividends contingent on the profits of a business enterprise is plainly within the class of instruments Congress intended the securities laws to cover. *Landreth Timber* does not signify a lack of concern with economic reality; rather, it signals a recognition that stock is, as a practical matter, always an investment if it has the economic characteristics traditionally associated with stock. Even if sparse exceptions to this generalization can be found, the public perception of common stock as the paradigm of a security suggests that stock, in whatever context it is sold, should be treated as within the ambit of the Acts. [Citation omitted.]

We made clear in *Landreth Timber* that stock was a special case, explicitly limiting our holding to that sort of instrument. [Citation omitted.] Although we refused finally to rule out a similar per se rule for notes, we intimated that such a rule would be unjustified. Unlike "stock," we said, "'note' may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context." [Citation omitted.] While common stock is the quintessence of a security, [citation omitted], and investors therefore justifiably assume that a sale of stock is covered by the Securities Acts, the same simply cannot be said of notes, which are used in a variety of settings, not all of which involve investments. Thus, the phrase "any note" should not be interpreted to mean literally "any note," but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts.

Because the *Landreth Timber* formula cannot sensibly be applied to notes, some other principle must be developed to define the term "note." A majority of the Courts of Appeals that have considered the issue have adopted, in varying forms, "investment versus commercial" approaches that distinguish, on the basis of all of the circumstances surrounding the transactions, notes issued in an investment context (which are "securities") from notes issued in a commercial or consumer context (which are not). [Citations omitted.]

The Second Circuit's "family resemblance" approach begins with a presumption that any note with a term of more than nine months is a "security." [Citation omitted.] Recognizing that not all notes are securities, however, the Second Circuit has also devised a list of notes that it has decided are obviously not securities. Accordingly, the "family resemblance" test permits an issuer to rebut the presumption that a note is a security if it can show that the note in question "bear[s] a strong family resemblance" to an item on the judicially crafted list of exceptions, [citation omitted], or convinces the court to add a new instrument to the list, [citation omitted].

In contrast, the Eighth and District of Columbia Circuits apply the test we created in *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946), to determine whether an instrument is an "investment contract" to the determination whether an instrument is a "note." Under this test, a note is a security only if it evidences "(1) an investment; (2) in a common enterprise; (3) with a reasonable expectation of profits; (4) to be derived from the entrepreneurial or managerial efforts of others." [Citation omitted.]

We reject the approaches of those courts that have applied the *Howey* test to notes; *Howey* provides a mechanism for determining whether an instrument is an "investment contract." The demand notes here may well not be "investment contracts," but that does not mean they are not "notes." ***

The other two contenders—the "family resemblance" and "investment versus commercial" tests—are really two ways of formulating the same general approach. Because we think the "family resemblance" test provides a more promising framework for analysis, however, we adopt it. The test begins with the language of the statute; because the Securities Acts define "security" to include "any note," we begin with a presumption that every note is a security.* We nonetheless recognize that this presumption cannot be irrebutable. As we have said, [citation omitted], Congress was concerned with regulating the investment market, not with creating a general federal cause of action for fraud. In an attempt to give more content to that dividing line, the Second Circuit has identified a list of instruments commonly denominated "notes" that nonetheless fall without the "security" category. See [citation omitted] (types of notes that are not "securities" include "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of

* [Footnote by court:] The Second Circuit's version of the family resemblance test provided that only notes with a term of more than nine months are presumed to be "securities." [Citation omitted.] No presumption of any kind attached to notes of less than nine months' duration. The Second Circuit's refusal to extend the presumption to all notes was apparently founded on its interpretation of the statutory exception for notes with a maturity of nine months or less. Because we do not reach the question of how to interpret that exception, [citation omitted], we likewise express no view on how that exception might affect the presumption that a note is a "security."

accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized)"); [citation omitted] (adding to list "notes evidencing loans by commercial banks for current operations").

We agree that the items identified by the Second Circuit are not properly viewed as "securities." More guidance, though, is needed. It is impossible to make any meaningful inquiry into whether an instrument bears a "resemblance" to one of the instruments identified by the Second Circuit without specifying what it is about those instruments that makes them non-"securities." Moreover, as the Second Circuit itself has noted, its list is "not graven in stone," [citation omitted], and is therefore capable of expansion. Thus, some standards must be developed for determining when an item should be added to the list.

An examination of the list itself makes clear what those standards should be. In creating its list, the Second Circuit was applying the same factors that this Court has held apply in deciding whether a transaction involves a "security." First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." [Citation omitted.] Second, we examine the "plan of distribution" of the instrument, [citation omitted], to determine whether it is an instrument in which there is "common trading for speculation or investment," [citation omitted]. Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. [Citations omitted.] Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary. [Citation omitted.]

We conclude, then, that in determining whether an instrument denominated a "note" is a "security," courts are to apply the version of the "family resemblance" test that we have articulated here: A note is presumed to be a "security," and that presumption may be rebutted only by a showing that the note bears a strong resemblance (in terms of the four factors we have identified) to one of the enumerated categories of instrument. If an instrument is not sufficiently similar to an item on the list, the decision whether another category should be added is to be made by examining the same factors.

[II.B] Applying the family resemblance approach to this case, we have little difficulty in concluding that the notes at issue here are "securities." Ernst & Young admits that "a demand note does not closely resemble any of the Second Circuit's family resemblance examples." [Citation omitted.] Nor does an examination of the four factors we have identified as being relevant to our inquiry suggest that the demand notes here are not "securities" despite their lack of similarity to any of the enumerated categories. The Co-Op sold the notes in an effort to raise capital for its general business operations, and purchasers bought them in order to earn a profit in the form of interest.* Indeed, one of the primary inducements offered purchasers was an interest rate constantly revised to keep it slightly above the rate paid by local banks and savings and loans. From both sides, then, the transaction is most naturally conceived as an investment in a business enterprise rather than as a purely commercial or consumer transaction.

As to the plan of distribution, the Co-Op offered the notes over an extended period to its 23,000 members, as well as to nonmembers, and more than 1,600 people held notes when the Co-Op filed for bankruptcy. To be sure, the notes were not traded on an exchange. They were, however, offered and sold to a broad segment of the public, and that is all we have held to be necessary to establish the requisite "common trading" in an instrument. [Citations omitted.]

The third factor—the public's reasonable perceptions—also supports a finding that the notes in this case are "securities." We have consistently identified the fundamental essence of a "security" to be its character as an "investment." [Citation omitted.] The advertisements for the notes here characterized them as "investments," [citation omitted], and there were no countervailing factors that would have led a reasonable person to question this characterization. In these circumstances, it would be reasonable for a prospective purchaser to take the Co-Op at its word.

Finally, we find no risk-reducing factor to suggest that these instruments are not in fact securities. The notes are uncollateralized and uninsured. Moreover, unlike the certificates of deposit in [citation omitted], which were insured by the Federal Deposit Insurance Corporation and subject to substantial regulation under the federal banking laws, and unlike the pension plan in [citation omitted], which was comprehensively regulated under the Employee Retirement Income Security Act of 1974, [29 U.S.C. § 1001 *et seq*., also known as "ERISA"], the notes here would escape federal regulation entirely if the Acts were held not to apply.

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* [Footnote by court:] We emphasize that by "profit" in the context of notes, we mean "a valuable return on an investment," which undoubtedly includes interest. We have, of course, defined "profit" more restrictively in applying the *Howey* test to what are claimed to be "investment contracts." See, e.g., [*United Housing Foundation v. Forman*, 421 U.S. 837, 852 (1975)] ("[P]rofit" under the *Howey* test means either "capital appreciation" or "a participation in earnings"). To apply this restrictive definition to the determination whether an instrument is a "note" would be to suggest that notes paying a rate of interest not keyed to the earning of the enterprise are not "notes" within the meaning of the Securities Acts. Because the *Howey* test is irrelevant to the issue before us today, [citation omitted], we decline to extend its definition of "profit" beyond the realm in which that definition applies.

The court below found that "[t]he demand nature of the notes is very uncharacteristic of a security," [citation omitted], on the theory that the virtually instant liquidity associated with demand notes is inconsistent with the risk ordinarily associated with "securities." This argument is unpersuasive. Common stock traded on a national exchange is the paradigm of a security, and it is as readily convertible into cash as is a demand note. The same is true of publicly traded corporate bonds, debentures, and any number of other instruments that are plainly within the purview of the Acts. The demand feature of a note does permit a holder to eliminate risk quickly by making a demand, but just as with publicly traded stock, the liquidity of the instrument does not eliminate risk altogether. Indeed, publicly traded stock is even more readily liquid than are demand notes, in that a demand only eliminates risk when, and if, payment is made, whereas the sale of a share of stock through a national exchange and the receipt of the proceeds usually occur simultaneously.

We therefore hold that the notes at issue here are within the term "note" in § 3(a)(10).

***

[Opinions of other Justices omitted.]

Problems

Problem 15-1: So, was your roommate's "IOU" for lunch yesterday a "note"?

Problem 15-2: Is the mortgage on your house a "note"? What about the promissory note that you signed when you bought your car?

E. "UNLESS THE CONTEXT OTHERWISE REQUIRES"

Don't forget that Section 2(a) of the Securities Act provides that all of the definitions set forth in that section apply "[u]nless the context otherwise requires." This means that a court could find that something that is, in the abstract, a "security" is really not a "security" in the circumstances of the case.

This has happened from time to time. For example, *Marine Bank v. Weaver*, 455 U.S. 551 (1982), concerned a certificate of deposit, or "CD," that had been issued by a national bank. On its face, a CD certainly looks like either a note or an evidence of indebtedness: if you buy a CD, the bank is promising to repay the principal amount of the CD, plus interest, at the end of CD's term. Nonetheless, the Supreme Court found that the CD at issue in the case was not a "security" because (among other reasons), the bank that issued the CD was subject to federal regulation that was designed to protect purchasers and was also federally insured. As a result, a CD purchaser doesn't really need the extra protection that the securities laws would provide.

However, in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), the Supreme Court found that "stock" is always "stock" (at least outside an unusual situation like in the *Forman* case). Before *Landreth Timber*, some federal courts of appeals had held that, in the context of the sale of *all* of the stock of a business, stock is not a "security." To understand this, think back to Chapter 14. As you learned in that chapter, two alternative ways to acquire an entire business are (1) to purchase all or substantially all of its assets or (2) to purchase all of its stock from its existing shareholders. Clearly, most business assets are not securities, whereas shares of stock are securities. As such, this would mean that (1) a purchaser of *assets* would not get the protection of the securities laws if it had been defrauded by the seller, whereas (2) a purchaser of *stock* would.

Because the choice of whether to acquire a business by buying its assets or instead buying its stock is largely driven by tax and other considerations, the lower federal courts developed the "sale of business doctrine." This doctrine held that stock is not a "security" when it is sold in connection with the acquisition of an entire business. This was meant to bring some legal parity to both of the above-described types of transactions: the securities laws would apply to *neither* of them. However, as noted above, *Landreth Timber* overruled these decisions. Again, "stock" is "stock" regardless of the context in which it is sold.

§ 15.02 REGISTRATION REQUIREMENTS OF THE SECURITIES ACT

A. IN GENERAL

If you want to sell something that is a "security," you have two choices: (1) register that security with the Securities and Exchange Commission (the SEC) before you offer or sell it to anyone, or (2) find an exemption from the Securities Act's registration requirement, either for the *security itself* or the type of *transaction* in which it is offered and sold. For example, if a corporation wants to do a stock offering to raise money for the business, it must either register the shares of stock that it will offer or comply with an exemption from the registration requirement. In Section 15.03 below, you will learn about some commonly used exemptions from registration. But first, let's assume that the issuer has chosen to conduct a registered offering.[*]

[*] Registered offerings are often referred to as public offerings. In most cases, a "registered" offering will also be a "public" offering (and vice versa) but these two phrases technically concern two different aspects of an offering. Calling a securities offering a "registered" offering simply means that the securities were registered with the SEC, as you will learn about in this section. On the other hand, a "public" offering typically means one in which a large number of potential investors are solicited. As you will learn in Section 15.03 below, it's possible to do a "public" offering on an exempt basis, such as under Rule 504.

Section 6 of the Securities Act provides that one registers securities by filing a ***registration statement*** for those securities with the SEC. For example, if ABC Corp. wanted to issue and sell 1 million shares of its common stock in a registered offering, it would file a registration statement with the SEC registering those 1 million shares. A Securities Act registration statement registers the shares that are being sold *in that offering* (although there are a few exceptions to this that we will not discuss here), rather than the entire class of those securities. If a year from now ABC Corp. wants to issue and sell more shares of its common stock, it would have to file a new registration statement for those shares (unless an exemption from registration applied).

Although Section 7 of the Securities Act provides that most registration statements must contain the information that is required by "Schedule A," that is largely of historical interest today. Instead, the required contents of the registration forms can be found in the forms themselves. Although you will likely learn more about what is required by these forms if you take a course on Securities Regulation in law school,[*] suffice it to say here that registration statements usually are *extremely* detailed, containing just about all of the information that an investor would (or should) want to know about the issuer of the securities and the securities themselves—and then some. If you don't believe this statement, you may want to take a look at the registration statement that Google Inc. (now renamed Alphabet Inc.) filed in 2004 for its initial public offering, or "IPO." (I chose to mention Google simply because it is a company that is familiar to all readers of this textbook who do not live under a rock.) Google's IPO registration statement can be found at the following web address:

http://www.sec.gov/Archives/edgar/data/1288776/000119312504142742/ds1a.htm

Note a few things about Google's registration statement. Once you get past the cover page, the ***prospectus*** portion of the registration statement appears.[**] As you will learn in more detail below, in a registered offering the prospectus must be made available to all prospective investors and must be delivered to all actual purchasers of the registered securities. The main purpose of requiring a prospectus is so that investors may educate themselves about the issuer and the offered security before deciding to invest. Note that the SEC does not "rate" securities offerings or recommend that investors invest or not invest in a given securities offering. Instead, one of the primary goals of the Securities Act is to mandate the *disclosure* of information that investors would deem important and then allow them to make their own educated investment decisions. (The absence of such information was thought to have been one of the contributing factors to the stock market

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[*] On the other hand, many law school courses on Securities Regulation do not focus on *how* to draft a registration statement. To paraphrase Stephen Schulman, my favorite professor from law school, you will spend seven years as a law firm associate drafting registration statements. Then you will become a partner and find some other poor sucker to do it.

[**] Following the prospectus is "Part II" of the registration statement, which largely consists of signatures and various exhibits to the registration statement. Part II is typically not given to investors, although they could review it online at the SEC's website.

crash of 1929; the Securities Act and the Securities Exchange Act of 1934 were enacted shortly thereafter.)

So, exactly how much information is there about Google in its IPO registration statement? A *lot*—the prospectus is 124 pages long, followed by 62 pages of financial statements, and then several other documents. This length is typical of a registration statement for an IPO. As you might imagine, a great deal of lawyer, accountant, and businessperson time went into the preparation of that document. However, if a company is currently a publicly traded company, preparing a Securities Act registration statement is likely to be a much easier process, because much of the information in it could be "incorporated by reference" from the company's filings under the Securities Exchange Act (which you will learn about in Chapter 17). Because Google was a privately held company before it conducted its IPO, it would have had to have drafted its registration statement "from scratch."

So much for the preparation of the registration statement, as it is not something that can be taught in much detail in law school. (As the saying goes, it is something that must be learned by doing.) Instead, let's examine some of the legal issues involved in conducting a registered public offering. Our focus here will be Section 5 of the Securities Act.

Section 5 makes very little sense when you first read it. For one thing, even though it divides the registered offering process into three time periods (the pre-filing period, the waiting period, and the post-effective period) and contains three subsections, the subsections do not correspond to the time periods. In other words, Section 5 is not in chronological order; it is a jumble. For those of you who are keeping score, the subsections that apply during the pre-filing period are subsections (a) and (c); the subsections that apply during the waiting period are subsections (a) and (b)(1); and the subsection that applies during the post-effective period is subsection (b).

But first, let's discuss what these three time periods are. The ***pre-filing period*** refers to the period of time that ends when the issuer files its registration statement with the SEC.[*] Once the issuer has filed its registration statement, the ***waiting period*** begins. What are you waiting for during the waiting period? That's right, the SEC. Once the SEC declares the registration statement to be "effective," the ***post-effective period*** begins. As noted above, however, the SEC's purpose (or at least its stated purpose) is not to decide whether an investment is a good investment. Instead, by reviewing the registration statement during the waiting period, the SEC attempts to ensure that the issuer has disclosed all of the information that is required by the applicable registration statement form (although the SEC does not *verify* the information). When it is satisfied that the

[*] Does that mean that everything back to the dawn of time is part of a given issuer's pre-filing period? Not really. Although authorities are a bit vague on this point, the pre-filing typically is said to begin when the issuer takes some concrete steps toward conducting the offering, such as hiring an underwriter or when its board of directors passes a resolution approving the offering.

issuer has made all of the required disclosures, the SEC will declare the registration statement effective and the post-effective period will begin. How long the waiting period lasts is largely a function of how well the issuer and its lawyers and accountants prepared the registration statement. If they did a poor job, the waiting period can take a long, long time and result in many SEC comment letters.

One of the goals of Section 5 is to *slow down* the offering process, giving investors an opportunity to receive and review information about the securities offering *before* deciding to invest. As such, the three time periods go from most restrictive to least restrictive. In other words, there are fewer things that the issuer is legally allowed to do during the pre-filing period than in the waiting period. Again, the primary goal of the Securities Act can be summarized in three words: disclosure, disclosure, disclosure. While the law obviously cannot ensure that investors will review this information or that they will come to intelligent conclusions about it, it can at least give them the tools to do so. Although a securities law expert would view the following discussion as a bit over-simplified, the general rules during the registration process can be summarized as follows.

B. THE PRE-FILING PERIOD

During the pre-filing period, the issuer can *neither offer nor sell* the securities that will be registered. To again use Google as an example, it would have been illegal for Google or anyone acting on its behalf merely to offer to sell Google stock before it had filed its registration statement with the SEC.

At first, this prohibition on pre-filing offers may strike you as sort of silly. After all, what harm is there in merely *offering* a security, assuming that the offeree doesn't actually *buy* the security? Again, keep in mind that the goal of Section 5 is to slow down the offering process and allow investors to be able to see all of the "fine print" before they invest. If an issuer were permitted to make offers before it had prepared its registration statement/prospectus, it surely would only tell potential investors the "good" information about itself. As such, investors could be "pre-sold" on the idea of investing, making them less likely to read that detailed prospectus when it became available. To avoid this possibility, Section 5 makes offers illegal during the pre-filing period.

Moreover, the Securities Act takes a very expansive view of what constitutes an "offer." In your Contracts course in law school, you learned that an "offer" must be definite in its terms. Applying that concept to a securities offering, you might think that an "offer" would have to, at a minimum, specify the security and the asking price. But you would be wrong. This is because Section 2(a)(3) of the Securities Act provides in part that the "term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." This is a very broad definition. Further, note that by including the phrase "shall include" (as opposed to something like "shall mean") the drafters of the Securities Act did not even provide us with a complete definition.

Taking advantage of this opportunity, the SEC has been liberal in finding that pre-filing activities were "offers." For example, in *In re Carl M. Loeb, Rhoades & Co.*, 38 S.E.C. 843 (1959), which was an internal administrative proceeding, the SEC found that two press releases were illegal "offers." Given that press releases are designed to have a wide circulation, this probably isn't terribly surprising. But in the following portion of the opinion, the SEC gave the following guidance about "offers":

> Section 5(c) of the Securities Act, as here pertinent, prohibits offers to sell any security, through the medium of a prospectus or otherwise, unless a registration statement, has been filed. Section [2(a)(3)] defines "offer to sell" to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security for value." Section [2(a)(10)] defines a "prospectus" to mean "any prospectus, notice, circular, advertisement, letter, or communication ... which offers any security for sale …." These are broad definitions, and designedly so. It is apparent that they are not limited to communications which constitute an offer in the common law contract sense, or which on their face purport to offer a security. Rather, as stated by our General Counsel in 1941, they include "any document which is designed to procure orders for a security." [Citation omitted.]
>
> The broad sweep of these definitions is necessary to accomplish the statutory purposes in the light of the process of securities distribution as it exists in the United States. Securities are distributed in this country by a complex and sensitive machinery geared to accomplish nationwide distribution of large quantities of securities with great speed. ***
>
> One of the cardinal purposes of the Securities Act is to slow down this process of rapid distribution of corporate securities, at least in its earlier and crucial stages, in order that dealers and investors might have access to, and an opportunity to consider, the disclosures of the material business and financial facts of the issuer provided in registration statements and prospectuses. Under the practices existing prior to the enactment of the statute in 1933, dealers made blind commitments to purchase securities without adequate information, and in turn, resold the securities to an equally uninformed investing public. The entire distribution process was often stimulated by sales literature designed solely to arouse interest in the securities and not to disclose material facts about the issuer and its securities. ***
>
> ***
>
> The Congress *** adopted a carefully worked out procedure to meet the problem. It is essentially as follows: (1) the strict prohibition of offers prior to the filing of a registration statement ***; (2) during the

> period between the filing of a registration statement and its effective date offers but not sales may be made but written offers could be made only by documents prescribed or processed by the Commission; and (3) sales continued to be prohibited prior to the effective date. ***
>
> We accordingly conclude that publicity, prior to the filing of a registration statement by means of public media of communication, with respect to an issuer or it securities, emanating from broker-dealer firms who as underwriters *** have negotiated or are negotiating for a public offering of the securities of such issuer, must be presumed to set in motion or to be a part of the distribution process and therefore to involve an offer to sell or a solicitation of an offer to buy such securities prohibited by Section 5(c). ***

As a result of *In re Carl M. Loeb, Rhoades & Co.* and other SEC decisions over the years, lawyers advising companies that were contemplating a registered securities offering gave very conservative advice. While it was generally permissible for an issuer to continue its historical advertising and publicity practices, lawyers worried that a sudden change in these practices on the eve of a securities offering might be viewed by the SEC as an illegal offering during the pre-filing period—even if the advertising or publicity did not directly mention the upcoming securities offering. In addition, lawyers warned their clients not to mention upcoming securities offerings, not to make predictions about the company's future performance, and not to give their opinions about the value of the company's securities.

There are two problems with this sort of advice. First, it's very vague; clients (not to mention their lawyers!) often were unsure what could or could not be done during the pre-filing period. As a result, being perhaps overly cautious was the norm. Second, corporate clients don't like being advised that they should curb their public relations activities. After all, part of running a business involves publicity and advertising, and it is the rare businessperson that likes to be told that her company should be quiet, even for a short time.

Fortunately, there are a number of things that are specifically excluded from being considered "offers" and therefore may be done during the pre-filing period. One such example is found in Section 2(a)(3) itself, which provides that the word "offer" does not include "preliminary negotiations or agreements between an issuer … and any underwriter or among underwriters who are or are to be in privity of contract with an issuer …." Thus, the issuer can enter into contracts with the underwriters on the offering, even during the pre-filing period. (As discussed below, underwriters assist the issuer in selling the securities and receive commissions or other compensation for doing so.)

In addition, although you would certainly learn much more about them in a Securities Regulation course, the following SEC rules specify some communications that will not be considered to be "offers" during the pre-filing period.

Rule 135—This rule basically provides that a notice of a "proposed" offering won't be considered an "offer" if it contains only the very limited amount of information specified in the rule. For example, the communication can contain the name of the issuer; the "title, amount and basic terms of the securities offered"; and a "brief statement of the manner and the purpose of the offering, without naming the underwriters," among other things. In addition, the communication must contain a legend "to the effect that it does not constitute an offer of any securities for sale."

Rule 163A—This rule, which was enacted by the SEC in 2005, provides (with some exceptions not relevant here) that a communication that is made more than thirty days before a registration statement is filed won't be considered an "offer," provided that it "does not reference [the] securities offering that is or will be the subject of [the] registration statement." However, during the thirty days before the registration statement is filed, the issuer must take "reasonable steps within its control to prevent further distribution or publication of [the] communication." At first, this rule doesn't seem very exciting; however, it allows issuers to engage in virtually any sort of communications or advertising as long as they do so more than thirty days before filing the registration statement and don't actually refer to the upcoming securities offering. This removes a lot of the uncertainty about whether such activities would be considered illegal offers in the pre-filing period.

Rules 168 and 169—These two rules, which were also enacted in 2005, are very similar; however, Rule 168 applies only to issuers that are already publicly traded, whereas Rule 169 applies to *any* issuer. Basically, these rules provide that an issuer may—consistent with its past practices—continue to release "factual business information" (as defined in the rules) and, in the case of Rule 168 "forward-looking information" (as defined in Rule 168), without the communications being considered "offers." However, any communication made in reliance on these rules must not contain information about the registered offering or be "released or disseminated as part of the offering activities in the registered offering." Furthermore, Rule 169 requires that the information must be "released or disseminated for intended use by persons, such as customers and suppliers, other than in their capacities as investors or potential investors …."

Rule 163—The most generous of the new rules promulgated by the SEC in 2005, Rule 163 basically provides that an offer won't be considered an "offer." Thus, an issuer that was planning a registered offering and is in the pre-filing period could actually offer the securities to potential investors during the pre-filing period! However, there are a few catches. First, Rule 163 only applies to "well-known seasoned issuers," which basically are companies that have been publicly traded for more than twelve months and that meet some stringent size tests. Thus, Rule 163 may only be used by a relatively small group of very large, well-known companies. Second, if the offer is in writing, then additional requirements apply, including an obligation to file a copy of the writing with the SEC.

While the above description of the pre-filing period captures the main issues involved, you should keep in mind that there are many qualifications and exceptions to these rules. Again, you will learn much more about these rules if you take a course in Securities Regulation. However, see if you can handle the following problem. Be sure to consider Rules 135, 163A, 168, 169, and 163.

Problem

Problem 15-3: Michigan Widget Corp. (MWC) manufactures widgets. MWC is currently a privately held company, but it has decided to conduct a public offering of 1 million shares of its common stock. To that end, it has engaged Trosty Underwriters, Inc. to act as the underwriter on this offering and has begun, with its legal counsel, preparing a registration statement for eventual filing with the SEC. Before MWC filed its registration statement with the SEC, it placed the following advertisement in *The Wall Street Journal*, which appeared on March 1.

Attention Investors Michigan Widget Corp., a profitable and growing business, will be offering 1,000,000 shares of its common stock to new investors in an initial public offering in the very near future. The offering price will be $20 per share. The underwriter will be Trosty Underwriters, Inc.

MWC filed its registration statement with the SEC on May 1. *Did this advertisement cause MWC to violate Section 5 of the Securities Act?*

C. THE WAITING PERIOD

As noted above, the waiting period begins when the issuer files its registration statement for the offering with the SEC, and ends when the SEC declares the registration statement "effective." Keeping with the theme that the legal restrictions loosen as the registration process goes on, you should not be surprised that there are more things that the issuer (and those working on its behalf, such as underwriters) may do during the waiting period than in the pre-filing period.

Most importantly, the issuer may make offers (although sales are still prohibited). However, there are two major problems that make the previous sentence an over-simplification. First, any "offer" that appears in writing (including email) or by radio or television, will be considered a "prospectus" within the meaning of the Securities Act. The problem with finding that something is a "prospectus" is that Section 10 of the Securities Act provides, in general, that a "prospectus" must contain the information that appears in the registration statement. As you saw above, a registration statement typically is a very long and detailed document; Google's IPO registration statement was well over 100 pages long. Thus, typically the only written offer that may be used during the waiting period is a preliminary version of the long prospectus that appears in the registration statement. Most other written offers would be considered illegal prospectuses.*

Second, if the offeree actually *accepts* the offer, then a "sale" has been made—even if no money or securities have yet changed hands! This is because Section 2(a)(3) of the Securities Act defines a "sale" as including a "contract of sale." Thus, if an offeree does something that causes her to be contractually bound to purchase the offered securities, a "contract of sale" has arisen and a "sale" has been made. And as you know, sales are illegal during the waiting period (as well as the pre-filing period). Thus, it is common, when approaching potential investors during the waiting period, to solicit mere "indications of interest" from them. Doing so avoids a finding that a "sale" has occurred.

D. THE POST-EFFECTIVE PERIOD

Once the SEC declares the registration statement effective, the post-effective period begins. For the first time, the issuer may make sales. The issuer must deliver a copy of the final prospectus to each purchaser; the issuer may not deliver the securities to the purchaser until it has done so. Today, this delivery is typically done electronically.

A written offer continues to be considered a "prospectus." During the post-effective period the only legal "prospectus" that may be used is the final version of the prospectus that was contained in the registration statement. The final prospectus must have all of the blanks, such as the offering price of the securities, filled in. (Usually, the offering price is only determined shortly before the effective date, due to changing securities market conditions.) However, during the post-effective period, a writing that is accompanied by, or preceded by, the final statutory prospectus is considered "free-writing" and need not comply with Section 10. Technically, free writing is excluded from the definition of "prospectus." Thus, if an issuer or underwriter were simultaneously to send a prospective investor (1) a copy of the final prospectus that was contained in the registration statement (i.e., the long, detailed document that was discussed above) and (2) a brochure concerning the issuer or some other writing that would ordinarily be considered an "offer" and therefore a "prospectus," the second document will be permissible. In a sense, it is as if Congress said that it is OK for the issuer and/or underwriters to send prospective investors any written document—as long as they are doing so in the post-effective period when the final prospectus (having been reviewed by the SEC as part of the registration statement) is available and is simultaneously (or previously) sent to that investor.

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* See Securities Act Rule 430. However, Rule 134 allows the issuer to use certain other writings during the waiting period without them being considered a "prospectus." Further, the issuer may use a "free-writing prospectus" during the waiting period pursuant to Rules 164 and 433, which contain detailed rules governing the use of such documents.

Again, the above discussion of Section 5 is oversimplified and omits many important exceptions and qualifications. If you find this interesting or the prospect of working on a registered public offering exciting, you should take a course in Securities Regulation.

E. "EMERGING GROWTH COMPANIES"

As discussed above, Section 5 of the Securities Act generally makes it illegal for issuers or persons acting on their behalf to offer securities for sale before a registration statement covering those securities has been filed with the SEC (unless the offering qualifies for an exemption from the registration requirement). Moreover, the Securities Act takes a very expansive view of activities that may be considered "offers" and therefore would violate Section 5 in the pre-filing period.

The JOBS Act of 2012 amended Section 5 of the Securities Act to add new subsection (d). This new subsection provides that:

> Notwithstanding any other provision of this section, an emerging growth company or any person authorized to act on behalf of an emerging growth company may engage in oral or written communications with potential investors that are qualified institutional buyers or institutions that are accredited investors, as such terms are respectively defined in [Rule 144A and Rule 501(a) under the Securities Act], or any successor thereto, to determine whether such investors might have an interest in a contemplated securities offering, either prior to or following the date of filing of a registration statement with respect to such securities with the Commission, subject to the requirement of subsection (b)(2).

An "emerging growth company" is generally defined in new subsection (a)(19) of Section 2 of the Securities Act as an issuer that had annual gross revenues less than $1 billion (indexed for inflation every five years) during its most recently completed fiscal year (with some exceptions that are not important here). This subsection also contains rules for determining when an issuer would cease to meet this definition. Under these rules, an issuer could remain an "emerging growth company" for as long as five years after its initial public offering. This is important because, as discussed briefly below, emerging growth companies are also spared from some of the disclosure burdens imposed on public companies under the Securities Exchange Act. In other words, the JOBS Act doesn't just make it easier for emerging growth companies to *go* public under the Securities Act, it also makes it a bit easier for them to *stay* public under the Exchange Act.

Thus, under new Section 5(d) of the Securities Act an emerging growth company may—even during the pre-filing period—communicate with qualified institutional buyers within the meaning of Rule 144A or "institutions" (as opposed to individuals) that are accredited investors within the meaning of Rule 501(a) to determine whether they would be interested in purchasing securities. Before the JOBS Act, such communications almost certainly would have been illegal "offers" during the pre-filing period. This is an important change because, as discussed above, the process of preparing a registration statement is enormously time-consuming and expensive. Imagine an unlucky company that goes through that process only to find out that investors aren't very interested in buying its securities. Better to know that sooner rather than later. Thus, an emerging growth company can "test the waters" to some degree under new Section 5(d).

In addition, the JOBS Act made life easier in many other respects for emerging growth companies. For example, Section 106(a) of the JOBS Act provides that emerging growth companies may submit a "draft" registration statement for an IPO to the SEC for confidential review (provided that the registration statement is filed—and therefore available for review by the public—within certain deadlines). Further, the JOBS Act relaxed certain financial and other disclosure requirements for emerging growth companies in both Securities Act registration statements, as well as periodic reports under the Securities Exchange Act of 1934. Although many of these changes are beyond the scope of this textbook, suffice it to say that these changes exempt emerging growth companies from a few of the more "unpopular" provisions of the Exchange Act, some of which were added by the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

As commentators have pointed out, the market for IPOs by relatively small companies has significantly declined over the past decade. One possible reason for this decline is the increased regulatory burdens on public companies as a result of the Sarbanes-Oxley Act and the Dodd-Frank Act. As the thinking goes, many companies contemplating going public may have decided that the regulatory costs outweigh the benefits of going public. Because many view such "emerging" companies as drivers of economic growth, these provisions of the JOBS Act were intended to make it easier for such companies to raise capital in IPOs and, once public, to meet their reporting obligations under the Securities Exchange Act. Time will tell if these provisions have the intended effect.

F. UNDERWRITERS

Do you know people who could buy several million, or even billion, dollars' worth of securities? Me neither. Most issuers in securities offerings would answer this question similarly, and thus will need some assistance to sell the securities that they wish to sell. After all, even if the issuer is a great company and the registration statement/prospectus is a work of art, the offering will not be successful without actual buyers.

The people who will (for a fee, of course) help the issuer sell the securities are called ***underwriters.*** Although the statute defines an underwriter in part as someone "who has purchased from an issuer [or an affiliate of the issuer] with a view to, or offers or sells for an issuer [or an affiliate of the issuer] in connection with, the distribution of any security," when one thinks of underwriters in the context of a large public offering of securities one tends to think of large Wall Street investment banking firms. Indeed, if you looked at the cover page of the Google IPO prospectus, you would have seen some of the biggest names on Wall Street (including at least one that is no longer with us following the 2008-2009 financial crisis).

There are two basic kinds of underwriting agreements: ***firm commitment*** underwritings and ***best efforts*** underwritings. In a firm commitment, the underwriter actually purchases the securities from the issuer (at a discount from the anticipated public offering price) and then resells them to the public (at the higher public offering price). In contrast, in a best efforts underwriting, the underwriter only agrees to use its best efforts to find buyers for the securities, but does not guarantee that they will actually be sold. Obviously, a firm commitment underwriting is riskier for the underwriter due to possibility that it might not be able to sell the securities quickly (or at all). Thus, firm commitment underwritings typically involve higher underwriter fees and commissions than do best efforts underwritings and/or are reserved for "good" securities offerings.

§ 15.03 POPULAR EXEMPTIONS FROM REGISTRATION

As you certainly gathered from reading the above discussion, conducting a registered securities offering is a difficult and expensive process. Doing so might be economically efficient in the context of an offering for tens or hundreds of millions of dollars. But if every securities offering were required to go through the SEC registration process, capital formation (that is, the ability of companies to raise capital) would dry up. Companies would only be able to obtain funds to expand their businesses by getting bank loans. Obviously, the economy could be adversely affected. In addition, in most cases a registered offering will result in the issuer being subject to the periodic reporting requirements of the Securities Exchange Act afterwards for at least one year, which adds more compliance expense to the process. See Chapter 17 for more details.

Fortunately, there are a number of exemptions from registration. Exemptions come in two categories: exempt *securities* and exempt *transactions*. Exempt securities are those that are always exempt from having to be registered with the SEC prior to sale—regardless of how many are being sold and to how many and what types of purchasers they are sold. These exempt securities are primarily found in Section 3.

On the other hand, there are exempt transactions. In other words, securities that are sold in an offering that complies with certain requirements need not be registered with the SEC before they are offered and sold *in that offering*. However, if those same securities were to be later publicly offered and sold, they would most likely be required to be registered before such an offering could take place. The exempt transactions are primarily found in Section 4 of the Securities Act, as well as several SEC rules thereunder. (However, one exempt transaction that you will study below, the intrastate exemption, is inexplicably found in Section 3 rather than Section 4.)

There are many exempt securities and transactions found in the Securities Act and SEC rules, but we will consider only some of them: the Section 4(a)(2) exemption for "private" offerings; the two exemptions found in SEC Regulation D (Rules 504 and 506); the Section 3(a)(11) exemption for "intrastate" offerings; Regulation A (sometimes called "Regulation A+"); and the new "Regulation Crowdfunding." Keep in mind as you go into the real world, however, that there are other exemptions.

A. SECTION 4(a)(2)

Section 4(a)(2) of the Securities Act is one of the shortest sections that you will encounter in a securities law. It merely provides that securities need not be registered with the SEC when they are sold in "transactions by an issuer not involving any public offering." Thus, if a securities offering is not a "public" offering—that is, if it's a "private" offering—then the securities sold in that private offering need not be registered with the SEC. Sounds easy, right? Unfortunately, the Securities Act does not actually define the phrase "public offering" (or, for that matter, "private offering"). Thus, the courts were called on to interpret this phrase. The following case is the leading case interpreting Section 4(a)(2).

Securities and Exchange Commission v. Ralston Purina Co.
Supreme Court of United States
346 U.S. 119 (1953)

MR. JUSTICE CLARK delivered the opinion of the Court.

Section [4(a)(2)][*] of the Securities Act of 1933 exempts "transactions by an issuer not involving any public offering" from the registration requirements of § 5. We must decide whether Ralston Purina's offerings of treasury stock to its "key employees" are within this exemption. On a complaint brought by the Commission under § 20(b) of the Act seeking to enjoin respondent's unregistered offerings, the District Court held the exemption applicable and dismissed the suit. [Citation omitted.] The Court of Appeals affirmed. [Citation omitted.] The question has arisen many times since the Act was passed; an apparent need to define the scope of the private offering exemption prompted certiorari. [Citation omitted.]

Ralston Purina manufactures and distributes various feed and cereal products. Its processing and distribution facilities are scattered throughout the United States and Canada, staffed by some 7,000 employees. At least since 1911 the company has had a policy of encouraging stock ownership among its employees; more particularly, since 1942 it has made authorized but unissued common shares available to some of them. Between 1947 and 1951, the period covered by the record in this case, Ralston Purina sold

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[*] [Footnote by author:] At the time of this case, what is currently Section 4(a)(2) of the Securities Act was Section 4(1).

nearly $2,000,000 of stock to employees without registration and in so doing made use of the mails.

In each of these years, a corporate resolution authorized the sale of common stock "to employees ... who shall, without any solicitation by the Company or its officers or employees, inquire of any of them as to how to purchase common stock of Ralston Purina Company." A memorandum sent to branch and store managers after the resolution was adopted advised that "The only employees to whom this stock will be available will be those who take the initiative and are interested in buying stock at present market prices." Among those responding to these offers were employees with the duties of artist, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer, and veterinarian. The buyers lived in over fifty widely separated communities scattered from Garland, Texas, to Nashua, New Hampshire, and Visalia, California. The lowest salary bracket of those purchasing was $2,700 in 1949, $2,435 in 1950 and $3,107 in 1951. The record shows that in 1947, 243 employees bought stock, 20 in 1948, 414 in 1949, 411 in 1950, and the 1951 offer, interrupted by this litigation, produced 165 applications to purchase. No records were kept of those to whom the offers were made; the estimated number in 1951 was 500.

The company bottoms its exemption claim on the classification of all offerees as "key employees" in its organization. Its position on trial was that "A key employee … is not confined to an organization chart. It would include an individual who is eligible for promotion, an individual who especially influences others or who advises others, a person whom the employees look to in some special way, an individual, of course, who carries some special responsibility, who is sympathetic to management and who is ambitious and who the management feels is likely to be promoted to a greater responsibility." That an offering to all of its employees would be public is conceded.

The Securities Act nowhere defines the scope of § [4(a)(2)]'s private offering exemption. Nor is the legislative history of much help in staking out its boundaries. The problem was first dealt with in § 4(1) of the House Bill, [citation omitted], which exempted "transactions by an issuer not with or through an underwriter; ...." The bill, as reported by the House Committee, added "and not involving any public offering." [Citation omitted.] This was thought to be one of those transactions "where there is no practical need for [the bill's] application or where the public benefits are too remote." [Citation omitted.][*] The exemption as thus delimited became law.[**] It assumed its present

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[*] [Footnote by court:] "... the bill does not affect transactions beyond the need of public protection in order to prevent recurrences of demonstrated abuses." [Citation omitted.] In a somewhat different tenor, the report spoke of this as an exemption of "transactions by an issuer unless made by or through an underwriter so as to permit an issuer to make a specific or an isolated sale of its securities to a particular person, but insisting that if a sale of the issuer's securities should be made generally to the public that that transaction shall come within the purview of the Act." [Citation omitted.]

shape with the deletion of "not with or through an underwriter" by § 203(a) of the Securities Exchange Act of 1934, a change regarded as the elimination of superfluous language. [Citation omitted.]

Decisions under comparable exemptions in the English Companies Acts and state "blue sky" laws, the statutory antecedents of federal securities legislation, have made one thing clear—to be public an offer need not be open to the whole world. [Citation omitted.] In *Securities and Exchange Comm'n v. Sunbeam Gold Mines Co.*, 95 F. 2d 699 (9th Cir. 1938), this point was made in dealing with an offering to the stockholders of two corporations about to be merged. Judge Denman observed that:

> In its broadest meaning the term "public" distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less "public", in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering, though not open to everyone who may choose to apply, is none the less "public" in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made .... To determine the distinction between "public" and "private" in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction. [Citation omitted.]

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Exemption from the registration requirements of the Securities Act is the question. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of § [4(a)(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction "not involving any public offering."

** [Footnote by court:] The only subsequent reference was an oblique one in the statement of the House Managers on the Conference Report: "Sales of stock to stockholders become subject to the act unless the stockholders are so small in number that the sale to them does not constitute a public offering." [Citation omitted.]

The Commission would have us go one step further and hold that "an offering to a substantial number of the public" is not exempt under § [4(a)(2)]. We are advised that "whatever the special circumstances, the Commission has consistently interpreted the exemption as being inapplicable when a large number of offerees is involved." But the statute would seem to apply to a "public offering" whether to few or many. It may well be that offerings to a substantial number of persons would rarely be exempt. Indeed nothing prevents the [C]ommission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation.

The exemption, as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within § [4(a)(2)], e.g., one made to executive personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much members of the investing "public" as any of their neighbors in the community. Although we do not rely on it, the rejection in 1934 of an amendment which would have specifically exempted employee stock offerings supports this conclusion. The House Managers, commenting on the Conference Report, said that "the participants in employees' stock-investment plans may be in as great need of the protection afforded by availability of information concerning the issuer for which they work as are most other members of the public." [Citation omitted.]

Keeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable. [Citation omitted.] Agreeing, the court below thought the burden met primarily because of the respondent's purpose in singling out its key employees for stock offerings. But once it is seen that the exemption question turns on the knowledge of the offerees, the issuer's motives, laudable though they may be, fade into irrelevance. The focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with § 5.

Reversed.

[Opinions of other Justices omitted.]

Although *Ralston-Purina* provides a memorable catchphrase (the offerees in a Section 4(a)(2) offering must be able to "fend for themselves"), it isn't terribly helpful in defining the precise contours of Section 4(a)(2) or in giving us examples of people who can fend for themselves. The only example the *Ralston-Purina* Court gave was "executive personnel who because of their position have access to the same kind of information that the [Securities] Act would make available in the form of a registration statement."

Thus, although there are many cases from lower courts interpreting Section 4(a)(2), its exact requirements remain a bit vague. Here is how the SEC has described it:

> Section 4(a)(2) of the Securities Act exempts from registration transactions by an issuer not involving any public offering. To qualify for this exemption, [each of] the purchasers of the securities must:
>
> - have enough knowledge and experience in finance and business matters to evaluate the risks and merits of the investment (the "sophisticated investor"), or be able to bear the investment's economic risk;
>
> - have access to the type of information normally provided in a prospectus; and
>
> - agree not to resell or distribute the securities to the public.
>
> In general public advertising of the offering, and general solicitation of investors, is incompatible with the private placement exemption.
>
> The precise limits of this private offering exemption are not defined by rule. As the number of purchasers increases and their relationship to the company and its management becomes more remote, it is more difficult to show that the transaction qualifies for the exemption. If your company offers securities to even one person who does not meet the necessary conditions, the entire offering may be in violation of the Securities Act.

Securities and Exchange Commission, *Q&A: Small Business and the SEC; A guide to help you understand how to raise capital and comply with the federal securities laws*, available at https://www.sec.gov/smallbusiness/exemptofferings/rule506b.

In addition, the Committee on Federal Regulation of Securities of the American Bar Association Section of Business Law released a report entitled *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*.[*] In this report, the committee concluded that there are four important factors in a Section 4(a)(2) offering: (1) the manner of the offering, (2) the eligibility of the purchasers, (3) the information provided to the purchasers, and (4) the absence of non-exempt resales by the

[*] 66 BUS. LAW. 85 (2010).

initial purchasers.[**] A few words about these are in order here (both as the ABA committee and other authorities have interpreted them).

In terms of the manner of the offering, the ABA committee points out that the purchasers must be found through some private methods, rather than a public process. As the committee observed, neither the issuer nor anyone acting on its behalf may use any form of "general advertising" or "general solicitation" to locate purchasers. (As discussed below, this is also a requirement in most offerings under Regulation D.) To use an extreme example, if the issuer put up a billboard on the highway advertising its offering, the offering clearly would not qualify as exempt under Section 4(a)(2).

Second, each offeree—not just actual purchasers—must also be sophisticated in investing matters to some degree. As discussed below, Regulation D imposes a similar requirement, stating that each "non-accredited" investor in a Rule 506 offering must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment" or that the issuer must reasonably believe that the investor meets this standard. Purchasers can meet this standard either by themselves, or with the assistance of a "purchaser representative" as defined in Regulation D. The ABA committee believes that this standard from Regulation D should also be used in the context of a Section 4(a)(2) offering and some courts have in fact used similar language in opinions interpreting Section 4(a)(2). One troubling aspect of this requirement, however, is that some courts have stated that *every* offeree must be properly qualified and that the presence of even one unqualified offeree will ruin the exemption for the entire offering. Nonetheless, the ABA committee points out that the presence of one unqualified offeree is unlikely to ruin the entire offering, at least if the issuer believed in good faith (but mistakenly) that the offeree was able to fend for herself under the *Ralston-Purina* standard and otherwise tried to comply with the exemption.

Closely related to the offeree-sophistication requirement is the requirement that the issuer provide offerees with some amount of information about the issuer and the securities that are being offered. Naturally, this begs the question: how much information is needed? Unfortunately, there is no easy answer in the context of a Section 4(a)(2) offering. Obviously, the more information that the issuer discloses, the better its chances of successfully arguing that it has complied with Section 4(a)(2). On the other hand, the information need not be as extensive as that required by the SEC in a registered offering. (After all, what would be the point of an exempt offering if it didn't save the issuer any time and trouble?) Some cases have been interpreted as requiring an amount of information that is on a sliding scale with the sophistication of the offerees. In other words, the more sophisticated the offerees, or the less complex the investment, the less

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[**] This is not to say that courts have not found other factors to be important. For example, many courts insist on having a small number of purchasers in a Section 4(a)(2) offering. The ABA committee, however, views the number of investors as itself unimportant, as did the *Howey* court. On the other hand, the more purchasers there are, the more likely it is that some of them will not be able to "fend for themselves."

information that is probably required. If the offerees are not extremely sophisticated and/or the securities that are being offered are complex or unusual, the more information that is required. As discussed below, Regulation D solves this uncertainty by listing precise items of information that must be provided to investors in different contexts. The ABA committee appears to believe that the informational requirements of Regulation D are a good model for compliance with Section 4(a)(2). *See* 66 BUS. LAW. at 111-13.

The final important Section 4(a)(2) factor identified by the ABA committee is the *absence* of non-exempt resales by the initial purchasers. To understand why this is important, assume that an issuer wants to use Section 4(a)(2) to conduct an exempt securities offering and has identified several potential purchasers. Unfortunately, none of these offerees would qualify being able to "fend for themselves" under *Ralston-Purina.* (In other words, these potential investors are not "sophisticated.") To solve this problem, the issuer arranges to have a very sophisticated investor (let's call her Sally Sophisticated) purchase the securities. However, shortly after the offering, Sally resells the securities to the motley crew of investors to whom the issuer had originally wanted to sell.

To be sure, something this blatant would rarely happen, but if it did, ask yourself: who *really* bought these securities—Sally Sophisticated or the persons to whom she re-sold? Now, if Sally had resold the securities to some other person or persons who *themselves* would have been "*Ralston-Purina* types," or if her resales took place a year or more after she purchased the securities so that she could show she had "investment intent" when she bought the securities, then this would probably not be a problem. But if the persons to whom Sally sold would not have qualified as initial purchasers in the Section 4(a)(2) offering, then these resales probably ruined the exemption. It is as if Sally was really just a conduit for the securities to reach the later purchasers. Thus, issuers using the Section 4(a)(2) exemption are well-advised to advise purchasers that they may not resell the securities unless they do so either in a registered offering (not likely) or in a manner that would not violate the securities laws. In addition, it may be wise to have purchasers so agree in writing and to place a "legend" on any certificates representing the securities (e.g., stock certificates) referring to these restrictions on resale.

Despite the helpful guidance of the ABA committee and the many other authorities interpreting it, Section 4(a)(2) remains a bit vague. Thus, it's hard to give a client solid legal advice as to its compliance with Section 4(a)(2) in all but the most clear-cut examples. Fortunately, Rule 506 of Regulation D is a "safe harbor" under Section 4(a)(2). Regulation D is discussed immediately below.

"Safe Harbors"

A "safe harbor" refers to an SEC rule that may be used to ensure compliance with a statute. Although compliance with the rule is optional, if the issuer does comply with the rule, then it will conclusively be deemed to have complied with the statute. For example, SEC Rule 147 is a "safe harbor" under Section 3(a)(11). Thus, an issuer who complies with Rule 147 will be deemed to have a valid intrastate offering under Section 3(a)(11). Conversely, an issuer who did not comply with Rule 147 *may* still have a valid Section 3(a)(11) exemption.

B. REGULATION D

Regulation D, which consists of Rules 500 through 508 under the Securities Act, contains two different exemptions: Rule 504 and Rule 506. (Rule 505 was repealed in 2017.)

1. RULE 504

Rule 504 allows an issuer to sell $10 million of securities on an exempt basis. This limit (which in 2020 was increased from the prior $5 limit) is measured in "rolling" twelve-month periods—if the issuer has, within the past twelve months, sold securities under Rule 504 or pursuant to any other SEC exemption under Section 3(b) of the Securities Act, or in violation of Section 5(a) of the Securities Act, these sales would count against the $10 million limit. For example, if the issuer sold $2 million of securities pursuant to Rule 504 six months ago, it could only use Rule 504 to sell another $8 million of securities in the next six months.

The issuer is not required to disclose any specified information to investors in a Rule 504 offering (although, as discussed below, it would be unwise not to give investors any information). Further, there is no limit on the number of investors in a Rule 504 offering. Theoretically, the issuer could sell $10 of securities to one million investors. Moreover, investors in a Rule 504 offering do not need to be accredited or "sophisticated" in any way.

Although this makes Rule 504 seem like a public offering, albeit an unregistered one, note that Rule 504 usually prohibits the use of general advertising or general solicitation and usually results in investors receiving "restricted" securities. (As discussed below in Section 15.03(H), it is more difficult to resell restricted securities than it is to resell unrestricted securities.) However, Rule 504(b)(1) describes three situations in which these rules do not apply. In other words, if any of these three situations applies, then the issuer may use general advertising and general solicitation and investors will get unrestricted securities. When you read Rule 504(b)(1)(i) through (iii), note that (i) and (ii) are somewhat similar to one another.

Some issuers may not use Rule 504, including public companies, investment companies, and certain "development stage" companies. *See* Rule 504(a). In addition, the "bad actor" disqualifications that are discussed in the context of Rule 506 below also apply to Rule 504.

Finally, Rule 503 requires the issuer to file a Form D with the SEC within 15 days after the first sale in any Regulation D offering (not just Rule 504, but Rule 506 too). However, Form D is a relatively short form that can be quickly completed; the SEC mainly uses it for statistical purposes. Depending on the facts, the issuer may also be required to amend a Form D that it previously filed.

2. RULE 506

Rule 506 provides an exemption from registration whereby an issuer may sell an *unlimited* dollar amount of securities. However, the issuer may only sell the securities to a maximum of 35 persons, or must reasonably believe that there are only 35 purchasers, in any 90-calendar-day period.* (There is no limitation on the number of *offerees*, though.) But here's an interesting catch: under Rule 501(e)(1)(iv), "accredited investors" are excluded from this calculation, along with some other types of purchasers. This means that the issuer can sell securities in a Rule 506 offering to a maximum of 35 *non-*accredited investors, *and* a theoretically unlimited number of accredited investors.

Who is an accredited investor? Rule 501(a) contains a long list of "accredited investors," including many types of banks and institutional investors, as well as any entity in which all of the equity owners are accredited investors. But when would a natural person (that is, an individual) be an accredited investor? Rule 501(a) includes the following (among others) on the list:

- any "director, executive officer, or general partner of the issuer of the securities, or any director, executive officer, or general partner of a general partner of the issuer";

- any "natural person whose individual net worth, or joint net worth with that person's spouse or spousal equivalent, at the time of his purchase exceeds $1 million";*

- any "natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse or spousal equivalent in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year";

- any "natural person holding in good standing one or more professional certifications or designations or credentials from an accredited educational institution that the Commission has designated as qualifying an individual for accredited investor status"; and

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* The part about the 90-calendar-day period was added in 2020. Before that, it was a maximum of 35 investors during the entire offering.

* Rule 501(j), which was added in 2020, defines "spousal equivalent" as "a cohabitant occupying a relationship generally equivalent to that of a spouse." Assets do not need to be held jointly by the spouses or spousal equivalents to be counted toward the $1 million net worth figure. In addition, note that the $1 million figure excludes the value of the person's primary residence. The calculation of net worth also, in most cases at least, excludes *debt* that is secured by your principal residence. (Remember, net worth is assets minus liabilities.) See Rule 501(a)(5)(i), (ii).

- any "natural person who is a 'knowledgeable employee,' as defined in rule 3c-5(a)(4) under the Investment Company Act of 1940 (17 CFR 270.3c-5(a)(4)), of the issuer of the securities being offered or sold where the issuer would be an investment company, as defined in section 3 of such act, but for the exclusion provided by either section 3(c)(1) or section 3(c)(7) of such act."

There are several other requirements that the issuer must observe in a Rule 506 offering. First, the issuer cannot use Rule 506 if it or certain of its officers, directors, or other affiliates have been in the types of legal trouble set forth in Rule 262 under the Securities Act. These are sometimes called the "bad actor disqualification provisions." *See* Rule 506(d).

Second, the issuer must provide purchasers with the information that is specified in Rule 502(b). Without delving into too much detail about Rule 502(b), which is quite complicated, suffice it to say that if the issuer were to sell *only* to accredited investors, then no specific list of information is required. Of course, it would be unwise not to give investors any information! Not only would they be unwilling to invest blindly, but the issuer could also be sued for securities fraud if it fails to disclose material information to purchasers. On the other hand, Rule 502(b) mandates the disclosure of a great deal of information to *non*-accredited investors. The amount of these required disclosures depends in part on whether the issuer is publicly traded, as well as the size of the offering.

Third, in many cases, the issuer in a Rule 506 offering may not use any form of "general advertising" or "general solicitation" to reach investors. Rule 502(c) defines these terms as including—but not being limited to—(1) "[a]ny advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and (2) "[a]ny seminar or meeting whose attendees have been invited by any general solicitation or general advertising." This makes it difficult for an issuer to find potential investors; oftentimes, an investment banking firm may be needed to help find investors, such as clients with whom it has a pre-existing relationship. Obviously, such firms charge significant fees or commissions for their services in this regard. Also, over the years, the SEC has given "no-action letters" to many issuers, allowing them to undertake certain actions to locate investors without being deemed to be engaged in general advertising or general solicitation.

However, following revisions mandated by the JOBS Act, under subsection (c) of Rule 506, it is possible to use general advertising and general solicitation in a Rule 506 offering, as long as all of the *purchasers* are accredited investors. While the technical definition of an "accredited investor" in Rule 501 includes not only investors that *do* fall within one of the categories listed in that rule, but also investors that the issuer *reasonably believes* fall within any of those categories, note that Rule 506(c) requires the issuer to take "reasonable steps" to verify that the purchasers are in fact accredited investors, and then specifies various safe harbors for meeting this requirement. This is more difficult than under Rule 506(b), wherein investors could "self-certify" about their accredited status.

This ability to use general advertising and general solicitation obviously presents one reason to stay away from non-accredited investors in a Rule 506 offering. Another reason can be found in the following language from Rule 506(b)(2)(ii):

> Each purchaser who is not an accredited investor either alone or with his purchaser representative(s) [must have] such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.

In other words, non-accredited investors in a Rule 506 offering must be "sophisticated" or the issuer must reasonably believe that they are. This requirement makes sense when you remember that Rule 506 is a safe harbor under Section 4(a)(2). As you learned above, offerees in a Section 4(a)(2) offering must be persons who can "fend for themselves" within the meaning of *Ralston-Purina* and later authorities. Rule 506(b)(2)(ii) reflects this requirement.

Investors in a Rule 506 offering will receive "restricted" securities. As discussed below in Section 15.03(H), it is more difficult to legally resell restricted securities than it is to resell unrestricted securities. Rule 502(d) requires the issuer to use "reasonable care" to make sure that investors do not illegally resell the securities, and lists some actions by the issuer that may demonstrate this reasonable care.

C. THE INTRASTATE EXEMPTIONS

The Statutory Exemption. Another important exemption from registration is called the intrastate exemption, which is found in Section 3(a)(11) of the Securities Act. In addition, Rule 147 and new Rule 147A complement the statute.

But let's begin with the text of the statute. Section 3(a)(11) exempts from the Securities Act's registration requirements:

> Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.

Like Section 4(a)(2), this is another surprisingly short section for a securities law. But there is a lot of nuance in it. First, the phrase "part of an issue," tells us that the concept of *integration* is always a potential problem in a securities offering, but we will defer discussion of integration until later. Second, each offeree in a Section 3(a)(11) must be a "resident" of the same state. Some cases have held that Section 3(a)(11) may not be used as an exemption if a single offer was made, even mistakenly or inadvertently, to a resident of the "wrong" state. In addition, the SEC and other authorities have traditionally interpreted the residence requirement of Section 3(a)(11) as meaning domicile.

Question

For purposes of Section 3(a)(11), are you a "resident" of the state in which you attend law school? Why or why not?

To return to the phrase "part of an issue," another concern in a Section 3(a)(11) offering is whether the securities have "come to rest" in the state of the offering before they are resold outside the state. (This may remind you of the above discussion of non-exempt resales in Section 4(a)(2) offerings.) Assume that a corporation that is incorporated in Michigan and that does business in Michigan offers and sells shares of its stock to several Michigan residents pursuant to Section 3(a)(11). If those Michigan residents shortly thereafter resell the stock to Ohio residents, then it doesn't really look like the stock was bought by Michigan residents. Instead, it looks like the Michigan residents were used as funnels to resell the stock out of state, in a way that Section 3(a)(11) would not have permitted.

Most authorities interpreting Section 3(a)(11) state that one year is a good rule of thumb for securities to "come to rest" in the state before they may be resold outside the state. Note how this largely places the issuer at the mercy of its investors; their actions could ruin the Section 3(a)(11) exemption. Thus, even though there are no limits on the number or types of purchasers that you may have in a Section 3(a)(11) offering, typically they are sold only to a small number of people that the issuer can trust.

Further, if the issuer is a corporation, it must be incorporated in the same state in which all of the offerees reside.[*] In addition, it must be "doing business within" that state. This should raise a few questions in your mind. When is a corporation "doing business" within a given state? What sort of activities count as "business"? Must the issuer's business be *confined* to a single state, or may it have activities in more than one state? A few principles have emerged from case law interpreting Section 3(a)(11). First, "doing business" refers to money-making activities, such as manufacturing widgets or performing services. Simply having an office, or a bank account, or owning land, in a state does not mean that the corporation is "doing business" in that state. Second, while a corporation may do business in multiple states, it must have the predominant amount of its business activities in the state of the securities offering.

Admittedly, the above discussion of many aspects of Section 3(a)(11) is not crystal clear. Some of the requirements may also seem unduly harsh. Enter Rules 147 and Rule 147A.

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[*] Other types of issuers must be "residents" of the state where the offering occurs. Rules 147 and 147A contain rules for determining when a non-corporate issuer is a resident of a state.

Safe Harbor: Rule 147. Rule 147 is a complex rule, but we will discuss some of its highlights here. It primary benefit is that it takes some of the uncertainty of the Section 3(a)(11) exemption away. For example, Rule 147 exactly quantifies the "doing business" requirement. Under the rule, an issuer will be considered to be doing business in a state if it meets *any one or more* of four requirements: (1) the issuer derives at least 80 percent of its gross revenues from the state;* (2) the issuer had, at the end of the most recent semi-annual fiscal period, at least 80 percent of its assets in the state, on a consolidated basis with its subsidiaries, (3) the issuer intends to, and in fact does, use at least 80 percent of the net proceeds from the securities offering "in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within" the state, or (4) a majority of the issuer's employees are based in the state.

Another improvement that Rule 147 makes over Section 3(a)(11) is that an individual investor is deemed to be a resident of the state in which her "principal residence" is located. This is an easier determination than domicile. (The rule also specifies how to determine the residency of non-individual investors.) Further, the issuer only needs to have a *reasonable belief* that an offeree or purchaser is a resident of the state. However, under Rule 147(f)(1)(iii), the issuer must get a written representation from each *purchaser* as to the purchaser's residence. But the written representation, by itself, is not enough to give the issuer a reasonable belief about the person's state of residence.

Rule 147 also gives a bright-line rule for how much time must pass before securities are deemed to come to rest in the state; subsection (e) provides that resales of the securities, by any person, may only be made *within* the state for six months following the last sale of securities by the issuer. Once six months has passed, resales may be made outside the state. Subsection (f) specifies some precautions that the issuer must take to prevent the occurrence of resales that violate the rule, including disclosure requirements. However, keep in mind that impermissible resales may still occur despite the issuer's efforts.**

Rule 147A. Doesn't it seem a little silly that under Section 3(a)(11), as well as Rule 147, the issuer can't make *offers* to persons who are not (or the issuer doesn't reasonably believe are) residents of the applicable state? Doesn't it also seem silly that both Section 3(a)(11) and Rule 147 require the issuer to be incorporated in the state? This prevents a corporation that is incorporated in Delaware but has its headquarters and business operations in a different state from using either Section 3(a)(11) or Rule 147. So along came Rule 147A in 2017. But there are some catches, of course.

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* This is measured on a consolidated basis, that is, including the issuer's subsidiaries (if any). Rule 147 also specifies the time period used to determine if the issuer derived at least 80 percent of its gross revenues from the state, which depends on when during the calendar year the offering occurs.

** Rule 147 doesn't actually require the *issuer* to comply with the limitations on resale in subsection (e). See Rule 147(b). However, it must comply with the requirements of subsections (c), (d), and (f) through (h). Subsection (f) is discussed in the text above.

Unlike Rule 147, Rule 147A is not a safe harbor to Section (3)(a)(11). Instead, it was adopted pursuant to the SEC's authority to adopt exemptions under Section 28 of the Securities Act. Accordingly, Rule 147A doesn't have to comply with the strict requirements of Section 3(a)(11) like Rule 147 does. One thing that this means for us is that Rule 147A does not have any restriction on offers—offers may be made to persons regardless of where they reside. However, Rule 147A does require that all *sales* be made only to residents of the issuer's state.

Also, Rule 147A does not require the issuer to be incorporated or organized in the state where the offering occurs; instead, it needs to have its principal place of business in the state. *See* Rule 147A(c)(1). Thus, a Delaware corporation that has its headquarters and business operations in New York could do a Rule 147A offering in New York. (Note that this is also a requirement under Rule 147.)

We won't cover all of them here, but some notable requirements of Rule 147A are as follows:

- General advertising and general solicitation is allowed, as long as *sales* are made only to persons who are residents of the applicable state, or who the issuer reasonably believes are residents of that state. (As with Rule 147, an individual is considered to be a resident of the state in which she has her principal residence.) However, the issuer must include with all offering materials prominent disclosures that sales will be made only to residents of the applicable state, which is also a requirement of Rule 147.

- The issuer must be "doing business" in the applicable state. To demonstrate this, the issuer could show that it meets at least one of the same four "doing business" requirements that are found in Rule 147.

- As with Rule 147, the issuer must get a written representation from each *purchaser* as to the purchaser's residency. (Also, the written representation, by itself, is not enough to give the issuer a reasonable belief about the person's state of residence.)

- Rule 147A contains the same six-month prohibition on out-of-state resales as found in Rule 147, as well as the same precautions that the issuer must take to prevent impermissible resales.

- An issuer that is a registered investment company under the Investment Company Act of 1940, or that is required to be one, may not use Rule 147A.

D. REGULATION A

In General. Regulation A consists of Rules 251 to 263 under the Securities Act. Although it's technically an exemption, Regulation A functions similarly to the registered offering process. For example, the issuer cannot not sell any of the securities until the SEC declares the offering "qualified," which it will do only after its review of a fairly detailed offering circular. Further, investors in a Regulation A offering receive unrestricted securities, which make it easier for them to resell than if they receive restricted securities (as they will in many other exemptions). However, some aspects of Regulation A, such as the disclosure requirements, are much less onerous than in a registered public offering. Further, Regulation A has long had a "testing the waters" provision (discussed below) that was not available for registered offerings. Nonetheless, Regulation A was seldom used in the past because it used to have a $5 million limit. After all, it was a rare issuer who would want to go nearly the same amount of trouble as it would in a registered offering to do a securities offering capped at $5 million; registered offerings don't have any dollar limitation.

In 2012, however, the JOBS Act directed the SEC to adopt a new exemption that would, among other things: allow up to $50 million of securities to be sold to the public; result in unrestricted securities; allow the issuer to "solicit interest in the offering prior to filing any offering statement, on such terms and conditions as the [SEC] may prescribe in the public interest or for the protection of investors"; and require the SEC to review the $50 million limitation every two years and increase the limit if it "determines appropriate." Although the SEC could have compiled with this statutory directive by promulgating an entirely new exemption, the end result was a significantly redesigned Regulation A. It took effect in June 2015 and is now referred to, somewhat facetiously, as "Regulation A+." Many additional changes were made in late 2020.

Dollar Limitations: Tier 1 and Tier 2. Under Regulation A, there are two types of offerings: Tier 1 and Tier 2. In a Tier 1 offering, the issuer can offer up to $20 million in a 12-month period.[*] Of this $20 million, a maximum of $6 million can be sold by affiliates of the issuer. For example, if ABC Corp. wanted to do a Tier 1 offering under Regulation A and its president (an affiliate) wanted to sell $3 million of *her* shares of ABC stock, this would mean that the company could only sell $17 million. In a Tier 2 offering, the limitation is $75 million, of which $22.5 million can be sales by affiliates.

However, Rule 251(a)(3) provides that the amount sold by current security holders in the issuer's first Regulation A offering, or any other Regulation A offering done within one year later, cannot exceed 30% of the overall offering price. Thus, for example, assume that this is ABC Corp.'s first Regulation A offering and that it is using Tier 1. If the company itself sold $7 million of stock, this would mean that its shareholders who are piggybacking[**] on the offering could sell no more than $3 million of *their* stock in the offering ($3 million is 30% of the $10 million total in this example.)

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[*] Rule 251(a) provides that the sum of (1) the aggregate offering price in the current Regulation A offering plus (2) the aggregate sales amount for Regulation A offerings that the issuer conducted in the prior 12 months may not exceed the amounts specified in the text above. Also, Rule 251(c) refers us to Rule 152 to see if the offering should be integrated with other offerings (see Section 15.03(G) below).

[**] If you're wondering why it is beneficial for current shareholders to be able to sell some of their shares by "piggybacking" on the issuer's offering, remember that Section 5 of the Securities Act

Nature of the Issuer. Tier 1 and Tier 2 offerings under Regulation A share many common requirements. First, an issuer that wants to use Regulation A must meet the requirements of Rule 251(b), which include (among other things) that the issuer: must be organized under the laws of the United States or a state or territory thereof, or Canada, and have its principal place of business in the United States or Canada; not be a "development stage company" or a registered investment company; and not be subject to the extensive "bad actor" disqualification provisions of Rule 262.

The Three Time Periods in a Regulation A Offering. Like a registered offering, an issuer using Regulation A must file an offering statement (as opposed to a *registration* statement) with the SEC and the SEC will hopefully eventually "qualify" the offering (as opposed to declaring it "effective" in a registered offering). This means that, much like a registered offering, there are three time periods in a Regulation A offering: the pre-filing period, the waiting period, and the post-qualification period.

The Regulation A Pre-filing Period. In the pre-filing period, the issuer (and its affiliates) may not make any offers of the securities. (As discussed in Section 15.02(B) above, the word "offer" is defined very broadly under the federal securities laws.) The only exception to this rule is the "testing the waters" provision, which is discussed below. Obviously, sales may not be made in the pre-filing period either.

The Regulation A Waiting Period. After the issuer has filed the offering statement with the SEC, it can make oral offers. However, care must be taken so that the offers are not *accepted*, in which case a "sale" would have occurred; sales are not permitted in the waiting period. In addition, the issuer can provide a copy of the preliminary offering circular to prospective investors under Rule 254 and can continue to use the "testing the waters" provisions of Rule 255 during the waiting period.

The Regulation A Post-Qualification Period. After the SEC has qualified the offering, the issuer can continue to make oral offers. It can also make written offers, provided that they are accompanied or preceded by the most recent offering circular, which is similar to the concept of "free writing" in a registered offering. To illustrate, during the waiting period, essentially the only type of written offer that could be made would be to give the prospective investor a copy of the preliminary offering circular. In the post-qualification period, however, the issuer could provide *other* written materials as long as that particular investor gets the offering circular at the same time or earlier.

No sales may be made until the post-qualification period (obviously). Even then, a sale may not be made unless the somewhat complicated requirements of Rule 251(d)(2) are observed. One of these requirements concerns limitations on the amount that investors may invest in a Tier 2 offerings, which are discussed below. In addition, in almost all

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provides that *any person* who wants to offer or sell securities must either register them or find an exemption from the registration requirement. See Section 15.03(H) below.

cases, this rule will require that purchasers receive a copy of the final offering circular. See Rule 251(d)(2)(ii).

The Offering Statement and the Offering Circular. The careful reader may have noticed that the phrases "offering statement" and "offering circular" were used in the preceding paragraphs and may have wondered: what is the difference between these two documents? Essentially, the offering circular is a *part* of an offering statement, much like a prospectus is a part of a registration statement in a registered offering. The meat (or veggies) of the sandwich, if you will. In other words, the offering statement is the document that the issuer files with the SEC, whereas the offering circular is that portion of it which the issuer provides to prospective investors.

Rule 252 concerns offering statements, which are filed on Form 1-A, and Rule 253 concerns offering circulars. We won't go into much detail about what Form 1-A or those rules require here, except to note that it is, generally speaking, much easier to complete the disclosure requirements of a Form 1-A than a registration form for a registered offering. (Also, the disclosure requirements are somewhat more demanding in a Tier 2 offering than in a Tier 1 offering.) Further, in some cases Rule 252 allows the issuer to submit a confidential (i.e., not available to the public) "draft" Form 1-A for SEC review and comment.

Testing the Waters Under Rule 255. What if you went to all the trouble and expense of preparing a Form 1-A only to find that investors were not interested in your securities offering? What a bad outcome that would be! Fortunately, Rule 255 allows you to "test the waters." If after doing so it doesn't look like there will be sufficient interest in your securities offering, perhaps you should consider other financing alternatives like a bank loan. This process generally isn't available in a registered offering (unless you are a well-known seasoned issuer using Rule 163, as discussed in Section 15.02(B) above, or an emerging growth company, as discussed in Section 15.02(D)).

Rule 255 communications with prospective investors may be oral or in writing, and may provide for a way in which persons can submit non-binding "indications of interest" to the issuer. In any case, though, a Rule 255 communication must: state that "no money or other consideration is being solicited, and if sent in response, will not be accepted"; state that no offers to buy can be accepted, nor any part of the purchase price received, until the offering statement has been qualified, and that offers can be revoked before they are accepted (which could only happen after the offering statement has been qualified); state that an indication of interest "involves no commitment or obligation of any kind"; and, if the offering statement has been filed, either include a copy of the preliminary offering circular or describe specified ways of accessing it. In fact, an issuer could "tweet" a Rule 255 communication so long as it included a link to the preliminary offering circular and observed the other requirements of Rule 255. (Note that Rule 255 only applies before the offering statement is qualified.)

New "Testing the Waters" Rule for All Exempt Offerings

Effective in March 2021, the SEC adopted new Rule 241, which allows an issuer that is *planning* an exempt offering to solicit indications of interest from potential investors, subject to the requirements of the rule. This will help the issuer determine which exemption to use (Regulation D, Regulation A, etc.). Technically, if the issuer has already decided which exemption to use, Rule 241 is not available.

Nature of Offerees and Purchasers. As noted above, Regulation A essentially allows for a public, albeit unregistered, offering. That being the case, there are no limits on the number of offerees or purchasers or requirements that they be "sophisticated" or accredited (but see the next paragraph).

Limitations on Investments in Tier 2 Offerings. Nonetheless, Rule 251(d)(2)(i)(C) provides that, in a Tier 2 offering of securities that will not be listed on a national securities exchange when the offering is qualified, sales may not be made to a person unless (1) the person is an accredited investor, as defined in Rule 501 of Regulation D, or (2) the person's aggregate purchase price is "no more than ten percent (10%) of the greater of such purchaser's: (1) Annual income or net worth if a natural person (with annual income and net worth for such natural person purchasers determined as provided in Rule 501 … or (2) Revenue or net assets for such purchaser's most recently completed fiscal year end if a non-natural person."

Problem

> Problem 15-4: *Would the above-described investment limitations apply if the purchaser were a famous movie star? What information would you need to answer this question? What if the stock that was being offered was listed on the New York Stock Exchange?*

After the Regulation A Offering. After a Tier 1 Regulation A offering, the issuer must file a relatively simple "exit report" within 30 days after the completion or termination of the offering. See Rule 257(a).

Not so fast for Tier 2 issuers, however. Under Rule 257(b), they are subject to a regime of ongoing, periodic reporting that in some ways mirrors the reporting system for publicly traded companies under the Securities Exchange Act, which is discussed in Chapter 17. Nonetheless, the required forms are "easier" than under the Exchange Act. For example, instead of quarterly reports on Form 10-Q, a Tier 2 Regulation A issuer submits semi-annual reports. See Rule 257 for details, including information about how long this reporting obligation will continue.

Unrestricted Securities. Regardless of whether Tier 1 or Tier 2 is used, purchasers in a Regulation A offering will receive unrestricted securities, which will make them easier to resell, as discussed briefly in Section 15.03(H) below. All other things being equal, investors may be willing to pay more for unrestricted securities than they would pay for restricted securities.

E. REGULATION CROWDFUNDING

In general, "crowdfunding" refers to raising money from large numbers of people, most of whom contribute relatively small amounts, though the use of general advertising such as a website. You probably have heard of popular crowdfunding websites like Kickstarter.com, GoFundMe.com, Patreon.com, and Indiegogo.com. While websites like these are very interesting, they need not concern us here because they follow a donation model or a subscription model of crowdfunding. In other words, persons who pay or donate money on these and similar websites are not buying *securities*. Instead, they are subscribing to some content, or donating money to causes or projects in which they believe, without an expectation of a monetary return on their donation (although in some cases, they may be entitled to a tax deduction for a charitable donation if the donee is a tax-exempt entity, and in some cases donors may receive "perks" or "rewards" for their donations).

But what if you tried to do a stock offering (clearly, that would be a securities offering) through a crowdfunding model? For example, what if your company advertised a stock offering on its website, seeking small investments from hundreds of investors, without any sort of screening mechanism to determine whether investors were sophisticated or accredited or where they reside? Hopefully, you will easily see why none of the exemptions discussed above would work in this situation. For example, Section 4(a)(2) would not be available because you are essentially offering your securities to the entire world, whereas Section 4(a)(2) requires that all of your offerees be able to "fend for themselves" within the meaning of the *Ralston-Purina* case and its progeny. Regulation D prohibits general advertising and general solicitation (like a website advertising a securities offering) except in limited situations. The intrastate exemptions of Section 3(a)(11) and Rule 147 require that all *offerees* be residents of a particular state. The list of reasons goes on.

However, Title III of the JOBS Act of 2012 added new Section 4(a)(6) to the Securities Act and directed the SEC to implement rules for a new crowdfunding exemption within certain parameters. The SEC's response was "Regulation Crowdfunding," which can be found in Part 227 of Title 17 of the Code of Federal Regulations. When reading the following discussion, ask yourself whether you think Regulation Crowdfunding would be a desirable way to conduct a securities offering, or whether you instead think its costs and disadvantages outweigh its advantages.

Nature of the Issuer. To use Regulation Crowdfunding, the issuer must be organized under the law of a state or territory of the U.S. (including Washington D.C.) and not be an Exchange Act reporting company, an investment company (or excluded from the definition of an investment company under Section 3(b) or 3(c) of the Investment Company Act*), or a developmental stage company that "[h]as no specific business plan or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies." Further, the issuer must not be subject to the detailed disqualification provisions set forth in Section 227.503, and must not have failed to comply with its post-offering reporting requirements (discussed below) arising out of any prior Regulation Crowdfunding offerings that it conducted.

Dollar Limits on Offering. Under Section 227.100(a)(1) of Regulation Crowdfunding, the issuer can sell a maximum of $5 million of securities in a 12-month period. (Note that this limit only applies to amounts sold under Section 4(a)(6). But see the discussion of integration in Section 15.03(G) below. Also note that this limit will be adjusted at least every five years. Inflation, you know.)

Limits on Amounts Non-Accredited Investors May Invest. Under Section 227.100(a)(2), an investor *who is not an accredited investor* (as defined in Rule 501 of Regulation D) is subject to the following limits in any 12-month period. These limitations apply "across all issuers," meaning that they aggregate all of the Regulation Crowdfunding investments that the investor made in the last 12 months, not just what the investor is purchasing in *this* offering.

- If *either* her annual income or her net worth is less than $107,000, the investor can invest no more than the *greater* of (1) $2,200 or (2) 5 percent of the *greater* of her annual income or net worth.

- If *both* her annual income and her net worth are $107,000 or more, the investment limit is 10 percent of the *greater* of her annual income or net worth, but "not to exceed an amount sold of $107,000."

Note that issues can rely on crowdfunding intermediaries to determine if investors have reached these limits, provided that the issuer doesn't have actual knowledge otherwise.

Problems

> Problem 15-5: Ivy Investor has an annual income of $80,000 and a net worth of $200,000. She has not purchased securities in any Regulation Crowdfunding Offering before. ABC Corp. is offering up to $1 million worth of its common stock in a Regulation Crowdfunding offering. *How*

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* *See also* Investment Company Act Rule 3a-9 (excluding from the definition of "investment company" certain "crowdfunding vehicles").

> *much ABC Corp. stock may Ivy purchase? Does your answer change if Ivy is married and her spouse has the same annual income and net worth? See* instruction 2 to Section 227.100(a)(2).
>
> Problem 15-6: Same facts, except that Ivy's annual income is $200,000.
>
> Problem 15-7: Maynard Moneybags has a net worth of $100 million and an annual income of $10 million. Last month, he purchased $50,000 of stock in a Regulation Crowdfunding offering by a different issuer. *How much ABC stock may Maynard purchase? (In answering this question, ask yourself: Is Maynard an accredited investor?)*

Disclosure Requirements. Under Sections 227.201 and 227.203, the issuer in a Regulation Crowdfunding offering must file a Form C Offering Statement with the SEC and make specified disclosures to investors concerning (among many other items): the target offering amount, the deadline for reaching that amount, and whether the issuer will go above the target amount; how the offering price was determined; financial statements for two years or a shorter period if the issuer was formed fewer than two years ago (if the offering exceeds $535,000, audited financials are required in most cases; in many other cases, financial statements can be reviewed by an independent public accountant) and a "discussion of the issuer's financial condition"; a description of the issuer's business and its planned use of the offering proceeds; a "discussion of the material factors that make an investment in the issuer speculative or risky"; and information about officers, directors, controlling shareholders, and specified related-party transactions. Further, under subsection (j) of Section 227.201, the disclosures must include:

> A description of the process to complete the transaction or cancel an investment commitment, including a statement that:
>
> (1) Investors may cancel an investment commitment until 48 hours prior to the deadline identified in the issuer's offering materials;
>
> (2) The intermediary will notify investors when the target offering amount has been met;
>
> (3) If an issuer reaches the target offering amount prior to the deadline identified in its offering materials, it may close the offering early if it provides notice about the new offering deadline at least five business days prior to such new offering deadline (absent a material change that would require an extension of the offering and reconfirmation of the investment commitment); and
>
> (4) If an investor does not cancel an investment commitment before the 48-hour period prior to the offering deadline, the funds will be

released to the issuer upon closing of the offering and the investor will receive securities in exchange for his or her investment;

While Section 227.201 is very long and complicated (if you copy and paste it into a Word document, it will be 11 pages long), its disclosure requirements still are less difficult than in a registered offering.

Advertising. Section 227.204 provides that an issuer can only advertise the Regulation Crowdfunding offering on a limited basis. In essence, any advertisement must contain only a specified, limited amount of information and must also direct viewers to the intermediary's platform (discussed immediately below). (Oral communications are not required to have a link to the platform.)[*]

Testing the Waters. Section 227.206, which was added in early 2021, provides that, before it files its Form C Offering Statement, a crowdfunding issuer may "communicate orally or in writing to determine whether there is any interest in a contemplated securities offering." However, "[n]o solicitation or acceptance of money or other consideration, nor of any commitment, binding or otherwise, from any person is permitted until the offering statement is filed." Subsection (b) requires disclosures that are consistent with the prior sentence. The attentive reader will have noticed that this provision is similar to Regulation A's "testing the waters" rule (Rule 255), as discussed above.

"Funding Portal" Requirements. A Regulation Crowdfunding offering must be conducted exclusively through the "platform" of an intermediary that complies with the requirements of Section 4A of the Securities Act and the related portions of Regulation Crowdfunding, including Sections 227.301 to 227.305 (which require intermediaries to take specified steps to reduce fraud, and meet many transaction-related requirements), and Sections 227.400 to 227.404 (which concern registration requirements, recordkeeping requirements, and other matters). While we won't delve into these rules in any detail here, note that an intermediary in a Regulation Crowdfunding offering must either be registered as a broker-dealer under the Exchange Act or registered as a "funding portal" (which is easier to do than registering as a broker-dealer). The self-regulatory authority (SRO) for broker-dealers and funding portals is the Financial Industry Regulatory Authority (FINRA), which has also promulgated rules with which Regulation Crowdfunding intermediaries must comply.

Post-Offering Reporting Requirements. Under Section 227.202 of Regulation Crowdfunding, the issuer must file with the SEC (and post on its website) an annual report of its results of operations and financial statements, as well as much of the information that is required by Section 227.201. The issuer must continue to do so until (1) it becomes an Exchange Act reporting company (in which case it obviously would then need to

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[*] *See also* Rule 148 (concerning "demo days" that won't be considered general advertising or general solicitation).

comply with the Exchange Act's more rigorous disclosure requirements, which are discussed in Chapter 17); (2) it has filed at least one annual report under Regulation Crowdfunding and has fewer than 300 record security holders; (3) it has filed at least three annual reports and has assets below $10 million; (4) the issuer or another person repurchases all of the securities that were sold under Regulation Crowdfunding; or (5) the issuer liquidates or dissolves.*

Resale Restrictions. Under 227.501, securities purchased in a Regulation Crowdfunding offering are subject to a one-year restriction on resales, although there are some exceptions to this rule, such as resales to the issuer, to certain of the investor's family members or trusts for their benefit, or to accredited investors.

> ***What About Crowdfunding Under Rule 506?***
>
> As discussed above, following the JOBS Act and related SEC rule-making, Rule 506(c) allows general advertising and general solicitation to be used in a Rule 506 offering, provided that all of the *purchasers* are accredited investors. In addition, the JOBS Act amended Section 4 of the Securities Act to provide that, in Rule 506 offerings, persons who meet certain requirements will not need to register as broker-dealers under the Securities Exchange Act merely because they maintain "a platform or mechanism" that permits the offer or sale of securities, or permits general solicitations, general advertisements, or similar or related activities, "whether online, in person, or through any other means," or they provide "ancillary services with respect to such securities." All of this means that Rule 506(c) can essentially be used as a "crowdfunding" exemption for offerings only to accredited investors.

F. COMPARING AND CONTRASTING EXEMPTIONS

There is no perfect exemption from Securities Act registration; the choice of an exemption will depend on the characteristics and needs of your client, the issuer of the securities. For example, if the issuer wants to raise, say, $80 million, then you should immediately recognize that some of the exemptions that you learned about above (Rule 504, Regulation A, and Regulation Crowdfunding) would not be available for that offering. Alternatively, if the issuer believes that it will need to sell the securities to many dozens or hundreds of persons, many of whom are not "sophisticated" in investment matters, then you should recognize that Section 4(a)(2) or Rule 506 would not be good choices of exemption for that offering.

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* Section 227.203(a)(3) also requires the issuer to file certain "progress updates" during the offering, but I have omitted a discussion of that requirement here.

To test your knowledge of the basics, you may want to try your hand at completing a chart or similar document, answering the following questions with respect to each of the exemptions that we discussed above, namely Section 4(a)(2); Rule 504; Rule 506; Section 3(a)(11) and/or Rule 147; Rule 147A; Regulation A; and Regulation CF:

- Are there restrictions on what types of issuers may use the exemption? If so, what are they?
- Is there a dollar limit on the offering? If so, during what period of time?
- Is there a limit on the number of purchasers?
- Must investors be accredited or sophisticated? What about *offerees*?
- Are there any limits on the residence of investors?
- Are there any specific items of information required to be disclosed?
- Is general advertising or general solicitation allowed? Can I "test the waters"?
- Does the exemption result in investors having "restricted" securities?

As you answer the above questions, it should become obvious that there is no perfect exemption and that there are advantages and disadvantages to each. But wait! The SEC has already done this for you! With some slight modifications, the following pages present a chart that the SEC posted to its website in November 2020 comparing and contrasting several different exemptions.

Type of Offering	Offering Limit Within 12 Month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing or Disclosure Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Section 4(a)(2)	None	No	None	Transactions by an issuer not involving any public offering. See SEC v. Ralston Purina Co.	None	Yes. Restricted securities	No
Rule 506(b)	None	No	"Bad actor" disqualifications apply	Unlimited accredited investors Up to 35 sophisticated but non-accredited investors in a 90 day period	Form D Aligned disclosure requirements for non-accredited investors with Regulation A offerings	Yes. Restricted securities	Yes
Rule 506(c)	None	Yes	"Bad actor" disqualifications apply	Unlimited accredited investors Issuer must take reasonable steps to verify that all purchasers are accredited investors	Form D	Yes. Restricted securities	Yes

Type of Offering	Offering Limit Within 12 Month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing or Disclosure Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Regulation A: Tier 1	$20 million	Permitted; before qualification, testing-the-waters permitted before and after the offering statement is filed	U.S. or Canadian issuers Excludes blank check companies, registered investment companies, business development companies, issuers of certain securities, certain issuers subject to a Section 12(j) order, and Regulation A and reporting issuers that have not filed certain required reports “Bad actor” disqualifications apply No asset-backed securities	None	Form 1-A, including two years of financial statements Exit report	No	No

Type of Offering	Offering Limit Within 12 Month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing or Disclosure Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Regulation A: Tier 2	$75 million	Same as above for Tier 1	Same as above for Tier 1	Non-accredited investors are subject to investment limits based on the greater of annual income and net worth, unless securities will be listed on a national securities exchange	Form 1-A, including two years of audited financial statements Annual, semi-annual, current, and exit reports	No	Yes
Rule 504 of Regulation D	$10 million	Permitted in limited circumstances	Excludes blank check companies, Exchange Act reporting companies, and investment companies “Bad actor” disqualifications apply	None	Form D	Yes. Restricted securities except in limited circumstances	No

Type of Offering	Offering Limit Within 12 Month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing or Disclosure Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Regulation Crowdfunding; Section 4(a)(6)	$5 million	Testing the waters permitted before Form C is filed Permitted with limits on advertising after Form C is filed Offering must be conducted on an internet platform through a registered intermediary	Excludes non-U.S. issuers, blank check companies, Exchange Act reporting companies, and investment companies “Bad actor” disqualifications apply	No investment limits for accredited investors Non-accredited investors are subject to investment limits based on the greater of annual income and net worth	Form C, including two years of financial statements that are certified, reviewed or audited, as required Progress and annual reports	12-month resale limitations	Yes
Intrastate: Section 3(a)(11)	No federal limit (generally, individual state limits between $1 and $5 million)	Offerees must be in-state residents.	In-state residents “doing business” and incorporated in-state; excludes registered investment companies	Offerees and purchasers must be in-state residents	None	Securities must come to rest with in-state residents	No

Type of Offering	Offering Limit Within 12 Month Period	General Solicitation	Issuer Requirements	Investor Requirements	SEC Filing or Disclosure Requirements	Restrictions on Resale	Preemption of State Registration and Qualification
Intrastate: Rule 147	No federal limit (generally, individual state limits between $1 and $5 million)	Offerees must be in-state residents	In-state residents "doing business" and incorporated in-state; excludes registered investment companies	Offerees and purchasers must be in-state residents	None	Yes. Resales must be within state for six months	No
Intrastate: Rule 147A	No federal limit (generally, individual state limits between $1 and $5 million)	Yes	In-state residents and "doing business" in-state; excludes registered investment companies	Purchasers must be in-state residents	None	Yes. Resales must be within state for six months	No

A few other things should be noted about exemptions from Securities Act registration. First, if the SEC or an investor challenges the validity of the exemption, the issuer has the burden of proving that it complied with the requirements of the exemption. Second, if possible, it often is wise to structure a securities exemption so that it simultaneously complies with two or more exemptions. That way, if the issuer does not meet the requirements of an exemption, a back-up may be available.

Finally, despite the fact that a securities offering may be exempt from the *registration* requirements of the Securities Act, the issuer (and perhaps others) will remain liable for securities fraud, such as material omissions from offering documents and false or misleading statements. You will learn a bit more about this elsewhere in this book, as well as in a course on Securities Regulation.

G. INTEGRATION OF OFFERINGS

Another issue that may arise if an issuer conducts two or more securities offerings simultaneously or close together in time is the concept of ***integration.*** If two or more (supposedly) separate securities offerings are integrated, that means that the SEC will view them as really being only one securities offering. As so combined, the offering must either have been registered or comply with an exemption from registration. In the past, (see, e.g., SEC Release 33-4552 (Nov. 6, 1962), 27 Fed. Reg. 11316), the SEC examined five factors to determine whether two or more offerings should be integrated:

- Are the offerings part of a single plan of financing?
- Do the offerings involve issuance of the same class of securities?
- Are the offerings made at or about the same time?
- Is the same type of consideration to be received?
- Are the offerings made for the same general purpose?

These factors were, to put it politely, a little vague. For example, it seems as if the first factor is really just a summary of the remaining four factors. Making matters worse, the SEC refused to say how many factors were necessary or whether some factors were more important than others. In addition, many of the exemptions discussed above used to have their *own* specific rules as to when they would (or would not) be integrated with other offerings. However, in late 2020, the SEC adopted new Rule 152 (which replaced "old" Rule 152, which concerned a slightly different topic) to clarify matters and have "one-stop shopping" for all of your integration questions.*

Subsection (a) sets forth a "general principle of integration," which applies unless one of the safe harbors in subsection (b) applies. It's worth quoting subsection (a) in full:

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* The integration sections in many exemptions now simply refer the reader to Rule 152. See, e.g., Rule 147(g), Rule 147A(g), Rule 251(c), Rule 502(a), and Section 277.100(e) of Regulation Crowdfunding.

> (a) *General principle of integration.* If the safe harbors in paragraph (b) of this section do not apply, in determining whether two or more offerings are to be treated as one for the purpose of registration or qualifying for an exemption from registration under the [Securities] Act, offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering either complies with the registration requirements of the Act, or that an exemption from registration is available for the particular offering. In making this determination:
>
> (1) For an exempt offering prohibiting general solicitation, the issuer must have a reasonable belief, based on the facts and circumstances, with respect to each purchaser in the exempt offering prohibiting general solicitation, that the issuer (or any person acting on the issuer's behalf) either:
>
> (i) Did not solicit such purchaser through the use of general solicitation; or
>
> (ii) Established a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation; and
>
> (2) For two or more concurrent exempt offerings permitting general solicitation, in addition to satisfying the requirements of the particular exemption relied on, general solicitation offering materials for one offering that includes information about the material terms of a concurrent offering under another exemption may constitute an offer of securities in such other offering, and therefore the offer must comply with all the requirements for, and restrictions on, offers under the exemption being relied on for such other offering, including any legend requirements and communications restrictions.

For example, assume that an issuer conducts a registered IPO and simultaneously conducts a Rule 506(b) offering (which would not allow general solicitation). The two offerings won't be integrated if the Rule 506(b) investors were not solicited using the IPO registration statement (or other general solicitation) or if the issuer or someone acting on the issuer's behalf established a "substantive relationship" with the investors before the start of the Rule 506(b) offering. Subsection (a)(2) would apply if the two exempt offerings both permitted general solicitation.

As noted above, subsection (b) of Rule 152 then has four safe harbors from integration. At the risk of oversimplifying things (you should read the rule itself, of course), here is a brief description of them. The first safe harbor provides that offerings won't be integrated if they occur more than 30 days apart. This applies to both public/registered offerings and exempt offerings. However, "for an exempt offering for which general solicitation is not permitted that follows by 30 calendar days or more an offering that allows general solicitation," the rule principles of subsection (a)(1) apply. (Think about that for a minute.)

The second safe harbor provides that offerings under Rule 701 (which is generally for employee benefit plans) or under Regulation S (offshore offerings) won't be integrated with other offerings. The third safe harbor provides that a registered offering will not be integrated with a prior offering that was terminated or completed in three situations (see subsection (d) for when an offering is considered to be "terminated" or "completed"). Finally, the fourth safe harbor provides that "[o]ffers and sales made in reliance on an exemption for which general solicitation is permitted will not be integrated if made subsequent to any terminated or completed offering."

H. RESALES AND RULE 144—A BRIEF NOTE

If you were paying close attention when you read Section 5 of the Securities Act, you would have noticed that it applies to "any person." Thus, literally *any* person—not just an issuer—who wants to offer and sell a "security" must either register the security with the SEC or find an exemption for the transaction. Thus, if you happen to own some shares of Apple Corp. stock or The Coca-Cola Company stock and want to resell them, you must either register them (not likely) or find an exemption.

Luckily, for an "ordinary" investor there is a readily available exemption: Section 4(a)(1). This section exempts securities that are sold in "transactions by any person other than an issuer, underwriter, or dealer." In an ordinary stock market transaction, Section 4(a)(1) will easily apply. However, if the person selling the securities (1) is an "affiliate" of the issuer, such as an officer or director of the issuer, or (2) holds "restricted" securities,[*] then compliance with Section 4(a)(1) is more problematic. If either (or both) of these situations apply, the person who wishes to resell the securities would be well-advised to do so in compliance with SEC Rule 144. You will likely learn more about Rule 144 in a course on Securities Regulation. Note that the chart in Section 15.03(F) above contains a column entitled "Restrictions on Resale" that concerns whether investors receive restricted or unrestricted securities in various exempt offerings. As noted above, restricted securities cannot be resold until applicable holding periods have been met.

[*] SEC Rule 144 defines "restricted" securities in part as those that were "acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." As noted above, some of the exemptions from registration discussed earlier in this chapter will result in purchasers having restricted securities. By contrast, stock purchased through the U.S. stock markets will not be considered restricted.

§ 15.04 OTHER PROVISIONS OF THE SECURITIES ACT

I have said so repeatedly throughout this chapter, but there is much, much more to learn about the Securities Act and other securities laws. If you are interested in this topic then you should take a course on Securities Regulation. With that disclaimer in mind, we should briefly touch on three other sections of the Securities Act.

Section 11 of the Securities Act provides that if an effective registration statement for a securities offering contained an "untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading," then any person who purchased the registered securities may sue the issuer and various other persons. Section 11 provides defendants with some potential defenses and also specifies how to calculate the plaintiff's recovery if the plaintiff wins the lawsuit.

Section 12 of the Securities Act is another section that creates potential civil liability. It provides that any person who offers or sells a security in violation of Section 5 is liable for damages to the person who purchased the security from her. There are virtually no defenses to a Section 12(a)(1) lawsuit; it basically imposes strict liability for Section 5 violations. Thus, if an issuer conducted a securities offering without having a valid exemption from registration or if the issuer otherwise violated Section 5 during the offering, purchasers would have the right to rescind their purchase or, if applicable, collect other damages. In this sense, Section 5 is self-enforcing (although the SEC of course can impose penalties for Section 5 violations); no issuer would want to have to give investors all of their money back plus interest.

Section 12(a)(2) provides a civil cause of action in the case of any false or misleading "prospectus." Given that the prospectus is the portion of a registration statement that is most likely to be false or misleading (as opposed to the other parts of a registration statement), Section 12(a)(2) overlaps with Section 11 to a large degree. This is particularly so following the Supreme Court's decision in *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).[*] Unlike Section 12(a)(1), there are some potential defenses to a Section 12(a)(2) lawsuit.

Finally, Section 18 *partially* pre-empts some state securities laws. It provides that, with some exceptions, the registration or qualification requirements of state securities laws do not apply to "covered securities," or securities that will be "covered securities" upon completion of the securities offering. Covered securities include those that are listed on national securities exchanges such as the New York Stock Exchange or certain tiers of Nasdaq, as well as any securities of the same issuer that are equal in seniority or senior to

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[*] Despite the broad definition given to "prospectus" in Section 2(a)(10) of the Securities Act, the Court in *Gustafson* held that, for purposes of Section 12(a)(2) lawsuits, a "prospectus" means a publicly disseminated document. Many commentators believe that *Gustafson*, which was a 5-4 decision, was mistakenly decided.

such a listed security. In addition, Section 18 pre-empts state registration requirements for securities that are sold in *some* exempt offerings, which could enormously simplify the process of conducting a securities offering where investors (or offerees) are in multiple states. Note that the chart in Section 15.03(F) above contains a column entitled "Preemption of State Registration and Qualification" that concerns this issue.

However, Section 18 does preserve states' ability to pursue actions for fraud or deceit, and to require filings and filing fees in some situations. Nonetheless, states may not require the *registration* of an offering of Section 18 covered securities. Conversely, states *may* require the registration of securities that are not Section 18 covered securities, as discussed in the next section.

Problems

> Problem 15-8: DEF Corp. common stock is listed on the New York Stock Exchange. *What are some securities of the same issuer that would be "senior" to DEF Corp. common stock?* See Section 18(d)(4).

§ 15.05 A NOTE ON STATE SECURITIES LAWS

You should not forget that all of the states have their own securities laws, which are referred to as "blue sky" laws. Thus, just because an issuer registered a securities offering with the SEC, that does not mean that it was registered in any of the states in which the issuer wishes to offer and sell the securities. Similarly, just because the securities offering is exempt at the federal level, that does not mean that it is exempt from any state's securities law. (However, as discussed in the previous section, Section 18 of the Securities Act pre-empts the registration requirements of state securities laws for some types of securities offerings.)

While there is a great deal of diversity among state securities laws, several states have adopted the Uniform Securities Act (or parts of it). The Uniform Securities Act contains many provisions that should be familiar to persons who have previously studied the federal Securities Act. For example, Section 102(28) contains a definition of "security" that is very similar, albeit more detailed, than the definition found in the Securities Act. Section 201 sets forth a list of exempted securities that is somewhat similar to those on the list of exempt securities in Section 3 of the Securities Act. Section 202 also provides for several exemptions from state registration requirements, some of which can be easily coordinated with a federal exemption from registration.

If an issuer does need to register a securities offering in a state that has adopted the Uniform Securities Act, there are three ways to do it: ***registration by notice***; ***registration by coordination***; and ***registration by qualification***. *See* Uniform Securities Act §§ 302-304. Registration by notice is reserved for investment companies (e.g., mutual funds) that are registered under the federal Investment Company Act of 1940. The aptly named registration by coordination refers to a process of simultaneously registering a federally registered offering in one or more states. Essentially, the states rely on the SEC to review the registration statement and, assuming a few conditions are met, will declare the registration statement effective in their states at the same time that the SEC declares it effective at the federal level.

Finally, registration by qualification is the only option left for securities offerings that are not exempt and that cannot qualify for either registration by notice or registration by qualification. Again, diversity is prevalent among state securities laws, and trying to comply with the requirements of several states at the same time can be very challenging. This is particularly so because some states impose "merit" regulation, at least for some types of offerings. That is, unlike the SEC (whose mantra is "Disclosure, disclosure, disclosure"), some states will prohibit securities offerings that they do not "like."

CHAPTER 16
INSIDER TRADING

In 2016, the United States Supreme Court decided Salman v. United States, *580 U.S. ___ (2016). Essentially, the* Salman *decision upholds the rule from* Dirks v. Securities and Exchange Commission, 463 U.S. 646 (1983), *which appears beginning on page 741 of the textbook.*

Although* Dirks *thus remains good law, the discussion on pages 754-757 of the physical textbook should be updated to reflect the* Salman *decision, which appears below.

Salman v. United States
United States Supreme Court
580 U.S. ___ (2016)

JUSTICE ALITO delivered the opinion of the Court.

Section 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b-5 prohibit undisclosed trading on inside corporate information by individuals who are under a duty of trust and confidence that prohibits them from secretly using such information for their personal advantage. 48 Stat. 891, as amended, 15 U.S.C. §78j(b) (prohibiting the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance in contravention of such rules as the [Securities and Exchange Commission] may prescribe"); 17 CFR § 240.10b–5 (2016) (forbidding the use, "in connection with the sale or purchase of any security," of "any device, scheme or artifice to defraud," or any "act, practice, or course of business which operates … as a fraud or deceit"); see *United States v. O'Hagan*, 521 U.S. 642, 650-652 (1997). Individuals under this duty may face criminal and civil liability for trading on inside information (unless they make appropriate disclosures ahead of time).

These persons also may not tip inside information to others for trading. The tippee acquires the tipper's duty to disclose or abstain from trading if the tippee knows the information was disclosed in breach of the tipper's duty, and the tippee may commit securities fraud by trading in disregard of that knowledge. In *Dirks v. SEC*, 463 U.S. 646 (1983), this Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend." *Id.*, at 664.

Petitioner Bassam Salman challenges his convictions for conspiracy and insider trading. Salman received lucrative trading tips from an extended family member, who had received the information from Salman's brother-in-law. Salman then traded on the information. He argues that he cannot be held liable as a tippee because the tipper (his brother-in-law) did not personally receive money or property in exchange for the tips and thus did not personally benefit from them. The Court of Appeals disagreed, holding that Dirks allowed the jury to infer that the tipper here breached a duty because he made a "'gift of confidential information to a trading relative.'" 792 F.3d 1087, 1092 (CA9 2015) (quoting *Dirks*, supra, at 664). Because the Court of Appeals properly applied *Dirks*, we affirm the judgment below.

I. Maher Kara was an investment banker in Citigroup's healthcare investment banking group. He dealt with highly confidential information about mergers and acquisitions involving Citigroup's clients. Maher enjoyed a close relationship with his older brother, Mounir Kara (known as Michael). After Maher started at Citigroup, he began discussing aspects of his job with Michael. At first he relied on Michael's chemistry background to help him grasp scientific concepts relevant to his new job. Then, while their father was battling cancer, the brothers discussed companies that dealt with innovative cancer treatment and pain management techniques. Michael began to trade on the information Maher shared with him. At first, Maher was unaware of his brother's trading activity, but eventually he began to suspect that it was taking place.

Ultimately, Maher began to assist Michael's trading by sharing inside information with his brother about pending mergers and acquisitions. Maher sometimes used code words to communicate corporate information to his brother. Other times, he shared inside information about deals he was not working on in order to avoid detection. [Citation omitted.] Without his younger brother's knowledge, Michael fed the information to others—including Salman, Michael's friend and Maher's brother-in-law. By the time the authorities caught on, Salman had made over $1.5 million in profits that he split with another relative who executed trades via a brokerage account on Salman's behalf.

Salman was indicted on one count of conspiracy to commit securities fraud, see 18 U.S.C. § 371, and four counts of securities fraud, see 15 U.S.C. §§ 78j(b), 78ff; 18 U.S.C. § 2; 17 CFR § 240.10b–5. Facing charges of their own, both Maher and Michael pleaded guilty and testified at Salman's trial.

The evidence at trial established that Maher and Michael enjoyed a "very close relationship." Maher "love[d] [his] brother very much," Michael was like "a second father to Maher," and Michael was the best man at Maher's wedding to Salman's sister. Maher testified that he shared inside information with his brother to benefit him and with the expectation that his brother would trade on it. While Maher explained that he disclosed the information in large part to appease Michael (who pestered him incessantly for it), he also testified that he tipped his brother to "help him" and to "fulfil[l] whatever needs he had." For instance, Michael once called Maher and told him that "he needed a favor." Maher offered his brother money but Michael asked for information instead. Maher then disclosed an upcoming acquisition. Although he instantly regretted the tip and called his brother back to implore him not to trade, Maher expected his brother to do so anyway. [Citations omitted throughout this paragraph.]

For his part, Michael told the jury that his brother's tips gave him "timely information that the average person does not have access to" and "access to stocks, options, and what have you, that I can capitalize on, that the average person would never have or dream of." Michael testified that he became friends with Salman when Maher was courting Salman's sister and later began sharing Maher's tips with Salman. As he explained at trial, "any time a major deal came in, [Salman] was the first on my phone list." Michael also testified that he told Salman that the information was coming from Maher. ("'Maher is the source of all this information'"). [Citations omitted throughout this paragraph.]

After a jury trial in the Northern District of California, Salman was convicted on all counts. He was sentenced to 36 months of imprisonment, three years of supervised release, and over $730,000 in restitution. After his motion for a new trial was denied, Salman appealed to the Ninth Circuit. While his appeal was pending, the Second Circuit issued its opinion in *United States v. Newman*, 773 F.3d 438 (2014), cert. denied, 577 U.S. ___ (2015). There, the Second Circuit reversed the convictions of two portfolio managers who traded on inside information. The *Newman* defendants were "several steps removed from the corporate insiders" and the court found that "there was no evidence that either was aware of the source of the inside information." 773 F.3d, at 443. The court acknowledged that *Dirks* and Second Circuit case law allow a factfinder to infer a personal benefit to the tipper from a gift of confidential information to a trading relative or friend. 773 F.3d, at 452. But the court concluded that, "[t]o the extent" *Dirks* permits "such an inference," the inference "is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature." 773 F.3d, at 452.*

Pointing to *Newman*, Salman argued that his conviction should be reversed. While the evidence established that Maher made a gift of trading information to Michael and that Salman knew it, there was no evidence that Maher received anything of "a pecuniary or similarly valuable nature" in exchange—or that Salman knew of any such benefit. The Ninth Circuit disagreed and affirmed Salman's conviction. 792 F.3d 1087. The court reasoned that the case was governed by *Dirks*'s holding that a tipper benefits personally by making a gift of confidential information to a trading relative or friend. Indeed, Maher's disclosures to Michael were "precisely the gift of confidential information to a trading relative that *Dirks* envisioned." 792 F.3d, at 1092 (internal quotation marks

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* [Footnote by Court:] The Second Circuit also reversed the *Newman* defendants' convictions because the Government introduced no evidence that the defendants knew the information they traded on came from insiders or that the insiders received a personal benefit in exchange for the tips. 773 F.3d, at 453–454. This case does not implicate those issues.

omitted). To the extent *Newman* went further and required additional gain to the tipper in cases involving gifts of confidential information to family and friends, the Ninth Circuit "decline[d] to follow it." 792 F.3d, at 1093. We granted certiorari to resolve the tension between the Second Circuit's Newman decision and the Ninth Circuit's decision in this case.[**] 577 U.S. ___ (2016).

II.A In this case, Salman contends that an insider's "gift of confidential information to a trading relative or friend," *Dirks*, 463 U.S., at 664, is not enough to establish securities fraud. Instead, Salman argues, a tipper does not personally benefit unless the tipper's goal in disclosing inside information is to obtain money, property, or something of tangible value. He claims that our insider-trading precedents, and the cases those precedents cite, involve situations in which the insider exploited confidential information for the insider's own "tangible monetary profit." He suggests that his position is reinforced by our criminal-fraud precedents outside of the insider-trading context, because those cases confirm that a fraudster must personally obtain money or property. More broadly, Salman urges that defining a gift as a personal benefit renders the insider-trading offense indeterminate and overbroad: indeterminate, because liability may turn on facts such as the closeness of the relationship between tipper and tippee and the tipper's purpose for disclosure; and overbroad, because the Government may avoid having to prove a concrete personal benefit by simply arguing that the tipper meant to give a gift to the tippee. He also argues that we should interpret *Dirks*'s standard narrowly so as to avoid constitutional concerns. Finally, Salman contends that gift situations create especially troubling problems for remote tippees—that is, tippees who receive inside information from another tippee, rather than the tipper—who may have no knowledge of the relationship between the original tipper and tippee and thus may not know why the tipper made the disclosure. [Citations omitted throughout this paragraph.]

The Government disagrees and argues that a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove securities fraud. See Brief for United States 27 ("*Dirks*'s personal-benefit test encompasses a gift to any person with the expectation that the information will be used for trading, not just to 'a trading relative or friend'" (quoting 463 U.S., at 664; emphasis in original)). Under the

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[**] [Footnote by Court:] *Dirks v. SEC*, 463 U.S. 646 (1983), established the personal-benefit framework in a case brought under the classical theory of insider trading liability, which applies "when a corporate insider" or his tippee "trades in the securities of [the tipper's] corporation on the basis of material, nonpublic information." *United States v. O'Hagan*, 521 U.S. 642, 651–652 (1997). In such a case, the defendant breaches a duty to, and takes advantage of, the shareholders of his corporation. By contrast, the misappropriation theory holds that a person commits securities fraud "when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information" such as an employer or client. Id., at 652. In such a case, the defendant breaches a duty to, and defrauds, the source of the information, as opposed to the shareholders of his corporation. The Court of Appeals observed that this is a misappropriation case, 792 F.3d, 1087, 1092, n. 4 (CA9 2015), while the Government represents that both theories apply on the facts of this case, Brief for United States 15, n. 1. We need not resolve the question. The parties do not dispute that *Dirks*'s personal-benefit analysis applies in both classical and misappropriation cases, so we will proceed on the assumption that it does.

Government's view, a tipper personally benefits whenever the tipper discloses confidential trading information for a noncorporate purpose. Accordingly, a gift to a friend, a family member, or anyone else would support the inference that the tipper exploited the trading value of inside information for personal purposes and thus personally benefited from the disclosure. The Government claims to find support for this reading in *Dirks* and the precedents on which *Dirks* relied. See, e.g., id., at 654 ("fraud" in an insider-trading case "derives 'from the inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone'" (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S. E. C. 933, 936 (1968))).

The Government also argues that Salman's concerns about unlimited and indeterminate liability for remote tippees are significantly alleviated by other statutory elements that prosecutors must satisfy to convict a tippee for insider trading. The Government observes that, in order to establish a defendant's criminal liability as a tippee, it must prove beyond a reasonable doubt that the tipper expected that the information being disclosed would be used in securities trading. The Government also notes that, to establish a defendant's criminal liability as a tippee, it must prove that the tippee knew that the tipper breached a duty—in other words, that the tippee knew that the tipper disclosed the information for a personal benefit and that the tipper expected trading to ensue. [Citations omitted throughout this paragraph.]

B. We adhere to *Dirks*, which easily resolves the narrow issue presented here.

In *Dirks*, we explained that a tippee is exposed to liability for trading on inside information only if the tippee participates in a breach of the tipper's fiduciary duty. Whether the tipper breached that duty depends "in large part on the purpose of the disclosure" to the tippee. 463 U.S., at 662. "[T]he test," we explained, "is whether the insider personally will benefit, directly or indirectly, from his disclosure." *Ibid*. Thus, the disclosure of confidential information without personal benefit is not enough. In determining whether a tipper derived a personal benefit, we instructed courts to "focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Id*., at 663. This personal benefit can "often" be inferred "from objective facts and circumstances," we explained, such as "a relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient." *Id*., at 664. In particular, we held that "[t]he elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend." *Ibid.* (emphasis added). In such cases, "[t]he tip and trade resemble trading by the insider followed by a gift of the profits to the recipient." *Ibid.* We then applied this gift-giving principle to resolve *Dirks* itself, finding it dispositive that the tippers "received no monetary or personal benefit" from their tips to Dirks, "nor was their purpose to make a gift of valuable information to Dirks." *Id*., at 667 (emphasis added).

Our discussion of gift giving resolves this case. Maher, the tipper, provided inside information to a close relative, his brother Michael. *Dirks* makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to "a trading relative," and that rule is sufficient to resolve the case at hand. As Salman's counsel acknowledged at oral argument, Maher would have breached his duty had he personally traded on the information here himself then given the proceeds as a gift to his brother. It is obvious that Maher would personally benefit in that situation. But Maher effectively achieved the same result by disclosing the information to Michael, and allowing him to trade on it. *Dirks* appropriately prohibits that approach, as well. *Cf.* 463 U.S., at 659 (holding that "insiders [are] forbidden" both "from personally using undisclosed corporate information to their advantage" and from "giv[ing] such information to an outsider for the same improper purpose of exploiting the information for their personal gain"). *Dirks* specifies that when a tipper gives inside information to "a trading relative or friend," the jury can infer that the tipper meant to provide the equivalent of a cash gift. In such situations, the tipper benefits personally because giving a gift of trading information is the same thing as trading by the tipper followed by a gift of the proceeds. Here, by disclosing confidential information as a gift to his brother with the expectation that he would trade on it, Maher breached his duty of trust and confidence to Citigroup and its clients—a duty Salman acquired, and breached himself, by trading on the information with full knowledge that it had been improperly disclosed.

To the extent the Second Circuit held that the tipper must also receive something of a "pecuniary or similarly valuable nature" in exchange for a gift to family or friends, *Newman*, 773 F.3d, at 452, we agree with the Ninth Circuit that this requirement is inconsistent with *Dirks*.

C. Salman points out that many insider-trading cases—including several that *Dirks* cited—involved insiders who personally profited through the misuse of trading information. But this observation does not undermine the test *Dirks* articulated and applied. Salman also cites a sampling of our criminal-fraud decisions construing other federal fraud statutes, suggesting that they stand for the proposition that fraud is not consummated unless the defendant obtains money or property. *Sekhar v. United States*, 570 U.S. ___ (2013) (Hobbs Act); *Skilling v. United States*, 561 U.S. 358 (2010) (honest-services mail and wire fraud); *Cleveland v. United States*, 531 U.S. 12 (2000) (wire fraud); *McNally v. United States*, 483 U.S. 350 (1987) (mail fraud). Assuming that these cases are relevant to our construction of §10(b) (a proposition the Government forcefully disputes), nothing in them undermines the commonsense point we made in *Dirks*. Making a gift of inside information to a relative like Michael is little different from trading on the information, obtaining the profits, and doling them out to the trading relative. The tipper benefits either way. The facts of this case illustrate the point: In one of their tipper-tippee interactions, Michael asked Maher for a favor, declined Maher's offer of money, and instead requested and received lucrative trading information.

We reject Salman's argument that *Dirks*'s gift-giving standard is unconstitutionally vague as applied to this case. *Dirks* created a simple and clear "guiding principle" for determining tippee liability, 463 U.S., at 664, and Salman has not demonstrated that either §10(b) itself or the *Dirks* gift-giving standard "leav[e] grave uncertainty about how to estimate the risk posed by a crime" or are plagued by "hopeless indeterminacy," *Johnson v. United States*, 576 U.S. ___, ___, ___ (2015) (slip op., at 5, 7). At most, Salman shows that in some factual circumstances assessing liability for gift-giving will be difficult. That alone cannot render "shapeless" a federal criminal prohibition, for even clear rules "produce close cases." *Id*., at ___, ___ (slip op., at 9, 10). We also reject Salman's appeal to the rule of lenity, as he has shown "no grievous ambiguity or uncertainty that would trigger the rule's application." *Barber v. Thomas*, 560 U.S. 474, 492 (2010) (internal quotation marks omitted). To the contrary, Salman's conduct is in the heartland of *Dirks*'s rule concerning gifts. It remains the case that "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts." 463 U.S., at 664. But there is no need for us to address those difficult cases today, because this case involves "precisely the 'gift of confidential information to a trading relative' that *Dirks* envisioned." 792 F.3d, at 1092 (quoting 463 U.S., at 664).

III. Salman's jury was properly instructed that a personal benefit includes "the benefit one would obtain from simply making a gift of confidential information to a trading relative." App. 398–399. As the Court of Appeals noted, "the Government presented direct evidence that the disclosure was intended as a gift of market-sensitive information." 792 F.3d, at 1094. And, as Salman conceded below, this evidence is sufficient to sustain his conviction under our reading of *Dirks*. Appellant's Supplemental Brief in No. 14-10204 (CA9), p. 6 ("Maher made a gift of confidential information to a trading relative [Michael] … and, if [Michael's] testimony is accepted as true (as it must be for purposes of sufficiency review), Salman knew that Maher had made such a gift" (internal quotation marks, brackets, and citation omitted)). Accordingly, the Ninth Circuit's judgment is affirmed.

It is so ordered.

CHAPTER 17
PUBLICLY TRADED CORPORATIONS

In Chapter 8, you learned a lot of general information about corporations, such as how they are formed, the respective decision-making spheres of the board and the shareholders, and how the board and shareholders go about making decisions. The vast majority of the information that you learned in Chapter 8 will carry over to this chapter. In other words, publicly traded corporations (as that term will be defined below) are still corporations—they have articles and bylaws, directors, shareholders, stock, etc., just like any other corporation. However, Chapter 8 primarily concerned *state* law. By contrast, this chapter will in large part address additional requirements that *federal* law imposes on publicly traded corporations.

The primary federal statute that we will study in this chapter is the Securities Exchange Act of 1934, otherwise known as the "***Exchange Act***" or sometimes the "***1934 Act***." This is one of two federal securities laws that were enacted as part of Franklin Delano Roosevelt's "New Deal" legislative program shortly after the stock market crash of 1929. (The other statute is the Securities Act of 1933, which is the subject of Chapter 15.) The Exchange Act is largely directed at "after-market" trading activity, that is, the functions of securities markets, as well as brokers, dealers, investment banks, and other market participants. In Section 17.02 of this chapter, we will examine some of the basic attributes of the stock markets in the United States.

The Exchange Act imposes extremely complex regulations on publicly traded companies. Thus, this chapter will begin with a discussion of when an issuer must become a "public" or "reporting" company under the Exchange Act. From there, we will examine the periodic reporting requirements of the Exchange Act, the rules governing the solicitation of proxies from shareholders of public companies, and some of the civil liabilities that may result from materially false or misleading proxy statements or other Exchange Act reports. Note, however, that some other portions of the Exchange Act were covered in earlier chapters, most notably Chapters 14 and 16.

Finally, Section 17.03 concerns "governance" issues that affect publicly traded corporations. Although one could make a good argument that some (but not all) of these issues should have been addressed in Chapter 8 because they can affect any large corporation, whether or not it is publicly traded, given the great societal importance of these issues with respect to publicly traded corporations, it seemed more appropriate to address them in this chapter than in Chapter 8.

Please note that, given the complex (and constantly changing) nature of much of the material in this chapter, it is somewhat less "interactive" than prior chapters. I have not included learning objectives in this chapter and there are a relatively small number of problems for you to consider.

§ 17.01 THE SECURITIES EXCHANGE ACT OF 1934

As discussed in Chapter 8, for most corporations, *state* law dictates the information that the corporation must provide to its shareholders. For example, Section 5.08(E) of Chapter 8 discusses the corporate information that shareholders are entitled to inspect under the MBCA. However, if the corporation is subject to the reporting requirements of the Exchange Act, the amount of information that it must provide to its shareholders—and the Securities and Exchange Commission ("***SEC***"), and therefore the world at large—dramatically increases. Indeed, as you will see, there is a virtual treasure trove of information about each publicly traded company in its SEC filings, which are easily available online. But before examining the Exchange Act's periodic reporting requirements, we will first examine when registration under the Exchange Act is required. In other words, the first task is to determine when a corporation must become a ***reporting company*** (also known as a ***public company*** or ***publicly traded company***).[*]

A. REGISTRATION REQUIREMENTS

There are two main ways whereby a company (also called an "***issuer***") can become subject to the reporting requirements of the Exchange Act: (1) registration under Section 12(b) and (2) registration under Section 12(g). Also, Section 15(d) of the Exchange Act requires issuers who have filed an effective registration statement for a securities offering under the Securities Act of 1933 (which, of course, is a different statute) to comply with the Exchange Act's reporting requirements for some period of time afterward, even if they do not have securities registered under Section 12.

Section 12(b). Section 12(b), along with Section 12(a) of the Exchange Act, essentially provides that any class of securities that is listed on a "national securities exchange" such as the New York Stock Exchange (the "***NYSE***"), Nasdaq, or several other "regional" exchanges, must be registered under Section 12(b). The details of how it gets to this result are a bit curious. First, Section 12(a) makes it unlawful:

> for any member [of a national securities exchange], broker, or dealer to effect any transaction in any security *** on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of [the Exchange Act] and the rules and regulations thereunder. ***

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[*] Technically, a "reporting" company is one that is subject to the Exchange Act's periodic reporting requirements that are discussed in Section 17.01(B), regardless of whether its stock is traded on a national securities exchange. The phrase "publicly traded" usually describes a company who stock is traded on such an exchange or other organized market. Nonetheless, these terms tend to be used interchangeably. Note, however, the some of the requirements discussed in this chapter do not apply to "Section 15(d)" companies, as discussed later in this section.

Meanwhile, Section 12(b) essentially lists the documents that an issuer must file with the SEC in order to register a class of securities under Section 12(b). (More on this below.) Taken together, these two sections mean that no registered broker-dealer may buy or sell a security over a national securities exchange unless that security is registered pursuant to Section 12(b). Not surprisingly, then, each national securities exchange requires a security to be registered under Section 12(b) before it may be traded on that exchange. In addition, as discussed in Section 17.02 below, each national securities exchange requires that certain other requirements must be met before a security may be traded on that exchange.

Section 12(g). Section 12(g) is very different from Section 12(b). Under Section 12(g), it does not matter if a security is traded on any sort of securities market. In fact, it may not be. Instead, Section 12(g), along with SEC Rule 12g-1 under the Exchange Act, requires an issuer to register a class of equity securities, such as stock, if certain conditions are met.

Before the Jumpstart Our Business Startups Act of 2012, H.R. 3606, otherwise known as the "JOBS Act," Section 12(g), along with SEC Rule 12g-1 under the Exchange Act, required an issuer to register a class of equity securities if three conditions were met:

(1) the issuer is engaged in interstate commerce or in a business affecting interstate commerce, or its securities are traded through the mails or instrumentalities of interstate commerce;

(2) the issuer has more than $10 million of assets; and

(3) the issuer's equity securities are "held of record" by 500 or more persons.[*]

Although the first two requirements for Section 12(g) registration described above remain the same, the JOBS Act amended the third requirement. Now, an issuer need not register under Section 12(g) unless its equity securities are held of record by either (1) 2,000 persons, or (2) 500 persons who are not accredited investors (as defined by the SEC[**]). Further, if the issuer is a bank or a bank holding company, then the number of

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[*] Section 12(g)(2) excludes eight types of securities from this requirement, including securities that are listed on a national securities exchange (and thus required to be registered under Section 12(b)), and securities issued by certain regulated financial institutions and insurance companies.

[**] The SEC will likely define "accredited investors" for purposes of Section 12(g) in the same manner that it defines accredited investors in Regulation D under the Securities Act (which is discussed in Chapter 13). See *Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*, Release No. 33-9693 (Dec. 18, 2014), 79 Fed. Reg. 78343. For many companies, it is not clear how they will be able to determine whether their current shareholders are accredited investors without resorting to periodic questionnaires.

record shareholders needed to trigger a Section 12(g) registration is 2,000, regardless of whether the shareholders are accredited investors.

The Section 12(g) "counting rules" got more interesting in two other respects after the JOBS Act. First, Section 502 of the JOBS Act amended Section 12(g) to provide that:

> For purposes of determining whether an issuer is required to register a security with the [SEC] pursuant to [Section 12(g)], the definition of "held of record" shall not include securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933.

Second, the JOBS Act directed the SEC to "exempt, conditionally or unconditionally," securities that are acquired pursuant to the new "crowdfunding" exemption under the Securities Act (which is discussed in Chapter 15). In other words, if a person acquires shares from an issuer in a crowdfunding transaction or pursuant to an employee compensation plan that was not conducting a registered offering (and that person doesn't own any other shares of the issuer's stock), that person will not count as a "holder of record" for purposes of Section 12(g).[*]

Whether an issuer must register a class of equity securities under Section 12(g) is determined at the end of its fiscal year. In the case of most companies, this will be December 31. If the issuer meets the requirements of Section 12(g) at the end of its fiscal year, it must register the relevant class of equity securities within the next 120 days. For example, assume that ABC Corp.'s fiscal year ends on December 31 and that ABC Corp. is considered to be engaged in interstate commerce. If, as of December 31, ABC Corp. had more than $10 million of assets, 2,001 record holders of its common stock (regardless of whether they are accredited investors or not), and 125 record holders of its preferred stock, it would be required to register its common stock (but not its preferred stock) under Section 12(g) within 120 days after December 31.

The "counting" threshold of Section 12(g) could raise several issues. SEC Rule 12g5-1(a) provides that securities are "held of record" by "each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer." Thus, each person who has a stock certificate for the issuer's stock will count toward this threshold. But who else counts as a holder of record? As discussed below in Section 17.01(D), for many companies whose securities are *already* traded on a stock market, this can be a very difficult question to answer. This is because such corporations may have "street name" or "beneficial" shareholders. In other words, many,

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[*] The JOBS Act also requires the SEC to adopt "safe harbor provisions that issuers can follow when determining whether holders of their securities received the securities pursuant to an employee compensation plan in transactions that were exempt from the registration requirements of section 5 of the Securities Act of 1933." As of the date of the textbook, the SEC had not finalized rules to implement these provisions of the JOBS Act.

if not most, of the shareholders of public companies own their shares through banks or brokerage firms and do not have physical stock certificates. Perhaps surprisingly, most such beneficial shareholders do *not* count toward the threshold of Section 12(g), even though we think of them as the "true" owners of the stock.

Note that a particular class of securities cannot be registered under Section 12(b) and Section 12(g) at the same time. Generally, if an issuer registered a class of equity securities under Section 12(g) but that class was *later* listed on a national securities exchange, the appropriate section for registration would be Section 12(b) rather than Section 12(g). This is true even though the class of securities would still meet the requirements of Section 12(g). *See* Section 12(g)(2)(A).

Registration Forms. If an issuer must register a class of securities under either Section 12(b) or Section 12(g), it usually would use SEC Form 10 to do so. While a discussion of that form is outside the scope of this textbook, suffice it to say that Form 10 calls for very detailed information about the issuer, akin to the information that would be included in a registration statement for a securities offering under the Securities Act of 1933 (which is discussed in Chapter 15) or in a Form 10-K Annual Report (discussed below). In some instances, the somewhat less extensive Form 8-A could be used instead. You may learn more about these, and other, forms in a course on Securities Regulation.

The Meaning of Registering a "Class" of Securities. As you learned in Chapter 15, when an issuer (or, for that matter, any person) wishes to *offer and sell* securities, Section 5 of the Securities Act provides two choices: (1) register the securities that will be offered and sold or (2) find an exemption from the registration requirement. Thus, for example, if ABC Corp. wanted to offer and sell 10 million shares of its common stock in a registered public offering, it would register *those 10 million shares* with the SEC. If, at some point in the future, ABC Corp. wanted to offer and sell *more* shares of its common stock in another offering, it would again be faced with the choice with registering the shares that it plans to sell at that time or finding an exemption from registration for that offering. The mere fact that ABC Corp. did a registered offering of its common stock in the past would not give it a "pass" from having to register the new offering, although it may be somewhat easier to do a such a secondary offering than an initial public offering (IPO).

By contrast, when an issuer registers under Section 12 of the Exchange Act, the issuer is registering an *entire class* of its securities. By definition, the number of units into which a class may be divided is indeterminate. For example, assume that the above-mentioned ABC Corp., after its registered public offering of common stock under the Securities Act, successfully applies to have its common stock listed on the NYSE. As you know from the above discussion, ABC Corp. would then be required to register its common stock under Section 12(b) of the Exchange Act. Assume further that, at that time, ABC Corp.'s articles of incorporation have 20 million shares of authorized common stock, of which 18 million shares are outstanding. How many of these shares are now registered under Section 12(b)? In a sense, it doesn't really matter. Again, the entire class is registered under the Exchange Act. If in the future ABC Corp. amends its articles of incorporation to create more authorized shares of common stock, the *class* of common stock would still remain registered under Section 12(b).*

Thus, registration of a class of securities under Section 12 of the Exchange Act is unrelated to any securities offering or other transaction. If ABC Corp. wants to offer and sell some of these new shares, it would again face the two choices under the *Securities Act*—register the new shares that the company plans to sell in this offering or find an exemption, as you learned in Chapter 15. Again, the fact that the class of securities is registered under the *Exchange Act* does not give ABC Corp. a "pass" to ignore the Securities Act when it wants to offer and sell shares of that class.

Pros and Cons of Being a Publicly Traded Company. Many companies wind up as Section 12 registrants after a public offering of securities under the Securities Act, because they apply to have their securities listed on a national securities exchange immediately after the offering and/or because the offering results in them meeting the requirements of Section 12(g). Thus, the decision to "go public" is voluntary for most companies.

Is it a good idea to be a public company? It depends on who you ask. Clearly, there are some advantages to being public. For example, a public company (at least one that has securities listed on a national securities exchange) has relatively easy access to the capital markets. That is, if it wishes to raise more money by selling securities, it may (somewhat) easily do so, both because of the name recognition and visibility that comes with being a public company and the fact that many such established companies are eligible to use "easier" SEC registration forms than companies that would be conducting an IPO. Such a secondary offering may have lower costs than the company's IPO. Further, the SEC may be more deferential to them than it would be to less well-known companies doing an IPO.

A public company also may be able to use its stock as "acquisition currency," that is, as consideration for the acquisition of other companies. As you learned in Chapter 14, in a merger the "target" company merges into the "surviving corporation" and the target shareholders receive the agreed-upon merger consideration in exchange for their shares. If the surviving corporation is private, the merger consideration most likely will be cash. On the other hand, if the surviving corporation is public, it might be able to use new shares of its own stock as the merger consideration, particularly if it is a well-established company with a stable stock price and a liquid market in which its shares can be resold. To be somewhat flippant, it's almost as if a public company has its own money printing press. Similarly, public companies are better able to use their stock as a compensation device for employees and consultants.

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* Note that Section 12(g)(5) defines a "class" of securities as "all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges."

Having shares listed on a national securities exchange can also be beneficial to the company's shareholders. In contrast to a private corporation that does not have an established trading market for its stock, being listed will make it easy for shareholders to sell their shares if they wish to do so. Moreover, the presence of market trading will act to "price" the stock, even for those who do not trade. Thus, you have a better idea of what your stock is worth than you would if it were not publicly traded. Finally, the mere fact that a company is public may give it an advertising and publicity advantage over its private competitors. News outlets tend to focus on public companies over similar, but private, companies.

These advantages come with a heavy cost, however. As you will appreciate more as you read this chapter, it is not easy being a public company. Great quantities of information must be released to the public on an ongoing basis. The SEC forms on which this information must appear are not exactly quickly and easily completed. Not only will these reporting obligations involve a lot of management time that could otherwise be spent on more productive pursuits such as actually running the company, but they will necessitate the use of attorneys and accountants. Such professionals are usually expensive. Moreover, in recent years the reporting and other obligations under the Exchange Act have gotten significantly more burdensome. Reporting deadlines have sped up and the information that must be reported has become much more extensive. The SEC and Congress have in several instances gone beyond pure reporting rules to impose substantive rules, as you will see later in this chapter.

Also, note that the documents that a public company must continually file with the SEC are *public*. This, of course, is because the Exchange Act and the SEC exist largely to protect investors, including potential investors. But, from the issuer's perspective, this means that not only may current shareholders or prospective shareholders review the issuer's SEC-filed documents but so too may competitors. Due to the detailed disclosure requirements of these forms, competitors will know information about a public company that they probably would not have known otherwise.

Further, officers and directors of a public company are at more of a risk of legal liability than their counterparts at private companies. For example, they could be the targets of lawsuits brought under Rule 10b-5 or other provisions of the Exchange Act that impose liability for materially false or misleading Exchange Act reports or proxy statements. Also, the CEO and Chief Financial Officer of a public company must personally certify the contents of the company's Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q, as discussed below. This could result in significant liability if the reports are materially inaccurate. Further, as you learned in Chapter 16, officers, directors, and 10% shareholders are subject to potential lawsuits for "short-swing" profits under Section 16(b) of the Exchange Act.

Shareholders can be problematic, as well. Being a publicly traded company means that basically anyone can get her hands on some of your stock, including "shareholder activists." This may lead to pressure on the company to make significant changes to its business or corporate governance tactics, as discussed in Section 17.03 below. It could also lead to takeover attempts, as discussed in Sections 14.06 and 14.07 of Chapter 14. Many shareholders, particularly institutional shareholders and hedge funds, seem to demand continual, explosive growth in the company's revenues and earnings, a pace that may be realistic for some time after a company's IPO but that won't continue indefinitely.

These and other disadvantages of being an Exchange Act registrant have led many public companies in recent years to question whether it is worth it.

De-Registering Under Sections 12(b) and 12(g). A company that has decided that the "cons" of being a public company outweigh the "pros" may want to de-register from Section 12, which is sometimes called "going dark." A company that goes dark can return to the simpler days of being a private company.

De-registering from Section 12(b) is relatively simple; the issuer would have its securities delisted from whatever national securities exchanged on which they trade. This is done by either the issuer or the exchange filing a Form 25 with the SEC. The removal of the securities from registration under Section 12(b) is typically effective 90 days after the form is filed. See SEC Rule 12d2-2 for more details. Under Section 12(g)(2)(A) of the Exchange Act, if an issuer has a class of securities registered under Section 12(b), then it need not register that class under Section 12(g). However, if the issuer were to deregister the class from Section 12(b), then it would be required to register those securities under Section 12(g) if, at that time, it met the requirements for Section 12(g) registration. Thus, the issuer should ensure that it could, if necessary, deregister its class of securities under Section 12(g).

As you should recall, registration under Section 12(g) is required when the issuer has 2,000 or more record shareholders of any type, or 500 or more record shareholders who are not accredited investors, and the issuer meets certain other requirements. Does this mean that the issuer could deregister the class of stock under Section 12(g) if it could somehow reduce the number of record shareholders the threshold, such as by redeeming stock from some holders? Surprisingly, no. To deregister under Section 12(g), the issuer must reduce the number of record shareholders below *300* (or 1,200 for banks and bank holding companies).[*] Some call this rule "500 going up and 300 coming down." See Section 12(g)(4) of the Exchange Act. (Again, however, don't forget that the determination of which shareholders "count" can be a bit complicated, as discussed in Section 17.01(D) below.) To deregister a class of securities from Section 12(g), the issuer must file a Form 15 with the SEC. See SEC Rule 12g-4 for more details.

As if the above weren't complex enough, at this point we need to introduce a discussion of Section 15(d) of the Exchange Act.

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[*] Alternatively, if the issuer has had fewer than $10 million in assets on the last day of each of its three most recent fiscal years, it could deregister the class of securities from Section 12(g) if there are fewer than 500 record holders of the class. See SEC Rule 12g-4.

Section 15(d). A company that is subject to Section 15(d)—but neither Section 12(b) nor Section 12(g)—is sometimes called a "quasi-public" company. This is because Section 15(d) issuers must abide by the periodic reporting requirements discussed in Section 17.01(B) below, but they escape other portions of the Exchange Act, including the proxy rules under Section 14 discussed in Section 17.01(D) below. In other words, Section 15(d) reporting companies are not "full" public companies.

When is a company a Section 15(d) reporter? The relevant portion of Section 15(d) is set forth below. When reading it, note that Section 13 of the Exchange Act is the section pursuant to which the SEC requires periodic reports such as Annual Reports on Form 10-K and Quarterly Reports on Form 10-Q.

> Each issuer which has filed a registration statement *** which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe ***, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title. The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class *** to which the registration statement relates are held of record by less than 300 persons, or, in the case of bank or a bank holding company, *** 1,200 persons. For the purposes of this subsection, the term "class" shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. ***.

Thus, if an issuer has done a registered offering under the *Securities Act*—which is a different statute—it will become a reporting company under the Exchange Act for some period of time. Whether it will remain so for an indefinite period will depend on whether it has 300 (1,200 for banks) or more shareholders as of the beginning of a fiscal year. However, note that the issuer will always be a reporting company with respect to the year in which its Securities Act registration statement was effective, regardless of how many shareholders it winds up with. It could stop filing period reports with respect to *later years*, however, if it has fewer than 300 (1,200 for banks) record shareholders at the beginning of a fiscal year. (If it goes back above 299 shareholders, it would go back to being a Section 15(d) reporter.)

In addition, SEC Rule 12h-3 would allow the issuer to file a Form 15 to suspend its Section 15(d) reporting requirements if at any time (as opposed to the beginning of a year) it has fewer than 300 record shareholders and meets certain other requirements.

However, even if it uses Rule 12h-3, it must still file Exchange Act reports with respect to the year in which its Securities Act registration statement became effective.

Confused yet? Hopefully you won't find the following problems difficult.

Problems

Problem 17-1: Private Co., which is engaged in selling widgets throughout the United States, had 506 nonaccredited shareholders, 600 accredited shareholders, and $11 million of assets as of December 21. Its stock is not listed on a national securities exchange, and its fiscal year ends on December 31. *What, if anything, would you recommend that Private Co. do before the end of the year? What would happen if Private Co. does not take your advice?*

Problem 17-2: Same facts as Problem 17-1, except that Private Co. has only 247 shareholders of record, even after completing a registered stock offering under the Securities Act earlier this year. *Does Private Co. have periodic reporting obligations under the Exchange Act? If so, how long will it continue to have these obligations?*

Problem 17-3: Same facts as Problem 17-2, except that Private Co. stock was admitted for trading on a national securities exchange. *Does Private Co. have periodic reporting obligations under the Exchange Act? If so, how long will it continue to have these obligations?*

Problem 17-4: *Can you explain the consequences of an issuer being a "Section 15(d) reporter," as opposed to having a class of securities registered under either Section 12(b) or Section 12(g)?*

B. PERIODIC REPORTING REQUIREMENTS AND REGULATION FD

Section 13(a) of the Exchange Act allows the SEC to specify periodic reports that must be filed by issuers that have a class of securities registered under Sections 12(b) or 12(g), or that are subject to Section 15(d).* The SEC requires many different reports, the most important being Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K. Section 12 issuers (as well as Section 15(d) issuers) are also subject to Regulation FD, the basic purpose of which is to require them to report to

* Section 13(*l*) of the Exchange Act also allows the SEC to promulgate rules requiring issuers to disclose "on a rapid and current basis" any information concerning "material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations," as the SEC determines is "necessary or useful for the protection of investors and in the public interest."

the public any previously nonpublic material information that is disclosed to certain third parties. As noted above, the purpose of these reporting requirements is to protect investors by ensuring a steady stream of reliable and current information concerning public companies.

ACCOUNTING AND AUDITOR REQUIREMENTS

In addition to the many disclosure requirements that the Exchange Act imposes on issuers (and others), it has many requirements for accounting firms that audit the financial statements of public companies. While this book will not discuss these requirements in any detail, suffice it to say that they are very stringent. Further, in Regulation S-X, the SEC imposes detailed accounting and financial disclosure requirements which are in addition to GAAP (which you encountered in Chapter 1) and GAAS (Generally Accepted Auditing Standards).

Form 10-K Annual Reports. Once a year, companies with securities registered under Section 12(b) or Section 12(g), as well as Section 15(d) reporting companies, must file an Annual Report on Form 10-K.* A full discussion of the contents of this form is outside the scope of this textbook; in fact, the only way to really learn how to prepare a Form 10-K is to actually work on one, preferably under the supervision of an experienced securities attorney. Nonetheless, it may be helpful to describe some—but not all—of the various items called for by Form 10-K. (Also, Rule 12b-20 provides that, "[i]n addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading.") Note that, generally speaking, references to the "issuer" in the following paragraphs include not only the issuer itself but also any subsidiaries that it has.

Item 1—Business. This item requires disclosure of the information called for by Item 101 of Regulation S-K, which is part of the SEC's integrated disclosure system. (This means that many of the items of information required by Exchange Act reports are the same as those that are required in a registration statement for a securities offering under the Securities Act of 1933.) Item 101 is very detailed, requiring the issuer to describe many aspects of its business, in ways too numerous to list here. Interested readers may want to peruse Item 101 to get an idea of its scope.

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* Before March 2009, issuers that were "small business issuers" could use the less demanding Form 10-KSB. This form has now been eliminated, as has similar Form 10-QSB. However, issuers that qualify as "smaller reporting companies" are excused from a few of Form 10-K's requirements. In addition, some portions of Regulation S-K specify relaxed disclosure requirements for smaller reporting companies. The JOBS Act does likewise for emerging growth companies (as defined in Chapter 15).

Item 1A—Risk Factors. This item, which is a relatively new addition to Form 10-K, requires the issuer to describe how the various "risk factors" listed in Item 503(c) of Regulation S-K apply to it, although "smaller reporting companies" are not required to do so. This disclosure must be made in "Plain English," some guidelines for which are listed in Rule 421(d) under the Securities Act. These include using short sentences, "definite, concrete, everyday words," and bullet points or tables whenever possible, and refraining from the use of "legal jargon or highly technical business terms" and double negatives. (Surprisingly, this rule has—in my opinion at least—resulted in more readable SEC filings.) The purpose of the risk factors section is to alert investors or potential investors in the issuer's securities to the many ways in which their investment may turn out badly.

Item 3—Legal Proceedings. This item requires the issuer to discuss any material legal proceedings within the meaning of Item 103 of Regulation S-K in which it is involved.

Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations. This item, which is referred to as "MD&A," is basically a companion piece to the audited annual financial statements that appear in Item 8. The MD&A, which must be prepared according to the exacting Item 303 of Regulation S-K, should explain the issuer's financial statements and results in sufficient detail to allow investors to make informed investment decisions about the issuer's securities. MD&A is necessary so that investors have a narrative discussion of the issuer's financial statements and the reasons for differences from prior years. Without such a discussion by the issuer, readers would likely be left guessing as to the causes of changes in the issuer's financial results from year to year. MD&A also serves to give readers information about the issuer's future prospects.

Item 8—Financial Statements and Supplementary Data. Item 8 is probably the most important part of Form 10-K. Item 8 requires annual financial statements prepared in accordance with generally accepted accounting principles (GAAP) and additional SEC requirements and audited by an accounting firm that meets stringent independence requirements.

Part III (Items 10 through 14)—Directors and Officers, Compensation, Etc. Part III of Form 10-K requires a great deal of information about the company's directors and officers, compensation practices, and other matters. However, this information may be omitted from the Form 10-K as long as the issuer includes it in a Schedule 14A proxy statement that it files within 120 days after the end of its fiscal year. For that reason, we will discuss that information in Section 17.03(D) below.

Again, this is not a complete list of the items required by Form 10-K, but hopefully it will suffice to give you a sense of the immense extent of the disclosures that public companies must make on an ongoing basis. The goal is disclosure, disclosure, disclosure. The hope is that this disclosure will allow the markets (that is, investors) to make informed investment decisions. As former Supreme Court Justice Louis Brandeis said of disclosure requirements: "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." To see whether you agree that the Exchange Act and the SEC are requiring sufficient "sunlight" or "electric light," you might want to read a recent Form 10-K for a public company in which you are interested in some way. With a few minor exceptions, all SEC filings are easily available, free of charge, on the SEC's website (www.sec.gov).

Form 10-Q Quarterly Reports. Public companies must file a Form 10-Q three times a year, following the end of the first, second, and third quarters of their fiscal years. (A Form 10-Q is not required with respect to the fourth quarter because a Form 10-K will be filed to cover the entire year.) Although Form 10-Q requires a great deal of information, its principal purpose is to present quarterly financial statements and MD&A. Unlike Form 10-K, financial statements in a Form 10-Q are not audited.

Filing Deadlines for Form 10-K and Form 10-Q. Before the Sarbanes-Oxley Act, the deadlines for filing Forms 10-K and 10-Q were almost leisurely: Form 10-K was required for all issuers within 90 days after the end of their fiscal year, and Form 10-Q was required within 45 days after the end of the relevant quarter. Thus, for example, an issuer whose fiscal year coincides with a calendar year would have until approximately March 31 to file its Form 10-K for the prior year.

Of course, the reader will guess correctly that the Sarbanes-Oxley Act and subsequent SEC rule amendments sped these deadlines up, but they did so in a complex way, creating three categories of Exchange Act filers: (1) ***large accelerated filers*** (basically, those whose securities have a market value of $700 million or more, excluding shares held by certain affiliates, and have been subject to the Exchange Act's reporting requirements for at least one year); (2) ***accelerated filers*** (these typically have a market value of $75 million or more, calculated in the same manner, and have also been reporting companies for at least one year); and (3) ***non-accelerated filers***, most of which are also known as ***smaller reporting companies***. (See Rule 12b-2 under the Exchange Act if you are interested in the precise definitions.) The first group, large accelerated filers, have only 60 days in which to file Forms 10-K and 40 days in which to file Forms 10-Q. Accelerated filers have 75 days to file Forms 10-K and 40 days for Forms 10-Q. The non-accelerated filers have stayed at the original deadlines of 90 days for Forms 10-K and 45 days for Forms 10-Q.

Form 8-K Current Reports. As discussed above, Forms 10-K and 10-Q have a set schedule; issuers know exactly when they must file these forms, quarter after quarter, year after year. In contrast, Form 8-K must be filed on an "as needed" basis. In other words, Form 8-K specifies a list of events or conditions that the SEC considers so important that they must be disclosed on a rapid basis, usually within four business days after they occur. Although simply listing these items probably gives you little understanding of what the items *mean*, it may be helpful to at least take a quick look at the types of things with which Form 8-K is concerned. Here is the list (excluding the items in Part 6, which only applies to issuers of asset-backed securities, which are specialized types of securities that you might learn about in an advanced course on Securities Regulation):

Item 1.01	Entry into a Material Definitive Agreement
Item 1.02	Termination of a Material Definitive Agreement
Item 1.03	Bankruptcy or Receivership
Item 1.04	Mine Safety; Reporting of Shutdowns and Patterns of Violations
Item 2.01	Completion of Acquisition or Disposition of Assets
Item 2.02	Results of Operations and Financial Condition
Item 2.03	Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant
Item 2.04	Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
Item 2.05	Costs Associated with Exit or Disposal Activities
Item 2.06	Material Impairments
Item 3.01	Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
Item 3.02	Unregistered Sales of Equity Securities
Item 3.03	Material Modification to Rights of Security Holders
Item 4.01	Changes in Registrant's Certifying Accountant
Item 4.02	Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
Item 5.01	Changes in Control of Registrant
Item 5.02	Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers

Item 5.03	Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
Item 5.04	Temporary Suspension of Trading Under Registrant's Employee Benefit Plans
Item 5.05	Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics
Item 5.06	Change in Shell Company Status
Item 5.07	Submission of Matters to a Vote of Security Holders
Item 5.08	Shareholder Director Nominations
Item 7.01	Regulation FD Disclosure

Item 8.01 of Form 8-K is a catchall entitled "Other Events." Nothing specific is required by this item; instead, it gives issuers the option to disclose events that they deem "of importance to security holders." Finally, Item 9.01 would require the issuer to list any financial statements or exhibits called for by another item of the form.

Schedule 13D. The Exchange Act imposes many additional reporting requirements with respect to Section 12 registrants, but in some cases *shareholders* of these companies are the ones who must do the reporting. For example, Section 13(d) requires a security holder (or a group acting in concert) to file a report with the SEC once it beneficially owns more than five percent of the outstanding units of a class of Section 12 equity securities. This report, Schedule 13D, requires not only information about the holder (or group) but also information about the holder's (or group's) plans for the issuer. Schedule 13D is discussed further in Section 14.06(B) of Chapter 14.

Section 16. Section 16(b), which is a presumed insider trading prohibition, applies to officers, directors, and 10% shareholders of Section 12 registrants. It requires these persons to remit to the issuer any actual or "hypothetical" profit resulting from a matched purchase and sale (or sale and purchase) of the issuer's securities that occur within six months of one another. This is discussed further in Section 16.03 of Chapter 16. To allow the SEC and potential plaintiffs' attorneys to monitor these persons' trading activity, Section 16(a) requires them to file reports with the SEC whenever they buy or sell any of the issuer's securities.

Regulation FD. When the SEC adopted Regulation FD in the year 2000, it stated:

> Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure. The regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic

> information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or non-intentional; for an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a non-intentional disclosure, the issuer must make public disclosure promptly. Under the regulation, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary distribution of the information to the public.

In other words, Regulation FD was designed to level the playing field between securities market participants such as analysts—who are often in a position to receive important, but nonpublic information, from the issuer—and ordinary investors. It may also reduce the incidence of insider trading (see Chapter 16) by requiring simultaneous or prompt *public* disclosure of such information that is given to persons such as analysts. While well-intentioned, Regulation FD can lead to a number of interpretive and compliance issues. You may learn more about it in a course on Securities Regulation.

C. OTHER EXCHANGE ACT REQUIREMENTS

The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 ("***SOX***") was enacted in the wake of Enron, WorldCom, and other major corporate scandals. While SOX, to a large degree, modifies the Exchange Act to make the reporting requirements imposed on public companies much tougher, it also represents a major federal intrusion into corporate governance matters, which traditionally had been the province of state law.* The following discussion is not a comprehensive description of SOX, and interested readers would likely learn more about it in a Securities Regulation course or other courses in law school. Also, given that SOX is nearly 15 years old, corporate practitioners have by now gotten "used" to it and accept it as just another part of the corporate governance landscape. Nonetheless, a brief review of some of the more notable provisions of SOX is important to persons taking the introductory Business Organizations course in law school, if only to show the trend of federal regulatory requirements.

Audit Committee Requirements. In section 301 of SOX, Congress directed the SEC to adopt a rule preventing each national securities exchange (e.g., NYSE) and national securities association (at the time of SOX, Nasdaq was not yet an "exchange") from listing the securities of issuers that are not in compliance with certain audit committee requirements. The main rule that the SEC adopted in response is Rule 10A-3 under the Exchange Act. This rule requires that exchange rules must require all audit committee members to be "independent" (as defined) from the issuer, subject to

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* *Cf. Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (invaliding SEC rule that would have regulated voting rights of shareholders).

some limited exceptions. Further, the exchange rules must require the audit committee to establish procedures for investigating complaints "regarding accounting, internal accounting controls, or auditing matters" and the "confidential, anonymous submission by employees … of concerns regarding questionable accounting or auditing matters." Also, pursuant to Section 407 of SOX and related SEC rules, a public issuer must periodically disclose whether its audit committee has at least one member who is a "financial expert" (as mentioned in Section 17.01(D) below).

Financial Statement Certification Requirements. Section 906 of SOX provides that each periodic Exchange Act report that contains financial statements must also contain a certification by the issuer's chief executive officer (CEO) and chief financial officer (CFO) that the report "fully complies" with the requirements of Section 13(a) or Section 15(d) of the Exchange Act and that the information in the report "fairly presents, in all material respects, the financial condition and results of operations of the issuer." In addition, Section 302, along with SEC rules, requires the CEO and CFO to certify in each annual and quarterly Exchange Act report that, among other things, they have reviewed the report and, based on their knowledge, the report does not contain any untrue statements or omit material facts, and that the financial statements and other information fairly present in all material respects the issuer's financial condition and results of operations. See also 18 U.S.C. § 1350 (criminal penalties for false certifications).

Internal Controls Report; Auditor Attestation. Section 404(a) of SOX directed the SEC to adopt rules that would require each annual report (e.g., Form 10-K) to contain an internal controls report (1) stating management's responsibility for establishing and maintaining an "adequate internal control structure and procedures for financial reporting" and (2) containing an assessment of the structure and procedures. Furthermore, Section 404(b) of SOX requires the issuer's independent auditors to attest to and report on the issuer's assessments made under Section 404(a). This section proved to be very controversial because companies found that complying with it was enormously expensive. As a result, although the SEC issued final rules on this topic in 2003 (the main one of which was Exchange Act Rule 13a-15), the rules contained phased-in compliance dates. Also, in the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress exempted smaller reporting companies (those with a market capitalization under $75 million) from having to comply with subsection (b) of Section 404, and the JOBS Act exempted emerging growth companies as well. This statute also directed the SEC to study how it could reduce the costs of complying with Section 404(b) for companies with market capitalizations between $75 million and $250 million "while maintaining investor protections for such companies." The SEC eventually recommended against any further exemptions from Section 404(b), although it continues to study all of its rules.

Enhanced Financial Disclosures. As required by Section 401 of SOX, the SEC amended the MD&A portions of Form 10-K to require issuers to explain any "off-balance sheet" arrangements. It also adopted Regulation G, which provides that if an issuer releases any non-GAAP financial measures it must also present the most directly comparable GAAP financial measure, as well as a reconciliation of the non-GAAP measure to the GAAP measure.

Auditor Requirements. Public accounting firms generally may no longer provide non-audit services to public companies contemporaneously with audit services, with some exceptions. SOX also created the Public Company Accounting Oversight Board ("***PCAOB***") and required essentially all public accounting firms to register with the PCAOB. The PCAOB has authority to establish "auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports" for public issuers, among other powers.

At one time, the PCAOB was considering a proposal that would have limited the number of years that a firm could perform auditing work for a company (sometimes called "auditor rotation requirements") but it has since abandoned that idea. Section 203 of SOX, however, added subsection (j) to Section 10A of the Exchange Act, which provides that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.

Code of Ethics for Senior Financial Officers. Section 406 of SOX directed the SEC to adopt rules requiring public companies to disclose whether they have a code of ethics for certain senior officers and, if not, why not. The rule, which is found in Item 406 of Regulation S-K, requires the code to be "reasonably designed to deter wrongdoing" and promote "[h]onest and ethical conduct," "[f]ull, fair, accurate, timely, and understandable disclosure in [Exchange Act] reports," and compliance with laws. This disclosure is required by Item 10 of Form 10-K (but may instead appear in an issuer's proxy statement that is filed with the SEC within 120 days after the end of the issuer's fiscal year).

Prohibition of Loans to Executives. Section 402 of SOX added new subsection (k) to Section 13 of the Exchange Act, which makes it illegal for issuers to "extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer," subject to some exceptions.

Forfeiture of Bonuses ("Clawbacks"). Section 304(a) of SOX provided that if an issuer has to restate its financial statements "due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws," the issuer's CEO and its CFO must repay any bonus or other incentive or stock-based compensation that they received during the year after the faulty financial statements were first filed with the SEC or publicly released, as well as any profits that they realized from selling the issuer's securities during that period. The SEC has brought many enforcement actions under this section in recent years

Attorney Conduct Rules. Attorneys were not left out of having new requirements imposed under SOX. Section 307 of SOX required the SEC to promulgate new rules applicable to attorneys representing public issuers. The basic purpose of the new rules, which are now found in Rules 1 through 7 of 17 C.F.R. Part 205, is to require "up the ladder" reporting by attorneys who become aware of evidence of a past, pending or imminent "material violation" involving an Exchange Act issuer or certain subsidiaries. "Material violations" include material violations of applicable federal or state securities laws, breaches of fiduciary duties under federal or state law, and "similar" violations of any federal or state law. An attorney who must report this evidence to the issuer usually must also determine whether the issuer adopts an "appropriate response."

The Dodd-Frank Wall Street Reform and Consumer Protection Act. This sprawling (849 pages in PDF format) statute, which was enacted in 2010, was a response by Congress to the financial crisis that began in 2007 and resulted in, among other things, the "fire sale" of Bear Stearns to JPMorgan Chase in March 2008, the subsequent bankruptcy of Lehman Brothers, the bailout of American International Group (AIG), Congress's passage of the Troubled Asset Relief Program (TARP), and many other dramatic events. This textbook is not the place for a detailed discussion of the many complex causes of the financial crisis or the provisions of the Dodd-Frank Act and other regulatory responses to the financial crisis. However, a brief discussion of a few of the provisions of this statute is in order. Keep in mind that this statute was adopted during a time of great public outcry over executive compensation, particularly at companies that received "bailouts."

Executive Compensation and "Say on Pay." The Dodd-Frank Act added Section 14A to the Exchange Act. This new section requires that, at least once every three years, public companies must allow their shareholders to have an advisory (i.e., non-binding[*]) vote on executive compensation. In addition, at least once every six years, the issuer must allow its shareholders to vote on whether the advisory vote on executive compensation will take place every year, every two years, or every three years. This is sometimes called "say on frequency."[**] The JOBS Act exempted emerging growth companies from these requirements.

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[*] As you know from Chapter 8, the board determines the compensation of the officers. Congress did not want to upset this state-law rule. Thus, the "say on pay" vote by the shareholders could be ignored by the board. On the other hand, the theory is that few boards will want to approve executive compensation that is widely disapproved by the shareholders.

[**] See Exchange Act Rule 14a-21. See also Item 24 of Schedule 14A (which is discussed below). This item requires proxy statements to, among other things, "briefly explain the general effect of each vote, such as whether each such vote is non-binding, and, when applicable, disclose the current frequency of shareholder advisory votes on executive compensation required by Rule 14a-21(a) and when the next such shareholder advisory vote will occur."

On a related note, the SEC had earlier amended Items 402 of Regulation S-K to require a "Compensation Discussion and Analysis," which must appear either in the issuer's Form 10-K or its proxy statement (if the proxy statement is filed within 120 days after the end of the issuer's fiscal year). Further, Item 407(e)(5) of Regulation S-K now requires extensive discussion of the activities of the issuer's compensation committee or, if the issuer does not have a compensation committee, the board members who perform equivalent functions.

Advisory Vote on "Golden Parachutes." New Exchange Act Section 14A also provides that, in any proxy materials in which shareholders are asked to approve a merger or similar change-of-control transaction involving a public company, the company must disclose, in a "clear and simple" manner in accordance with rules to promulgated by the SEC, any so-called "golden parachute" payments (e.g., severance payments) that may be received by high-level executives. Further, the shareholders must be allowed to cast an advisory vote on that compensation. The JOBS Act exempted emerging growth companies from these requirements.

As noted above, votes under Section 14A are advisory, meaning that issuers are free to ignore negative votes and pay the executives whatever compensation they were planning to anyway. Thus far, however, it seems that very few companies have faced this dilemma. For example, in 2012, only 2.6% of companies in the Russell 3000 (which consists of the 3,000 largest U.S.-traded stocks) that had say-on-pay votes did not achieve 50% support. By contrast, 72% of these companies achieved over 90% shareholder support. See Semler Brossy Consulting Group, *2012 Say on Pay Results*, *available at* http://www.semlerbrossy.com/wp-content/uploads/SBCG-SOP-2012-09-05.pdf. See also Kiersten Zaza, *The Impact of Say-on-Pay*, 31 REV. BANKING & FIN. L. 580, 581 (Spring 2012) ("By June 30 of the 2011 proxy season, a total of 2,502 say-on-pay votes yielded only thirty-nine rejections, despite proxy advisory firms' recommendations that shareholders reject plans in more than 250 votes.").

At the same time, the presence of say-on-pay votes (as well as the other SOX and Dodd-Frank requirements discussed above) does appear to have had the effect of making issuers be more deliberate in their compensation decision-making. See James F. Cotter, Alan R. Palmiter, & Randall S. Thomas, *The First Year of Say-on-Pay under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 993 (2013) ("Generally, companies responded with increased (and different) disclosures and became proactive in the face of a negative [Institutional Shareholder Services] voting recommendation. Shareholders also behaved differently, paying attention to new company outreach and focusing their attention on the say-on-pay vote rather than other avenues to communicate their views on pay practices. The failure by companies to address shareholder concerns, sometimes leading to a failed say-on-pay vote, often resulted in litigation. Proxy advisors took note of these developments, schooling their company clients on how to avoid say-on-pay failure.").

"Clawbacks." Expanding on Section 304 of SOX (discussed above), Section 954 of the Dodd-Frank Act required the SEC to pass rules that would prohibit national securities exchanges from listing the securities of issuers that do not develop and implement (and disclose) "clawback" policies. In general, these policies must require that executives, including former executives, repay incentive-based compensation that they earned with respect to the issuer's financial statements, if the financial statements are restated within three years after the compensation was earned. The amount of the repayment would be the difference between what the executive earned and what she "should have" earned, based on the restated financial statements. The SEC proposed rules on this topic in 2015, but as of the date of this textbook the rules have not been finalized. Proposed Exchange Act Rule 10D-1 would require stock exchanges to require listed companies to adopt clawback policies and would also require them to de-list noncompliant companies.

Disclosure of Relationship Between Executive and Shareholder Returns; Disclosure of Ratio of CEO Pay to Average Worker Pay. The Dodd-Frank Act added new subsection (i) to Section 14 of the Exchange Act. This subsection requires the SEC to promulgate rules that require issuers to include in their proxy statements information about the "relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer ...." As of the date of this textbook, the SEC is still in the process of finalizing rules on this topic, which eventually will be found in Item 402(v) of Regulation S-K.

The Dodd-Frank Act also directed the SEC to amend Item 402 of Regulation S-K so that public companies must disclose (1) "the median of the annual total compensation of all employees of the issuer, except the [CEO]"; (2) the CEO's annual total compensation; and (3) the ratio between those two amounts. In August 2015, the SEC finalized rules concerning the disclosure of pay ratios. See Item 402(u) of Regulation S-K; note that it does not apply to emerging growth companies (as defined in Chapter 15) and smaller reporting companies (as defined above). For most reporting companies, this new disclosure will be required beginning with their 2018 proxy statements.

Independent Compensation Committee Members. Much like what SOX did with respect to audit committees, Section 952 of the Dodd-Frank Act added new Section 10C to the Exchange Act. This new section directs the SEC to adopt rules preventing national securities exchanges from listing the securities of issuers that do not have "independent" compensation committees, subject to certain exceptions. The SEC implemented these new rules in 2012. See Exchange Act Rule 10C-1.

Of course, this is just a small sampling of some of the provisions of the Dodd-Frank Act. You may learn more about it in an advanced course on Securities Regulation or Banking Law. In addition, as should be obvious, this is a dynamic area of the law and you should expect continuing changes, some of them major, in the future.

D. PROXY RULES UNDER SECTION 14

Section 14(a)(1) of the Exchange Act provides in part that:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 12.

Note a few things about this section. First, it only applies to securities that are registered under Section 12 of the Exchange Act. Thus, if an issuer is only a Section 15(d) reporter, the proxy rules do not apply to it. Second, the statute itself doesn't make anything illegal. Instead, it provides that it would be illegal to solicit proxies *in violation of SEC rules on this topic.* This is a classic example of Congress delegating rulemaking authority to an administrative agency. Third, the phrase "or otherwise" means that there is no requirement that interstate commerce or other "jurisdictional means" be used.

As a practical matter, public companies must solicit proxies for shareholder meetings. Keep in mind that many public companies have thousands upon thousands of "small" shareholders who likely would not want to travel across the country to attend a shareholders meeting at which their shares would represent only a tiny fraction of the total number of outstanding shares. Given this situation, if shares could not be considered "present" at the meeting unless the holders of the shares were physically present, many companies would be unable to muster a quorum for their shareholder meetings, making the conduct of business at such meetings impossible.[*] As you learned in Chapter 8, a shareholder's shares can be represented—and voted—at a shareholders meeting through a proxy.

One of the most important SEC rules under Section 14(a) is Rule 14a-3, which provides that proxy "solicitations" may not occur unless each person solicited is furnished with a proxy statement that contains the information specified in Schedule 14A (which is discussed below). Further, if proxies are solicited by or on behalf of the issuer and the meeting is an annual meeting, each shareholder whose proxy is solicited must be provided with an annual report (often called the "glossy" annual report) that contains much of the information that is included in the issuer's Form 10-K for the prior year. As one might

[*] There are some public companies that have majority shareholders, whose presence at the meeting would ensure a quorum. While such companies would thus not need to solicit proxies from other shareholders, note that Section 14(c) of the Exchange Act would require them to provide to all shareholders an "information statement" that contains virtually all of the information that would be in a Schedule 14A proxy statement.

expect, Schedule 14A requires extremely detailed information for even routine annual shareholder meetings.

But before describing those requirements, you should understand when a "solicitation" of a proxy is being made. After all, if there is no "solicitation" being made, then one need not provide a Schedule 14A to the other party to the communication. Note that *anyone*, not just the issuer of the securities, could be involved in a proxy solicitation. Thus, the proxy rules are important in "proxy contests" and other takeover attempts (which are discussed further in Chapter 14).

What is a "Solicitation"? Rule 14a-1(*l*) provides in part that:

> (1) The terms "solicit" and "solicitation" include:
>
> (i) Any request for a proxy whether or not accompanied by or included in a form of proxy:
>
> (ii) Any request to execute or not to execute, or to revoke, a proxy; or
>
> (iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

Pretty clear, isn't it? Well, at least we can be certain that if someone is requesting that a shareholder complete a proxy card for an upcoming shareholders meeting, a "solicitation" is occurring. Other situations may be ambiguous. However, there are some additional rules that may be helpful. For example, Rule 14a-1(*l*) excludes some things from the definition of a "solicitation," including, in subsection (2)(iv):

> A communication by a security holder who does not otherwise engage in a proxy solicitation (other than a solicitation exempt under Rule 14a-2) stating how the security holder intends to vote and the reasons therefor, provided that the communication:
>
> (A) Is made by means of speeches in public forums, press releases, published or broadcast opinions, statements, or advertisements appearing in a broadcast media, or newspaper, magazine or other bona fide publication disseminated on a regular basis,
>
> (B) Is directed to persons to whom the security holder owes a fiduciary duty in connection with the voting of securities of a registrant held by the security holder, or

> (C) Is made in response to unsolicited requests for additional information with respect to a prior communication by the security holder made pursuant to this paragraph (l)(2)(iv).

Thus, under current law, if a shareholder wanted to make public statements supporting or opposing proposals that will be voted on by the shareholders, it may do so under this rule without worry that its activities would constitute the "solicitation" of a proxy which would require the filing of a Schedule 14A.[*]

In addition, even if something would constitute the "solicitation" of a proxy, Rule 14a-2 specifically excludes some activities from most (but not all) of the proxy rules. For example, under Rule 14a-2(b)(1), a solicitation is exempt from most of the proxy rules if the person making the solicitation is not affiliated with management of the issuer, does not have a personal interest in the matter to be voted upon by the shareholders, and does not directly or indirectly seek the power to act as a proxy or furnish or request a form of revocation, abstention, consent, or authorization (among other requirements).[**]

Also, Rule 14a-2(b)(2) excludes from most of the proxy rules "[a]ny solicitation made otherwise than on behalf of the registrant where the total number of persons solicited is not more than ten." This rule is useful for institutional shareholders, allowing them to communicate with one another more easily.

Another notable SEC rule is Rule 14a-2(b)(6), which provides in part that the following solicitations need not comply with most of the proxy rules:

> Any solicitation by or on behalf of any person who does not seek directly or indirectly, either on its own or another's behalf, the power to act as proxy for a shareholder and does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent, or authorization in an electronic shareholder forum that is established, maintained or operated pursuant to the provisions of [Rule 14a-17], provided that the solicitation is made more than 60 days prior to the date announced by a registrant for its next annual or special meeting of shareholders. ***

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[*] For a case concerning whether advertisements relating to a matter of public interest could be considered proxy solicitations, see *Long Island Lighting Company v. Barbash*, 779 F.2d 792 (2d Cir. 1985). Note, however, this case was decided before Rule 14a-1(*l*)(2)(iv)(A) was in effect.

[**] Under Rule 14a-6(g)(1) a person who engages in a solicitation that is exempt under Rule 14a-2(b)(1) does not need to file a Notice of Exempt Solicitation with the SEC if (1) the solicitation is done orally and not in writing or (2) the soliciting shareholder owns less than $5 million worth of the issuer's stock. Conversely, a person who owns more than $5 million worth of the company's stock and engages in a written proxy solicitation must file this Notice.

Under Rule 14a-17, a shareholder or a registrant, or someone acting on their behalf, may operate an "electronic shareholder forum" (e.g., Internet chat rooms or message boards) which "facilitate interaction" among the shareholders, or between the registrant and its shareholders. The rule specifically provides that no shareholder, registrant or person acting on their behalf would be liable for statements made *by other persons* in the forum.

In the end, even though some communications are excluded from the definition of "solicitation" or otherwise exempt from having to comply with most of the proxy rules, the basic fact remains that if a person—whether the registrant or an "insurgent" shareholder—is requesting proxies from other shareholders, that person will probably need to comply with the proxy rules. As noted above, the most important requirement of the proxy rules is that the solicitor must furnish a Schedule 14A to each person that is solicited.[*] In addition, Rule 14a-9 imposes civil liability for false or misleading statements made in connection with a proxy solicitation.

Proxy Statement and Proxy Card Requirements. To keep the following discussion relatively simple, we will assume that (1) the proxy solicitation is being made by the registrant (i.e., the issuer), rather than by a shareholder, and (2) the solicitation relates to a meeting at which directors will be elected, such as the annual meeting of shareholders. Further, we will assume that no other matters will be voted on by the shareholders at the meeting. (If the shareholders will vote on other matters then, as you might guess, detailed disclosures about those matters would be required under various parts of Schedule 14A.)

Schedule 14A requires very detailed information. As with the discussion of Form 10-K earlier in this chapter, the goal of the following is not to train readers how to prepare a Schedule 14A proxy statement, but rather to give you a sense of Schedule 14A and the extensive amount of information that it requires.

Schedule 14A. Item 1 of Schedule 14A requires information about the date, time, and place of the meeting (among other things) and Item 2 requires disclosure as to whether proxies are revocable. Item 4 requires disclosure about the persons making the solicitation and manner in which solicitations will occur and the costs thereof. Item 6, which is entitled "Voting Securities and Principal Holders Thereof," requires the registrant to:

- state the number of shares outstanding of each class of voting securities that is entitled to vote at the meeting and the record date (if any) with respect to the proxy solicitation;

- make certain disclosures if directors are to be elected at the meeting and the shareholders have cumulative voting rights (which is very rare for a public company);

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[*] *See also* Rule 14a-12 (permitting certain written and oral communications before the filing of a proxy statement in some circumstances).

- furnish the information required by Item 403 of Regulation S-K, which requires detailed information about the securities of the issuer owned by management (i.e., directors and executive officers) and any person or group that the issuer knows owns more than five percent of the issuer's voting securities; and

- make certain disclosures if a "change in control" of the issuer has occurred since the beginning of its last fiscal year.

So far, this isn't terribly difficult. But then come Items 7 and 8. Item 7 requires (among other things):

- a disclosure of any material legal proceedings to which any director or officer of the issuer (or any of their affiliates) is a "party adverse to the registrant or any of its subsidiaries or has a material interest adverse to the registrant or any of its subsidiaries," as required by Item 103 of Regulation S-K;

- detailed biographical and other information about the registrant's directors, officers, and "significant employees," as required by Item 401 of Regulation S-K;

- a description of "any transaction, since the beginning of the registrant's last fiscal year, or any currently proposed transaction, in which the registrant was or is to be a participant and the amount involved exceeds $120,000, and in which any related person [as that term is defined] had or will have a direct or indirect material interest," as well as a description of the "registrant's policies and procedures for the review, approval, or ratification of any [such] transaction," as required by Items 404(a) and (b) of Regulation S-K;

- information about compliance by the registrant's officers, directors, and ten-percent shareholders with Section 16(a) of the Exchange Act (which you learned about in Chapter 16), as required by Item 405 of Regulation S-K;

- information about the audit committee of the registrant's board of directors and whether the audit committee has an "audit committee financial expert," as required by Items 407(d)(4) and (5) of Regulation S-K;

- information about the "leadership structure" of the registrant's board of directors and its "role in risk oversight," as required by Item 407(h) of Regulation S-K; and

- information about the "independence" of the registrant's directors and many other "corporate governance" matters detailed in Item 407 of Regulation S-K (which is very extensive). Notably, Item 407 requires disclosure of information about the issuer's director nomination process, including a description of the "material elements" of any policy that the nominating committee (or, if there isn't one, the board of directors) follows in considering director candidates nominated by shareholders. Further, if "the nominating committee will consider candidates recommended by security holders, [the issuer must] describe the procedures to be followed ... in submitting such recommendations."

Item 8 of Schedule 14A, which is entitled "Compensation of Directors and Executive Officers," requires the information specified in Item 402 of Regulation S-K and portions of Item 407 of Regulation S-K. In turn, these items require incredibly detailed information about the compensation (in just about any conceivable form) received by the registrant's directors and four most highly compensated executive officers, as well as additional information about "compensation committee interlocks and insider participation." In addition, the compensation committee of the board of directors must include in the Schedule 14A a report containing the information required by Item 407(e)(5) of Regulation S-K.

Item 9 requires a great deal of information about the registrant's auditors, i.e., the accounting firm that audits the registrant's financial statements, including the fees that that firm earned for audit—and other—services in the past two fiscal years.

The last item of Schedule 14A that we will cover is Item 21, which requires (a thankfully brief) disclosure of the vote that is required for approval of each matter that the shareholders will vote upon, and the method by which votes (including abstentions and "broker nonvotes") will be counted.

"Glossy" Annual Report. In addition, Rule 14a-3(b) provides that if the solicitation is made on behalf of the registrant and relates to a meeting at which directors will be elected (typically the annual meeting of shareholders), each person whose proxy is solicited must be furnished with an annual report that meets the requirements of this rule. As noted above, this report is often called the "glossy" annual report. This is because many companies try to make it look "fancy" and include lots of attractive photographs and other graphics. However, the rule does not require this, and some companies have recently cut back on this practice due to high printing costs. (Also, as discussed below, electronic delivery is now widely used.) In any event, annual reports must contain a lot of the information that is included in the issuer's Form 10-K for the prior year, such as audited financial statements.

Proxy Card Requirements. There are separate requirements for the actual proxy *card*, which is the document that a shareholder would sign to authorize a person (typically a member of the registrant's management) to vote the shareholder's shares at the meeting if the shareholder chooses not to attend in person. Rule 14a-4 requires, that the proxy card must specify who is making the solicitation. Also, the rule requires, among other things, that the proxy card must:

- provide a blank space for dating the proxy card;

● "identify clearly and impartially" each matter upon which shareholders will vote (with some exceptions discussed below);

● with respect to the election of directors, "set forth the names of persons nominated for election as directors [and] *** clearly provide any of [four specified] means for security holders to withhold authority to vote for each nominee ***";

● with respect to matters other than the election of directors, provide means whereby the shareholder "is afforded an opportunity to specify by boxes a choice between approval or disapproval of, or abstention"; and

● with respect to the "say on frequency" vote on executive compensation discussed above, "provide means whereby the person solicited is afforded an opportunity to specify by boxes a choice among 1, 2 or 3 years, or abstain."

Provided that certain conditions are met, subsection (c) of Rule 14a-4 allows a proxy to give "discretionary authority" to the holder of the proxy to vote on certain matters as the holder thinks best. However, subsection (d) provides that a proxy card may not confer authority to vote on certain matters, including the election of any "office for which a bona fide nominee is not named in the proxy statement" (with some exceptions). In addition, a proxy card may not confer authority to vote at any meeting other than the *upcoming* annual meeting (or any adjournment of that meeting) or to vote with respect to more than one meeting (or any adjournment of that meeting). These last two prohibitions would thus prevent "open ended" proxy cards that could be used for several years.

Keeping with our assumption in this discussion that the Schedule 14A relates to the solicitation of proxies by the registrant (as opposed to an "insurgent" shareholder) and that the only matter that will be voted upon at the annual shareholders meeting is the election of directors, then Rule 14a-6 simply requires the registrant to file the "definitive" Schedule 14A (including a copy of the proxy card) with the SEC no later than the first day that it is sent to any shareholder. (In many other situations, the solicitor, whether the registrant or a shareholder, would be required to file a "preliminary" Schedule 14A with the SEC at least ten days before they are sent to any shareholder. This would give the SEC an opportunity to review these materials. Rule 14a-6 contains additional rules that apply in specialized situations.) Generally speaking, any other "soliciting material" must also be filed.

Again, the above discussion is not meant to teach readers how to prepare a Schedule 14A proxy statement or a proxy card that complies with Rule 14a-4. Indeed, there are many nuances, details, and exceptions that were purposely omitted from this discussion so that it would not become overwhelming. Further, one can expect that the above-described disclosure requirements will continue to change in coming years.

Hopefully though, you understand that complying with these rules is no small task, and that it will almost certainly involve the assistance of an experienced securities lawyer. This, of course, will involve significant costs. Another major cost will be printing and mailing of the proxy statement and proxy card to the shareholders, who many number in the thousands. After all, we need enough of these people to execute and return proxies to ensure that we will have a quorum at the shareholders meeting, which may only be a month or two away.*

Delivery Requirements; "Street Names" and Beneficial Owners. So, let's assume that we have our proxy statement and proxy card all ready to go and a printing company standing by to print it in mass quantities. To whom must we mail these materials?

That's easy, you may think to yourself. I remember from Chapter 8 that, under the MBCA, the notice of the meeting (which will be contained in the proxy statement) must be mailed to each shareholder who is "entitled to vote" at the meeting. This means each person who was a shareholder on the record date that the board set for the meeting. So, it should be as simple as looking at the company's stock ledger book, seeing who owned stock certificates on the record date and what their last known addresses are, and then mailing the proxy materials to those persons. We should also include postage-prepaid return envelopes so that people may easily return their proxy cards.

If only life were so simple. The above paragraph assumed that each of the registrant's shareholders was a ***record shareholder***, that is, a person who owned a physical stock certificate representing shares of the registrant's stock. It is true that many shareholders do indeed have stock certificates and therefore count as record shareholders. Today, however, the great majority of shareholders do not have physical stock certificates. Instead, they own stock through a bank or broker-dealer, which in turn holds *a portion of* a stock certificate for a large number of shares. This "big" certificate (which may represent literally millions of shares) often is issued in the name of a large clearing house like Cede & Co., which we will call the ***depositary***.* However, even though the depositary's name appears on the "big" certificate, it does not own that stock for itself. Rather, the depositary maintains constantly updated records of the banks and broker-dealers that hold a position in the shares represented by the certificate and how many of those shares they hold. Further down the line, the banks and broker-dealers are, of course, not the actual owners of the stock—their customers are. When a customer sells some of her shares (or buys more), the issuance of a new physical stock certificate typically is not required. Instead, records are updated electronically, which is a much more efficient way

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* As you learned in Chapter 8, the MBCA requires that notice must be given to shareholders at least 10, but not more than 60 days, before the meeting. As you will appreciate from the following discussion, as a practical matter 10 days will not be enough time for most public companies.

* The Depository Trust Company, a subsidiary of The Depository Trust & Clearing Corporation, is one of the largest clearing agencies in the world, and helps buyers and sellers of securities "settle" their transactions. Stocks held by DTC are held in the name of its nominee, Cede & Co. According to its website, "DTC brings efficiency to the securities industry by retaining custody of more than 3.5 million securities issues valued at US$37.2 trillion, including securities issued in the US and more than 131 countries and territories."

to settle securities trades. For a discussion of the historical evolution of this system, see ROBERT M. HAMILTON ET AL., CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 526-32 (11th. ed. 2010).

For purposes of Section 12(g) of the Exchange Act, institutional custodians such as the depositary are not counted as single holders of record. Instead, each of the depositary's accounts is counted as a record holder. In other words, securities held in street name are held of record only by the banks or brokers—not the ultimate beneficial owners. Thus, under current rules if the depositary held an issuer's stock for the account of two dozen brokerage firms which, in turn, held the stock for several thousand of their customers, only the brokerage firms would be counted toward the 500 or 2,000-record shareholder threshold of Section 12(g) discussed in Section 17.01(A) above—not the thousands of beneficial owners.

So, how does an issuer that may have thousands of beneficial owners of its stock but has almost no idea who they are (let alone how many shares they own or what their mailing addresses are) go about delivering proxy statements to these shareholders? Obviously, with respect to actual record holders (i.e., those with physical stock certificates), the issuer would mail the proxy statement to the last known addresses of those shareholders in its stock transfer records. With respect to beneficial owners, the process is very complicated, but essentially boils down to the issuer requesting a list from the depositary of the banks and brokers that held a position in its stock as of the record date for the meeting and then asking those banks and brokers how many copies of the proxy materials they will need for their customers. The issuer then delivers the required number of copies to such banks and brokers, who in turn deliver the proxy materials to their customers. You may learn more about this process in an advanced course on Securities Regulation or by reading SEC Rule 14b-1. Many companies "outsource" this work by engaging specialized firms to coordinate the delivery of proxy materials to beneficial shareholders.

Electronic Delivery and Voting. As if the above discussion wasn't complex enough, most proxy delivery and voting is now done electronically, rather than solely in paper form. Under SEC Rule 14a-16, which was adopted in 2007, an issuer must, at least 40 calendar days before the date of a shareholders meeting, send its shareholders a paper notice (called a "Notice of Internet Availability of Proxy Materials") stating, among other things, that the issuer's proxy materials are available on a website, but that shareholders may receive paper copies of proxy materials if they so choose.

If a shareholder does not opt for paper copies, then that shareholder would receive proxy materials, and vote, online. All of the materials identified in the notice must be publicly accessible, free of charge, at the website specified in the notice and the materials must remain on the website until the conclusion of the meeting. With some exceptions, the notice may not accompany any other document or materials, including the form of proxy (i.e., the proxy card) to be used for the meeting. Further, the issuer may send a form of proxy to its shareholders only if (1) at least ten days have passed since it sent the notice, and the form of proxy is accompanied by a copy of the notice, or (2) the form of proxy is accompanied or preceded by a copy, via the same "medium," of the proxy statement. Rule 14a-16 also requires the issuer to send a free, paper or e-mail copy of the proxy materials to any shareholder who requests a copy. The issuer must keep records of each shareholder who has requested paper or e-mail copies of proxy materials and continue to provide copies to that shareholder in that manner until the shareholder revokes her request to receive paper or e-mail copies. See Rule 14a-16 for more details.

Shareholder Proposals Under Rule 14a-8. Printing thousands of copies of a proxy statement and mailing it to thousands of shareholders could easily cost tens of thousands of dollars. Even with the advent of the "e-proxy" rules described in the previous paragraph, which may reduce printing costs, the *legal* costs involved in preparing a Schedule 14 proxy statement are daunting. For this reason, no one but the richest and/or most committed shareholders, or those who want to launch a takeover battle for the company, would bother soliciting proxies from their fellow shareholders if they wanted the shareholders to vote on something.

Perhaps recognizing this financial barrier to effective "shareholder democracy," SEC Rule 14a-8 provides that a shareholder who meets certain requirements can force the issuer to include a proposal in the issuer's proxy statement and have the shareholders vote on it. If a shareholder is able to submit a proposal in this way, she obviously avoids the printing and legal costs of preparing and delivering a Schedule 14A proxy statement to the other shareholders. However, Rule 14a-8 also recognizes that issuers should not be unduly harassed by their shareholders, many of whom may have motives that differ from promoting the issuer's long-term profitability. This uneasy balance is reflected in the requirements of Rule 14a-8.

Rule 14a-8 may be unique among federal administrative rules in that it is written in a question-and-answer format that was designed to facilitate easy understanding by non-lawyers. Question 2 of the rule asks "Who is eligible to submit a proposal, and how do I demonstrate to the company that I am eligible?" In response, the rule states in part:

> In order to be eligible to submit a proposal, you must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal. You must continue to hold those securities through the date of the meeting.

In addition, a shareholder may only submit one proposal per meeting. The proposal, together with any supporting statement, may not exceed 500 words. Either the shareholder or a legal representative of the shareholder must attend the meeting to present the proposal. The issuer's annual proxy statement must set forth the deadline for submitting shareholder proposals for the following year's annual meeting.

Even if a shareholder meets the requirements of Rule 14a-8 when submitting a proposal, there are several grounds that the issuer could use to exclude a proposal, that is, refuse to include it in its proxy materials. Rule 14a-8(i) (formerly subsection (c)) lists the following grounds:

> 1. *Improper under state law:* If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization;
>
> *Note to paragraph (i)(1):* Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. In our experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, we will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise.
>
> 2. *Violation of law:* If the proposal would, if implemented, cause the company to violate any state, federal, or foreign law to which it is subject;
> ***
>
> 3. *Violation of proxy rules:* If the proposal or supporting statement is contrary to any of the Commission's proxy rules, including Rule 14a-9, which prohibits materially false or misleading statements in proxy soliciting materials;
>
> 4. *Personal grievance; special interest:* If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to you, or to further a personal interest, which is not shared by the other shareholders at large;
>
> 5. *Relevance:* If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business;
>
> 6. *Absence of power/authority:* If the company would lack the power or authority to implement the proposal;
>
> 7. *Management functions:* If the proposal deals with a matter relating to the company's ordinary business operations;[*]

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[*] See *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015).

8. *Director elections:* If the proposal: (i) Would disqualify a nominee who is standing for election; (ii) Would remove a director from office before his or her term expired; (iii) Questions the competence, business judgment, or character of one or more nominees or directors; (iv) Seeks to include a specific individual in the company's proxy materials for election to the board of directors; or (v) Otherwise could affect the outcome of the upcoming election of directors;**

9. *Conflicts with company's proposal:* If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting; ***

10. *Substantially implemented:* If the company has already substantially implemented the proposal; ***

11. *Duplication:* If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting;

12. *Resubmissions:* If the proposal deals with substantially the same subject matter as another proposal or proposals that has or have been previously included in the company's proxy materials within the preceding 5 calendar years, a company may exclude it from its proxy materials for any meeting held within 3 calendar years of the last time it was included if the proposal received: (i) Less than 3% of the vote if proposed once within the preceding 5 calendar years; (ii) Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding 5 calendar years; or (iii) Less than 10% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding 5 calendar years; and

13. *Specific amount of dividends:* If the proposal relates to specific amounts of cash or stock dividends.

Few issuers like to include shareholder proposals—many proposals can be obnoxious or even downright embarrassing to the company. As such, issuers try, if at all possible, to exclude shareholder proposals on one or more of the foregoing grounds. For a determined shareholder, this can lead to litigation, as shown in the following case.

** This subsection is discussed further in Section 17.03(B) of this chapter.

Lovenheim v. Iroquois Brands, Ltd.
United States District Court for the District of Columbia
618 F. Supp. 554 (1985)

GASCH, District Judge.

I. BACKGROUND

This matter is now before the Court on plaintiff's motion for preliminary injunction.

Plaintiff Peter C. Lovenheim, owner of two hundred shares of common stock in Iroquois Brands, Ltd. (hereinafter "Iroquois/Delaware"), seeks to bar Iroquois/Delaware from excluding from the proxy materials being sent to all shareholders in preparation for an upcoming shareholder meeting information concerning a proposed resolution he intends to offer at the meeting. Mr. Lovenheim's proposed resolution relates to the procedure used to force-feed geese for production of paté de foie gras in France, a type of paté imported by Iroquois/Delaware. Specifically, his resolution calls upon the Directors of Iroquois/Delaware to:

> form a committee to study the methods by which its French supplier produces paté de foie gras, and report to the shareholders its findings and opinions, based on expert consultation, on whether this production method causes undue distress, pain or suffering to the animals involved and, if so, whether further distribution of this product should be discontinued until a more humane production method is developed.

***

Mr. Lovenheim's right to compel Iroquois/Delaware to insert information concerning his proposal in the proxy materials turns on the applicability of section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) ("the Exchange Act"), and the shareholder proposal rule promulgated by the Securities and Exchange Commission ("SEC"), Rule 14a-8. That rule states in pertinent part:

> If any security holder of an issuer notifies the issuer of his intention to present a proposal for action at a forthcoming meeting of the issuer's security holders, the issuer shall set forth the proposal in its proxy statement and identify it in its form of proxy and provide means by which security holders [presenting a proposal may present in the proxy statement a statement of not more than 200 words in support of the proposal].

Iroquois/Delaware has refused to allow information concerning Mr. Lovenheim's proposal to be included in proxy materials being sent in connection with the next annual shareholders meeting. In doing so, Iroquois/Delaware relies on an exception to the general requirement of Rule 14a-8, Rule 14a-8(c)(5). That exception provides that an issuer of securities "may omit a proposal and any statement in support thereof" from its proxy statement and form of proxy:

> if the proposal relates to operations which account for less than 5 percent of the issuer's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the issuer's business. [Citation omitted.]

***

II. LIKELIHOOD OF PLAINTIFF PREVAILING ON MERITS

***

C. *Applicability of Rule 14a-8(c)(5) Exception*

*** [T]he likelihood of plaintiff's prevailing in this litigation turns primarily on the applicability to plaintiff's proposal of the exception to the shareholder proposal rule contained in Rule 14a-8(c)(5).

Iroquois/Delaware's reliance on the argument that this exception applies is based on the following information contained in the affidavit of its president: Iroquois/Delaware has annual revenues of $141 million with $6 million in annual profits and $78 million in assets. In contrast, its paté de foie gras sales were just $79,000 last year, representing a net loss on paté sales of $3,121. Iroquois/ Delaware has only $34,000 in assets related to paté. Thus none of the company's net earnings and less than .05 percent of its assets are implicated by plaintiff's proposal. [Citation omitted.] These levels are obviously far below the five percent threshold set forth in the first portion of the exception claimed by Iroquois/Delaware.

Plaintiff does not contest that his proposed resolution relates to a matter of little economic significance to Iroquois/Delaware. Nevertheless he contends that the Rule 14a-8(c)(5) exception is not applicable as it cannot be said that his proposal "is not otherwise significantly related to the issuer's business" as is required by the final portion of that exception. In other words, plaintiff's argument that Rule 14a-8 does not permit omission of his proposal rests on the assertion that the rule and statute on which it is based do not permit omission merely because a proposal is not economically significant where a proposal has "ethical or social significance."

Iroquois/Delaware challenges plaintiff's view that ethical and social proposals cannot be excluded even if they do not meet the economic or five percent test. Instead, Iroquois/Delaware views the exception solely in economic terms as permitting omission of any proposals relating to a de minimis share of assets and profits. Iroquois/Delaware asserts that since corporations are economic entities, only an economic test is appropriate.

The Court would note that the applicability of the Rule 14a-8(c)(5) exception to Mr. Lovenheim's proposal represents a close question given the lack of clarity in the exception itself. In effect, plaintiff relies on the word "otherwise," suggesting that it indicates the drafters of the rule intended that other noneconomic tests of significance be used. Iroquois/Delaware relies on the fact that the rule examines other significance in relation to the issuer's business. Because of the apparent ambiguity of the rule, the Court considers the history of the shareholder proposal rule in determining the proper interpretation of the most recent version of that rule.

Prior to 1983, paragraph 14a-8(c)(5) excluded proposals "not significantly related to the issuer's business" but did not contain an objective economic significance test such as the five percent of sales, assets, and earnings specified in the first part of the current version. Although a series of SEC decisions through 1976 allowing issuers to exclude proposals challenging compliance with the Arab economic boycott of Israel allowed exclusion if the issuer did less than one percent of their business with Arab countries or Israel, the Commission stated later in 1976 that it did "not believe that subparagraph (c)(5) should be hinged solely on the economic relativity of a proposal." [Citation omitted.] Thus the Commission required inclusion "in many situations in which the related business comprised less than one percent" of the company's revenues, profits or assets "where the proposal has raised *policy questions* important enough to be considered `significantly related' to the issuer's business."

As indicated above, the 1983 revision adopted the five percent test of economic significance in an effort to create a more objective standard. Nevertheless, in adopting this standard, the Commission stated that proposals will be includable notwithstanding their "failure to reach the specified economic thresholds if a significant relationship to the issuer's business is demonstrated on the face of the resolution or supporting statement." [Citation omitted.] Thus it seems clear based on the history of the rule that "the meaning of 'significantly related' is not *limited* to economic significance." [Citation omitted.]

The only decision in this Circuit cited by the parties relating to the scope of section 14 and the shareholder proposal rule is *Medical Committee for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970). That case concerned an effort by shareholders of Dow Chemical Company to advise other shareholders of their proposal directed at prohibiting Dow's production of napalm. Dow had relied on the counterpart of the 14a-8(c)(5) exemption then in effect to exclude the proposal from proxy materials and the SEC accepted Dow's position without elaborating on its basis for doing so. In remanding the matter back to the SEC for the Commission to provide the basis for its decision, the Court noted what it termed "substantial questions" as to whether an interpretation of the shareholder proposal rule "which permitted omission of [a] proposal as one motivated primarily by *general* political or social concerns would conflict with the congressional intent underlying section 14(a) of the [Exchange] Act."

Iroquois/Delaware attempts to distinguish *Medical Committee for Human Rights* as a case where a company sought to exclude a proposal that, unlike Mr. Lovenheim's proposal, was economically significant merely because the motivation of the proponents was political. The argument is not without appeal given the fact that the *Medical Committee Court* was confronted with a regulation that contained no reference to economic significance. Yet the *Medical Committee* decision contains language suggesting that the Court assumed napalm was not economically significant to Dow:

> The management of Dow Chemical Company is repeatedly quoted in sources which include the company's own publications as proclaiming that the decision to continue manufacturing and marketing napalm was made not *because* of business considerations, but *in spite* of them; that management in essence decided to pursue a course of activity which generated little profit for the shareholders .... [Citation omitted.]

This Court need not consider, as the *Medical Committee* decision implied, whether a rule allowing exclusion of all proposals not meeting specified levels of economic significance violates the scope of section 14(a) of the Exchange Act. [Citation omitted.] Whether or not the Securities and Exchange Commission could properly adopt such a rule, the Court cannot ignore the history of the rule which reveals no decision by the Commission to limit the determination to the economic criteria relied on by Iroquois/ Delaware. The Court therefore holds that in light of the ethical and social significance of plaintiff's proposal and the fact that it implicates significant levels of sales, plaintiff has shown a likelihood of prevailing on the merits with regard to the issue of whether his proposal is "otherwise significantly related" to Iroquois/Delaware's business.

***

IV. CONCLUSION

For the reasons discussed above, the Court concludes that plaintiff's motion for preliminary injunction should be granted.

As you might guess, in addition to case law, there are a great many SEC no-action letters that contain guidance as to when an issuer may use any of the above-described provisions of Rule 14-8 to exclude a shareholder proposal from its proxy materials. In particular, the "ordinary business" exclusion has a long history of no-action letters (and shifting SEC positions on whether various matters concern an issuer's ordinary business operations).

Issuers often are unable to exclude shareholder proposals, particularly those that are submitted by large institutional shareholders or "activist" shareholders that have good legal counsel.[*] As a result, every year many companies are required to include shareholder proposals in their proxy statements and have shareholders vote on them. Most shareholder proposals do not achieve majority support from other shareholders. However, sometimes activist shareholders view a "good showing" as a public-relations success that may force the issuer to implement reforms out of embarrassment. A good way to keep track of the trends in this area is to read the annual "post-season" reports of Institutional Shareholder Services, a firm that advises many institutional shareholders (e.g., mutual funds and pension plans) on how they should vote their shares of public companies.

"Common Carrier" Requirements. Another shareholder-friendly rule under Section 14 of the Exchange Act is Rule 14a-7. This rule basically provides that if an issuer solicits proxies for a shareholder meeting, any shareholder who is eligible to vote at the meeting may ask the issuer for a list of shareholders, which would allow that shareholder to contact other shareholders and/or mail proxy materials to them. However, if the issuer does not want to provide the list of shareholders (and most issuers do not want to do so), it could instead offer to mail the requesting shareholder's proxy materials to the other shareholders—at the requesting shareholder's expense, of course. Within five business days after receiving the request, the issuer must notify the shareholder as to whether it will provide the list or instead mail the shareholder's materials. Also, the issuer must give the requesting shareholder a statement of the approximate number of beneficial shareholders and an estimate of the cost of mailing proxy materials to those shareholders.

E. EXCHANGE ACT CIVIL LIABILITY

The Exchange Act imposes civil[**] liability for material false or misleading Exchange Act reports and proxy statements. First, Section 18(a) of the Exchange Act provides in part that:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to [the Exchange Act] or any rule or regulation thereunder ***, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and

[*] Even if an issuer can exclude a shareholder proposal from its proxy statement pursuant to Rule 14a-8, it may still need to describe the proposal in its proxy materials if the shareholder will present the proposal at the meeting. *See* Item 20 of Schedule 14A ("If action is to be taken on any matter not specifically referred to in this Schedule 14A, [the issuer must] describe briefly the substance of each such matter in substantially the same degree of detail as is required by Items 5 to 19, inclusive, of this Schedule ....")

[**] See Section 32 for criminal liability.

> had no knowledge that such statement was false or misleading. *** In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant.

Unlike many provisions of the Securities Act, which tend to be very "plaintiff-friendly," this section imposes some serious hurdles for plaintiffs. First, note that this section requires the plaintiff to show that she purchased or sold securities at a price that was affected by the material misstatement or omission. Thus, someone who decided to *hold* securities that she already owned or who decided *not* to purchase securities could not be a plaintiff under Section 18. Even if the plaintiff did purchase or sell securities, she would be required to show that the price was affected by the false or misleading Exchange Act filing, which could present difficult issues of causation. Second, defendants can defend the lawsuit by establishing that they acted in good faith and did not have knowledge that the Exchange Act filing was materially false or misleading. Finally, the court can require an undertaking for costs, including reasonable attorney fees. Because of these demanding requirements, plaintiffs may opt to sue under Rule 10b-5 instead (which is discussed in Chapter 16).

SEC Rule 14a-9 also imposes civil liability for material false or misleading proxy statements, by providing in subsection (a) that:

> No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading ***.

The note to Rule 14a-9 then gives some examples of items that "may" be misleading.

There have been many cases brought under Rule 14a-9, resulting in important court decisions. In the following case, the Supreme Court discussed the meaning of materiality for purposes of Rule 14a-9.

TSC Industries, Inc. v. Northway, Inc.
Supreme Court of United States
426 U.S. 438 (1976)

MR. JUSTICE MARSHALL delivered the opinion of the Court.

***

[II.A.] As we have noted on more than one occasion, § 14(a) of the Securities Exchange Act "was intended to promote 'the free exercise of the voting rights of stockholders' by ensuring that proxies would be solicited with 'explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.'" [Citations omitted.] In [*J.I. Case Co. v. Borak*, 377 U.S. 426 (1964)], the Court held that § 14(a)'s broad remedial purposes required recognition *** of an implied private right of action for violations of the provision. And in [*Mills v. Electric Auto-Lite Co*., 396 U.S. 375 (1970)], we attempted to clarify to some extent the elements of a private cause of action for violation of § 14(a). In a suit challenging the sufficiency under § 14(a) and Rule 14a-9 of a proxy statement soliciting votes in favor of a merger, we held that there was no need to demonstrate that the alleged defect in the proxy statement actually had a decisive effect on the voting. So long as the misstatement or omission was material, the causal relation between violation and injury is sufficiently established, we concluded, if "the proxy solicitation itself ... was an essential link in the accomplishment of the transaction." [Citation omitted.] After *Mills*, then, the content given to the notion of materiality assumes heightened significance.

[II.B] The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. Variations in the formulation of a general test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment.

The Court of Appeals in this case concluded that material facts include "all facts which a reasonable shareholder might consider important." [Citation omitted.] This formulation of the test of materiality has been explicitly rejected by at least two courts as setting too low a threshold for the imposition of liability under Rule 14a-9. [Citations omitted.] ***

In arriving at its broad definition of a material fact as one that a reasonable shareholder might consider important, the Court of Appeals in this case relied heavily upon language of this Court in [*Mills*]. That reliance was misplaced. ***

***

[II.C] In formulating a standard of materiality under Rule 14a-9, we are guided, of course, by the recognition in *Borak* and *Mills* of the Rule's broad remedial purpose. That purpose is not merely to ensure by judicial means that the transaction, when judged by its real terms, is fair and otherwise adequate, but to ensure disclosures by corporate management in order to enable the shareholders to make an informed choice. [Citation omitted.] As an abstract proposition, the most desirable role for a court in a suit of this sort, coming after the consummation of the proposed transaction, would perhaps be to determine whether in fact the proposal would have been favored by the shareholders and consummated in the absence of any misstatement or omission. But as we recognized in *Mills,* [citation omitted], such matters are not subject to determination with certainty.

Doubts as to the critical nature of information misstated or omitted will be commonplace. And particularly in view of the prophylactic purpose of the Rule and the fact that the content of the proxy statement is within management's control, it is appropriate that these doubts be resolved in favor of those the statute is designed to protect. [Citation omitted.]

We are aware, however, that the disclosure policy embodied in the proxy regulations is not without limit. [Citation omitted.] Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making. Precisely these dangers are presented, we think, by the definition of a material fact adopted by the Court of Appeals in this case—a fact which a reasonable shareholder might consider important. We [believe] *** that the "might" formulation is "too suggestive of mere possibility, however unlikely." [Citation omitted.]

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills*['*s*] general description of materiality as a requirement that "the defect have a significant propensity to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

***

A Rule 14a-9 plaintiff must also prove causation, i.e., that the misstatement or omission caused harm to the plaintiff. Courts have broken this into two elements; ***loss causation***, which is a causal link between the false or misleading proxy statement and economic harm to the plaintiff; and ***transaction causation***, which is a causal link between the false or misleading proxy statement and the occurrence of the transaction upon which the shareholders were voting. Set forth below are two important opinions on causation.

Mills v. Electric Auto-Lite Co.
Supreme Court of United States
396 U.S. 375 (1970)

MR. JUSTICE HARLAN delivered the opinion of the Court.

This case requires us to consider a basic aspect of the implied private right of action for violation of § 14 (a) of the Securities Exchange Act of 1934 ***. [T]he asserted wrong is that a corporate merger was accomplished through the use of a proxy statement that was materially false or misleading. The question with which we deal is what causal relationship must be shown between such a statement and the merger to establish a cause of action based on the violation of the Act.

[I] Petitioners were shareholders of the Electric Auto-Lite Company until 1963, when it was merged into Mergenthaler Linotype Company. They brought suit on the day before the shareholders' meeting at which the vote was to take place on the merger, against Auto-Lite, Mergenthaler, and a third company, American Manufacturing Company, Inc. The complaint sought an injunction against the voting by Auto-Lite's management of all proxies obtained by means of an allegedly misleading proxy solicitation; however, it did not seek a temporary restraining order, and the voting went ahead as scheduled the following day. Several months later petitioners filed an amended complaint, seeking to have the merger set aside and to obtain such other relief as might be proper.

*** [Petitioners] alleged that the proxy statement sent out by the Auto-Lite management to solicit shareholders' votes in favor of the merger was misleading, in violation of § 14(a) of the Act and SEC Rule 14a-9 thereunder. [Citation omitted.] Petitioners recited that before the merger Mergenthaler owned over 50% of the outstanding shares of Auto-Lite common stock, and had been in control of Auto-Lite for two years. American Manufacturing in turn owned about one-third of the outstanding shares of Mergenthaler, and for two years had been in voting control of Mergenthaler and, through it, of Auto-Lite. Petitioners charged that in light of these circumstances the proxy statement was misleading in that it told Auto-Lite shareholders that their board of directors recommended approval of the merger without also informing them that all 11 of Auto-Lite's directors were nominees of Mergenthaler and were under the "control and domination of Mergenthaler." ***

*** [T]he District Court for the Northern District of Illinois ruled as a matter of law that the claimed defect in the proxy statement was, in light of the circumstances in which the statement was made, a material omission. The District Court concluded *** that it had to hold a hearing on the issue whether there was "a causal connection between the finding that there has been a violation of the disclosure requirements of § 14(a) and the alleged injury to the plaintiffs" before it could consider what remedies would be appropriate. [Citation omitted.]

After holding such a hearing, the court found that under the terms of the merger agreement, an affirmative vote of two-thirds of the Auto-Lite shares was required for approval of the merger, and that the respondent companies owned and controlled about 54% of the outstanding shares. Therefore, to obtain authorization of the merger, respondents had to secure the approval of a substantial number of the minority shareholders. At the stockholders' meeting, approximately 950,000 shares, out of 1,160,000 shares outstanding, were voted in favor of the merger. This included 317,000 votes obtained by proxy from the minority shareholders, votes that were "necessary and indispensable to the approval of the merger." The District Court concluded that a causal relationship had thus been shown, and it granted an interlocutory judgment in favor of petitioners on the issue of liability, referring the case to a master for consideration of appropriate relief. [Citation omitted.]

*** [The Court of Appeals] affirmed the District Court's conclusion that the proxy statement was materially deficient, but reversed on the question of causation. The court acknowledged that, if an injunction had been sought a sufficient time before the stockholders' meeting, "corrective measures would have been appropriate." [Citation omitted.] However, since this suit was brought too late for preventive action, the courts had to determine "whether the misleading statement and omission caused the submission of sufficient proxies," as a prerequisite to a determination of liability under the Act. If the respondents could show, "by a preponderance of probabilities, that the merger would have received a sufficient vote even if the proxy statement had not been misleading in the respect found," petitioners would be entitled to no relief of any kind. [Citation omitted.]

*** [R]ightly concluding that "[r]eliance by thousands of individuals, as here, can scarcely be inquired into" [citation omitted], the court ruled that the issue was to be determined by proof of the fairness of the terms of the merger. If respondents could show that the merger had merit and was fair to the minority shareholders, the trial court would be justified in concluding that a sufficient number of shareholders would have approved the merger had there been no deficiency in the proxy statement. In that case respondents would be entitled to a judgment in their favor.

*** [T]he petitioners then sought review in this Court. We granted certiorari, [citation omitted], believing that resolution of this basic issue should be made at this stage of the litigation and not postponed until after a trial under the Court of Appeals' decision.

[II] *** [Section] 14(a) stemmed from a congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." [Citation omitted.] The provision was intended to promote "the free exercise of the voting rights of stockholders" by ensuring that proxies would be solicited with "explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." [Citation omitted.] The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be bypassed, at least where the only legal challenge to the merger is a suit for retrospective relief after the meeting has been held. A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders.

The result would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders. Further, recognition of the fairness of the merger as a complete defense would confront small shareholders with an additional obstacle to making a successful challenge to a proposal recommended through a defective proxy statement. The risk that they would be unable to rebut the corporation's evidence of the fairness of the proposal, and thus to establish their cause of action, would be bound to discourage such shareholders from the private enforcement of the proxy rules that "provides a necessary supplement to Commission action." [Citation omitted.]

*** Use of a solicitation that is materially misleading is itself a violation of law, as the Court of Appeals recognized in stating that injunctive relief would be available to remedy such a defect if sought prior to the stockholders' meeting. ***

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote. This requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).

There is no need to supplement this requirement, as did the Court of Appeals, with a requirement of proof of whether the defect actually had a decisive effect on the voting. Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions. [Citations omitted.]

***

[Opinion of Justice Black, concurring in part and dissenting in part, omitted.]

At the end of the *Mills* opinion, the Court included the following footnote:

> We need not decide in this case whether causation could be shown where the management controls a sufficient number of shares to approve the transaction without any votes from the minority. Even in that situation, if the management finds it necessary for legal or practical reasons to solicit proxies from minority shareholders, at least one court has held that the proxy solicitation might be sufficiently related to the merger to satisfy the causation requirement, [citations omitted].

In other words, the Court did not decide whether a Section 14(a) cause of action would be valid if the proxy solicitation was not an "essential link" in the consummation of the transaction. In the following case, the Court considered this issue:

Virginia Bankshares, Inc. v. Sandberg
Supreme Court of United States
501 U.S. 1083 (1991)

MR. JUSTICE SOUTER delivered the opinion of the Court.

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The questions before us are whether a statement couched in conclusory or qualitative terms purporting to explain directors' reasons for recommending certain corporate action can be materially misleading within the meaning of Rule 14a-9, and whether causation of damages compensable under § 14(a) can be shown by a member of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the corporate action subject to the proxy solicitation. We hold that knowingly false statements of reasons may be actionable even though conclusory in form, but that respondents have failed to demonstrate the equitable basis required to extend the § 14(a) private action to such shareholders when any indication of congressional intent to do so is lacking.

[I] In December 1986, First American Bankshares, Inc. (FABI), a bank holding company, began a "freeze-out" merger, in which the First American Bank of Virginia (Bank) eventually merged into Virginia Bankshares, Inc. (VBI), a wholly owned subsidiary of FABI. VBI owned 85% of the Bank's shares, the remaining 15% being in the hands of some 2,000 minority shareholders. FABI hired the investment banking firm of Keefe, Bruyette & Woods (KBW) to give an opinion on the appropriate price for shares of the minority holders, who would lose their interests in the Bank as a result of the merger. Based on market quotations and unverified information from FABI, KBW gave the Bank's executive committee an opinion that $42 a share would be a fair price for the minority stock. The executive committee approved the merger proposal at that price, and the full board followed suit.

Although Virginia law only that such a merger proposal be submitted to a vote at a shareholders' meeting, and that the meeting be preceded by circulation of a statement of information to the shareholders, the directors nevertheless solicited proxies for voting on the proposal at the annual meeting set for April 21, 1987. In their solicitation, the directors urged the proposal's adoption and stated they had approved the plan because of its opportunity for the minority shareholders to achieve a "high" value, which they elsewhere described as a "fair" price, for their stock.

Although most minority shareholders gave the proxies requested, respondent Sandberg did not, and after approval of the merger she sought damages in the United States District Court for the Eastern District of Virginia from VBI, FABI, and the directors of the Bank. She pleaded two counts, one for soliciting proxies in violation of § 14(a) and Rule 14a-9, and the other for breaching fiduciary duties owed to the minority shareholders under state law. Under the first count, Sandberg alleged, among other things, that the directors had not believed that the price offered was high or that the terms of the merger were fair, but had recommended the merger only because they believed they had no alternative if they wished to remain on the board. At trial, Sandberg invoked language from this Court's opinion in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970), to obtain an instruction that the jury could find for her without a showing of her own reliance on the alleged misstatements, so long as they were material and the proxy solicitation was an "essential link" in the merger process.

The jury's verdicts were for Sandberg on both counts, after finding violations of Rule 14a-9 by all defendants and a breach of fiduciary duties by the Bank's directors. The jury awarded Sandberg $18 a share, having found that she would have received $60 if her stock had been valued adequately.

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On appeal, the United States Court of Appeals for the Fourth Circuit affirmed the judgments, holding that certain statements in the proxy solicitation were materially misleading for purposes of the Rule, and that respondents could maintain their action even though their votes had not been needed to effectuate the merger. [Citation omitted.] We granted certiorari because of the importance of the issues presented. [Citation omitted.]

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[III] The second issue before us, left open in [the footnote to the *Mills* opinion], is whether causation of damages compensable through the implied private right of action under § 14(a) can be demonstrated by a member of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the transaction giving rise to the claim. ***

Although a majority stockholder in *Mills* controlled just over half the corporation's shares, a two-thirds vote was needed to approve the merger proposal. After proxies had been obtained, and the merger had carried, minority shareholders brought a *Borak* action. [Citation omitted.] The question arose whether the plaintiffs' burden to demonstrate causation of their damages traceable to the § 14(a) violation required proof that the defect in the proxy solicitation had had "a decisive effect on the voting." [Citation omitted.] The *Mills* Court avoided the evidentiary morass that would have followed from requiring individualized proof that enough minority shareholders had relied upon the misstatements to swing the vote. Instead, it held that causation of damages by a material proxy misstatement could be established by showing that minority proxies necessary and sufficient to authorize the corporate acts had been given in accordance with the tenor of the solicitation, and the Court described such a causal relationship by calling the proxy solicitation an "essential link in the accomplishment of the transaction." [Citation omitted.] In the case before it, the Court found the solicitation essential, as contrasted with one addressed to a class of minority shareholders without votes required by law or bylaw to authorize the action proposed, and left it for another day to decide whether such a minority shareholder could demonstrate causation. [Citation omitted.]

In this case, respondents address *Mills*'[s] open question by proffering two theories that the proxy solicitation addressed to them was an "essential link" under the *Mills* causation test. They argue, first, that a link existed and was essential simply because VBI and FABI would have been unwilling to proceed with the merger without the approval manifested by the minority shareholders' proxies, which would not have been obtained without the solicitation's express misstatements and misleading omissions. On this reasoning, the causal connection would depend on a desire to avoid bad shareholder or public relations, and the essential character of the causal link would stem not from the enforceable terms of the parties' corporate relationship, but from one party's apprehension of the ill will of the other.

In the alternative, respondents argue that the proxy statement was an essential link between the directors' proposal and the merger because it was the means to satisfy a state statutory requirement of minority shareholder approval, as a condition for saving the merger from voidability resulting from a conflict of interest on the part of one of the Bank's directors, Jack Beddow, who voted in favor of the merger while also serving as a director of FABI. [Citation omitted.] Under the terms of Va. Code Ann. § 13.1-691(A) (1989), minority approval after disclosure of the material facts about the transaction and the director's interest was one of three avenues to insulate the merger from later attack for conflict, the two others being ratification by the Bank's directors after like disclosure and proof that the merger was fair to the corporation. On this theory, causation would depend on the use of the proxy statement for the purpose of obtaining votes sufficient to bar a minority shareholder from commencing proceedings to declare the merger void.

Although respondents have proffered each of these theories as establishing a chain of causal connection in which the proxy statement is claimed to have been an "essential link," neither theory presents the proxy solicitation as essential in the sense of *Mills*[*'s*] causal sequence, in which the solicitation links a directors' proposal with the votes legally required to authorize the action proposed. As a consequence, each theory would, if adopted, extend the scope of *Borak* actions beyond the ambit of *Mills* and expand the class of plaintiffs entitled to bring *Borak* actions to include shareholders whose initial authorization of the transaction prompting the proxy solicitation is unnecessary.

Assessing the legitimacy of any such extension or expansion calls for the application of some fundamental principles governing recognition of a right of action implied by a federal statute, the first of which was not, in fact, the considered focus of the *Borak* opinion. The rule that has emerged in the years since *Borak* and *Mills* came down is that recognition of any private right of action for violating a federal statute must ultimately rest on congressional intent to provide a private remedy, [citation omitted]. From this the corollary follows that the breadth of the right once recognized should not, as a general matter, grow beyond the scope congressionally intended.

This rule and corollary present respondents with a serious obstacle, for we can find no manifestation of intent to recognize a cause of action (or class of plaintiffs) as broad as respondents' theory of causation would entail. At first blush, it might seem otherwise, for the *Borak* Court certainly did not ignore the matter of intent. Its opinion adverted to the statutory object of "protection of investors" as animating Congress' intent to provide judicial relief where "necessary," [citation omitted], and it quoted evidence for that intent from House and Senate Committee Reports, [citation omitted]. *Borak*'s probe of the congressional mind, however, never focused squarely on private rights of action, as distinct from the substantive objects of the legislation, and one Member of the *Borak* Court later characterized the "implication" of the private right of action as resting modestly on the Act's "'exclusively procedural provision' affording access to a federal forum." [Citations omitted.] In fact, the importance of enquiring specifically into intent to authorize a private cause of action became clear only later, [citation omitted], and only later still, [citation omitted], was this intent accorded primacy among the considerations that might be thought to bear on any decision to recognize a private remedy. There, in dealing with a claimed private right under § 17(a) of the Act, we explained that the "central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action." [Citation omitted.]

Looking to the Act's text and legislative history mindful of this heightened concern reveals little that would help toward understanding the intended scope of any private right. According to the House Report, Congress meant to promote the "free exercise" of stockholders' voting rights, [citation omitted], and protect "[f]air corporate suffrage," [citation omitted], from abuses exemplified by proxy solicitations that concealed what the Senate Report called the "real nature" of the issues to be settled by the subsequent votes, [citation omitted]. While it is true that these Reports, like the language of the Act itself, carry the clear message that Congress meant to protect investors from misinformation that rendered them unwitting agents of self-inflicted damage, it is just as true that Congress was reticent with indications of how far this protection might depend on self-help by private action. The response to this reticence may be, of course, to claim that § 14(a) cannot be enforced effectively for the sake of its intended beneficiaries without their participation as private litigants. [Citation omitted.] But the force of this argument for inferred congressional intent depends on the degree of need perceived by Congress, and we would have trouble inferring any congressional urgency to depend on implied private actions to deter violations of § 14(a), when Congress expressly provided private rights of action in §§ 9(e), 16(b), and 18(a) of the same Act. [Citations omitted.]

The congressional silence that is thus a serious obstacle to the expansion of cognizable *Borak* causation is not, however, a necessarily insurmountable barrier. This is not the first effort in recent years to expand the scope of an action originally inferred from the Act without "conclusive guidance" from Congress, [citing *Blue Chip Stamps*], and we may look to that earlier case for the proper response to such a plea for expansion. There, we accepted the proposition that where a legal structure of private statutory rights has developed without clear indications of congressional intent, the contours of that structure need not be frozen absolutely when the result would be demonstrably inequitable to a class of would-be plaintiffs with claims comparable to those previously recognized. Faced in that case with such a claim for equality in rounding out the scope of an implied private statutory right of action, we looked to policy reasons for deciding where the outer limits of the right should lie. We may do no less here, in the face of respondents' pleas for a private remedy to place them on the same footing as shareholders with votes necessary for initial corporate action.

[III.A] *Blue Chip Stamps* set an example worth recalling as a preface to specific policy analysis of the consequences of recognizing respondents' first theory, that a desire to avoid minority shareholders' ill will should suffice to justify recognizing the requisite causality of a proxy statement needed to garner that minority support. It will be recalled that in *Blue Chip Stamps* we raised concerns about the practical consequences of allowing recovery, under § 10(b) of the Act and Rule 10b-5, on evidence of what a merely hypothetical buyer or seller might have done on a set of facts that never occurred, and foresaw that any such expanded liability would turn on "hazy" issues inviting self-serving testimony, strike suits, and protracted discovery, with little chance of reasonable resolution by pretrial process. [Citation omitted.] These were good reasons to deny recognition to such claims in the absence of any apparent contrary congressional intent.

The same threats of speculative claims and procedural intractability are inherent in respondents' theory of causation linked through the directors' desire for a cosmetic vote. Causation would turn on inferences about what the corporate directors would have thought and done without the minority shareholder approval unneeded to authorize action. A subsequently dissatisfied minority shareholder would have virtual license to allege that managerial timidity would have doomed corporate action but for the ostensible approval induced by a misleading statement, and opposing claims of hypothetical diffidence and hypothetical boldness on the part of directors would probably provide enough depositions in the usual case to preclude any judicial resolution short of the credibility judgments that can only come after trial. Reliable evidence would seldom exist. Directors would understand the prudence of making a few statements about plans to proceed even without minority endorsement, and discovery would be a quest for re-collections of oral conversations at odds with the official pronouncements, in hopes of finding support for *ex post facto* guesses about how much heat the directors would have stood in the absence of minority approval. The issues would be hazy, their litigation protracted, and their resolution unreliable. Given a choice, we would reject any theory of causation that raised such prospects, and we reject this one.

[III.B] The theory of causal necessity derived from the requirements of Virginia law dealing with postmerger ratification seeks to identify the essential character of the proxy solicitation from its function in obtaining the minority approval that would preclude a minority suit attacking the merger. Since the link is said to be a step in the process of barring a class of shareholders from resort to a state remedy otherwise available, this theory of causation rests upon the proposition of policy that § 14(a) should provide a federal remedy whenever a false or misleading proxy statement results in the loss under state law of a shareholder plaintiff's state remedy for the enforcement of a state right. Respondents agree with the suggestions of counsel for the SEC and FDIC that causation be recognized, for example, when a minority shareholder has been induced by a misleading proxy statement to forfeit a state-law right to an appraisal remedy by voting to approve a transaction, [citation omitted], or when such a shareholder has been deterred from obtaining an order enjoining a damaging transaction by a proxy solicitation that misrepresents the facts on which an injunction could properly have been issued. [Citations omitted.] Respondents claim that in this case a predicate for recognizing just such a causal link exists in Va. Code Ann. § 13.1-691(A)(2) (1989), which sets the conditions under which the merger may be insulated from suit by a minority shareholder seeking to void it on account of Beddow's conflict.

This case does not, however, require us to decide whether §14(a) provides a cause of action for lost state remedies, since there is no indication in the law or facts before us that the proxy solicitation resulted in any such loss. The contrary appears to be the case. Assuming the soundness of respondents' characterization of the proxy statement as materially misleading, the very terms of the Virginia statute indicate that a favorable minority vote induced by the solicitation would not suffice to render the merger invulnerable to later attack on the ground of the conflict. The statute bars a shareholder from seeking to avoid a transaction tainted by a director's conflict if, *inter alia*, the minority shareholders ratified the transaction following disclosure of the material facts of the transaction and the conflict. Va. Code Ann. § 13.1-691(A)(2) (1989). Assuming that the material facts about the merger and Beddow's interests were not accurately disclosed, the minority votes were inadequate to ratify the merger under state law, and there was no loss of state remedy to connect the proxy solicitation with harm to minority shareholders irredressable under state law. Nor is there a claim here that the statement misled respondents into entertaining a false belief that they had no chance to upset the merger until the time for bringing suit had run out.

[IV] The judgment of the Court of Appeals is reversed.

As noted above, *Virginia Bankshares* did not answer the question whether shareholders would have a valid Section 14(a) cause of action if they lost state-law remedies such as appraisal rights as a result of a misleading proxy statement. Generally, lower federal courts have said that they would.

Virginia Bankshares also considered the issue of whether statements of opinion can be considered material for purposes of Section 14(a). Rather than review the majority opinion on this issue, consider what Justice Scalia said in his concurring opinion:

> As I understand the Court's opinion, the statement "In the opinion of the Directors, this is a high value for the shares" would produce liability if in fact it was not a high value and the directors knew that. It would not produce liability if in fact it was not a high value but the directors honestly believed otherwise. The statement "The directors voted to accept the proposal *because* they believe it offers a high value" would not produce liability if in fact the directors' genuine motive was quite different — except that it would produce liability if the proposal in fact did not offer a high value and the directors knew that.
>
> I agree with all of this. However, not every sentence that has the word "opinion" in it, or that refers to motivation for directors' actions, leads us into this psychic thicket. Sometimes such a sentence actually represents facts as facts rather than opinions—and in that event no more need be done than apply the normal rules for § 14(a) liability. I think that is the situation here. In my view, the statement at issue in this case is most fairly read as affirming *separately* both the fact of the directors' opinion *and* the accuracy of the facts upon which the opinion was assertedly based. ***
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501 U.S. at 1108-09.

In 2015, the Supreme Court decided *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 135 S.Ct. 1318 (2015). *Omnicare* concerns liability under Section 11 of the Securities Act[*] (which is discussed in Section 15.04 of Chapter 15), so it is not entirely clear to what extent it will apply to Section 14(a), although it is likely that it will (and some federal district courts have applied it in the context of Rule

[*] Section 11 provides that if an effective registration statement for a securities offering contained an "untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading," then any person who purchased the registered securities may sue the issuer and various other persons. Section 11 provides defendants with some potential defenses and also specifies how to calculate the plaintiff's recovery if the plaintiff wins the lawsuit.

10b-5 lawsuits). In any event, *Omnicare* provides useful guidance for when a statement of opinion can be actionable.

In discussing opinions, the Court noted that:

> Consider [Section 11's] application to two hypothetical statements, couched in ways the Funds claim are equivalent. A company's CEO states: "The TVs we manufacture have the highest resolution available on the market." Or, alternatively, the CEO transforms that factual statement into one of opinion: "I *believe*" (or "I think") "the TVs we manufacture have the highest resolution available on the market." The first version would be an untrue statement of fact if a competitor had introduced a higher resolution TV a month before—even assuming the CEO had not yet learned of the new product. The CEO's assertion, after all, is not mere puffery, but a determinate, verifiable statement about her company's TVs; and the CEO, however innocently, got the facts wrong. But in the same set of circumstances, the second version would remain true. Just as she said, the CEO really did believe, when she made the statement, that her company's TVs had the sharpest picture around. And although a plaintiff could later prove that opinion erroneous, the words "I believe" themselves admitted that possibility, thus precluding liability for an untrue statement of fact. That remains the case if the CEO's opinion, as here, concerned legal compliance. If, for example, she said, "I believe our marketing practices are lawful," and actually did think that, she could not be liable for a false statement of fact—even if she afterward discovered a longtime violation of law. Once again, the statement would have been true, because all she expressed was a view, not a certainty, about legal compliance.
>
> That still leaves some room for [Section] 11's false-statement provision to apply to expressions of opinion. As even Omnicare acknowledges, every such statement explicitly affirms one fact: that the speaker actually holds the stated belief. [Citations omitted.] For that reason, the CEO's statement about product quality ("I believe our TVs have the highest resolution available on the market") would be an untrue statement of fact—namely, the fact of her own belief—if she knew that her company's TVs only placed second. And so too the statement about legal compliance ("I believe our marketing practices are lawful") would falsely describe her own state of mind if she thought her company was breaking the law. In such cases, [Section] 11's first part would subject the issuer to liability (assuming the misrepresentation were material).
>
> In addition, some sentences that begin with opinion words like "I believe" contain embedded statements of fact—as, once again, Omnicare recognizes. [Citation omitted.] Suppose the CEO in our running hypothetical said: "I believe our TVs have the highest resolution available

> because we use a patented technology to which our competitors do not have access." That statement may be read to affirm not only the speaker's state of mind, as described above, but also an underlying fact: that the company uses a patented technology. [Citation omitted.] Accordingly, liability under [Section] 11's false-statement provision would follow (once again, assuming materiality) not only if the speaker did not hold the belief she professed but also if the supporting fact she supplied were untrue.

Id. at 1326-27. In other words, "a sincere statement of pure opinion is not an 'untrue statement of material fact,' [within the language of Section 11] regardless whether an investor can ultimately prove the belief wrong." *Id*. at 1327.

However, the Court went on to consider whether *omissions* of facts could render statements of opinion actionable under Section 11. Consider the following passage:

> *** [A] reasonable investor may, depending on the circumstances, understand an opinion statement to convey facts about how the speaker has formed the opinion—or, otherwise put, about the speaker's basis for holding that view. And if the real facts are otherwise, but not provided, the opinion statement will mislead its audience. Consider an unadorned statement of opinion about legal compliance: "We believe our conduct is lawful." If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry—rather than, say, on mere intuition, however sincere. Similarly, if the issuer made the statement in the face of its lawyers' contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer's possession at the time. Thus, if a registration statement omits material facts about the issuer's inquiry into or knowledge concerning a statement of opinion, and if those facts conflict with what a reasonable investor would take from the statement itself, then [Section] 11's omissions clause creates liability.

Id. at 1328-29. Later, however, the Court noted that "to avoid exposure [i.e., liability] for omissions under [Section] 11, an issuer need only divulge an opinion's basis, or else make clear the real tentativeness of its belief." *Id*. at 1332.

Finally, another important source of civil liability under the Exchange Act is Rule 10b-5. However, we will discuss that rule in Chapter 14 instead of this chapter because (among other reasons), it technically applies to any security, not just those that are publicly traded. Speaking of "publicly traded," how do the stock markets in the United States work? That is the subject of the next section.

§ 17.02 AN OVERVIEW OF STOCK MARKETS

Many thousands of companies have securities (typically, shares of stock) that are traded on securities markets in the United States. Before discussing the various securities markets and their requirements, it is important to note that trading in these markets consists of persons buying and selling shares (or other securities, such as bonds) that are *already outstanding*. Thus, for example, if you decide this morning that you would like to buy some shares of Apple Inc., you would not contact the company itself and ask it to issue some "new" (i.e., authorized-but-unissued) shares to you. Instead, you would most likely call your stockbroker or visit your online trading account and submit a purchase order for a given number of shares of Apple stock at a specified price.[*] Meanwhile, someone else would be deciding to sell her shares of Apple stock. Through a very complicated process, your purchase order eventually would be matched with her sell order and you would end up purchasing her shares of Apple stock. If this is your first purchase of Apple stock, you are now a shareholder of Apple and have all of the rights associated with that status. If the seller has sold all of her shares of Apple stock, she would no longer be an Apple shareholder after this transaction.

Thus, on any given day, the number of outstanding shares of Apple stock does not change, assuming that Apple did not issue more shares or repurchase shares from existing shareholders on that day. Instead, the persons who own those shares, and the numbers of shares that they own, would change. In other words, virtually all of the trading in Apple stock on a given day consists of ***resales***. Once you understand this, it should be apparent that Apple Inc. itself does not receive any of the proceeds of these resales.[**] (On the other hand, Apple indirectly benefits by having a strong market for its shares. For example, the existence of a robust trading market for a company's shares will likely make it easier for the company to find investors willing to pay "top dollar" for new shares that the company may issue in the future. Investors in such a liquid stock can be relatively assured that, when they want to sell the stock, they will be able to do so easily and at prices that are determined by market forces.)

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[*] The price at which a buyer is willing to buy a security is sometimes called the ***bid price*** and the price at which a seller is willing to sell a security is the ***ask*** price (which is usually higher than the bid price). The difference between these two amounts is the ***spread***. There are different types of orders that a purchaser or seller may submit to a broker, such as ***market orders***, which could be filled at the then-prevailing market price, and ***limit orders***, which could only be filled at the price specified by the buyer or seller who submitted the order, or a better price. Of course, brokers also earn ***commissions*** for executing your trades.

[**] You should thus distinguish the market trading discussed here from the situation where a company decides to *issue* more shares to new investors. The process by which a company may issue securities is primarily regulated under the Securities Act of 1933. See Chapter 15.

As the SEC's website puts it, the "stock market is where buyers and sellers meet to decide on the price to buy or sell securities, usually with the assistance of a broker." The existence of a market for a stock is an enormous benefit for investors, making it relatively easy for them to buy and sell shares, which is known as ***liquidity***. As you learned about closely held corporations in Chapter 12, without a market for shares, a shareholder would not easily be able to sell shares as a practical matter even though she is usually legally free to do so. While shareholders of publicly traded companies could, of course, sell their shares to other persons in face-to-face, individually negotiated transactions, this rarely happens unless the shareholder is selling a very large amount of stock, such as an institutional shareholder like a mutual fund. Instead, it is usually more efficient to sell shares into the "market." The existence of a market also helps participants ensure they are getting the best prices available for their transactions, known as ***transparency***. (And, of course, the availability of the information the company must make public discussed earlier in this chapter helps buyers and sellers determine the prices at which they are willing to trade.)

When a broker receives an order from a customer that she cannot match with orders from her other customers, she will need to route the order elsewhere for completion. There are two categories of stock markets in the United States: ***national securities exchanges*** and the ***over-the-counter (OTC) market***. However, the distinctions between these two types of markets have become a bit blurry in recent years as technology has progressed. In addition, ***electronic communications networks*** are discussed below.

National Securities Exchanges. Generally, on a stock exchange buy and sell orders for a stock are communicated to a centralized location (a "floor") where a "specialist" in that stock matches the orders. Section 5 of the Exchange Act requires that securities exchanges (which the statute defines as any organization, association, or group "which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood ...."[*]) be registered as such with the SEC, unless the SEC grants the exchange an exemption from the registration requirement. Section 6 of the Exchange Act provides that an exchange may register with the SEC as a "national securities exchange" and details the process for doing so. National securities exchanges, as well as certain other market participants, are known as ***self-regulatory organizations***, or "***SROs***," meaning that they are required to adopt rules governing themselves and their members. However, any changes to the rules of an SRO must be approved by the SEC, and in some cases the SEC can force an SRO to adopt a particular rule. *See* Exchange Act § 19.

There are several securities exchanges registered with the SEC as national securities exchanges, the most important being the New York Stock Exchange (the "***NYSE***"). Another important national securities exchange is the Nasdaq Stock Market,

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[*] See also *Board of Trade v. SEC*, 923 F.2d 1270 (7th Cir. 1991).

which until recently was considered part of the OTC market. There are several other exchanges in the United States that are registered as national securities exchanges* (not to mention many securities exchanges in other countries). Trading volume on national securities exchanges is immense; every trading day, billions of shares worth tens of billions of dollars change hands on the NYSE and Nasdaq.

The NYSE is owned by a holding company called Intercontinental Exchange, Inc., which operates eleven securities exchanges around the world. There are approximately 2,600 issuers that have securities listed on the NYSE, including 78% of the companies in the Standard & Poor's (S&P) 500 index. As of the end of February 2016, the combined market capitalization of NYSE-listed securities was nearly $18.2 trillion.

There are more than 3,500 companies with securities listed on the Nasdaq Stock market, having a combined market capitalization of more than $9 trillion as of 2015. Nasdaq has three main markets: the Nasdaq Global Select Market, the Nasdaq Global Market, and the Nasdaq Capital Market (formerly known as the SmallCap Market).** The requirements for listing a security in these markets differ; the Global Select Market is the most demanding. In other words, it is more difficult for a company to qualify for the Global Select Market than the other markets.

Obviously, not every issuer may list its securities on NYSE or Nasdaq. First, because both NYSE and Nasdaq are SEC-registered national securities exchanges, any security listed on either of them must be registered under Section 12(b), which means that the issuer would become an Exchange Act reporting company. Second, both require issuers to meet very detailed—and stringent—quantitative tests for initial listing. These requirements relate to, among other things, financial measures such as the levels of the issuer's assets, revenues, earnings and/or cash flows; and liquidity measures such as the number of "round lot" shareholders (shareholders that own at least 100 shares), the issuer's market capitalization, the number of its outstanding shares, and/or the bid price for its shares. (Generally, issuers must continue to meet somewhat lesser standards for their securities to remain listed.) Nasdaq also requires that a listed issuer have at least three (or in some cases, four) "market makers," which are firms that must continually stand ready to buy and sell the company's securities for their own accounts at the then-

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* The SEC's website lists eighteen exchanges that are registered as national securities exchanges under Section 6 of the Exchange Act: NYSE MKT LLC (formerly NYSE AMEX and the American Stock Exchange); BATS Exchange, Inc.; BATS Y-Exchange, Inc.; BOX Options Exchange LLC; NASDAQ OMX BX, Inc. (formerly the Boston Stock Exchange); C2 Options Exchange, Incorporated; Chicago Board Options Exchange, Incorporated; Chicago Stock Exchange, Inc.; EDGA Exchange, Inc.; EDGX Exchange, Inc.; International Securities Exchange, LLC; ISE Gemini; Miami International Securities Exchange; The Nasdaq Stock Market LLC; National Stock Exchange, Inc.; New York Stock Exchange LLC; NYSE Arca, Inc.; and NASDAQ OMX PHLX, Inc. (formerly Philadelphia Stock Exchange).

** Nasdaq also operates a "Portal" market wherein qualified institutional buyers, as defined in Rule 144A under the Securities Act, may buy and sell certain securities, and a private market where shares of privately held companies that comply with certain requirements may be traded.

current bid and ask prices, so as to ensure a liquid market. (Market makers profit from the fact that the bid price is higher than the ask price.)

Even if an issuer meets the quantitative tests, it must also meet *qualitative* standards concerning corporate governance issues. (As noted above, as self-regulatory organizations, national securities exchanges may impose such requirments on listed companies.) For example, the NYSE LISTED COMPANY MANUAL contains detailed requirements relating to shareholder meetings and voting rights, classified boards of directors, and many other corporate governance issues. Nasdaq has detailed qualitative requirements on these topics as well. Moreover, both NYSE and Nasdaq recently implemented extensive changes to their corporate governance requirements to require that a majority of directors be independent; require executive sessions of independent directors; impose new obligations on audit committees, nominating committees, and compensation committees; and require codes of ethics that are applicable to all of an issuer's directors and employees. In general, these new requirements complement, but in many cases they go much further than, the requirements of, the Sarbanes-Oxley Act and the Dodd-Frank Act discussed in Section 17.01 above. You may learn more about these requirements in a course on Securities Regulation. But the important point here is that listed companies must not only comply with applicable state and federal law; if they want their securities to remain listed on an exchange, they must comply with that exchange's corporate governance (and other) requirements.

The Over-the-Counter Market. Unlike securities exchanges, the OTC markets do not have a centralized order-matching system or trading floor. Instead, OTC market trading takes place between brokers and dealers who communicate electronically and (historically, at least) by telephone. Before Nasdaq debuted in 1971, quotations in OTC stocks were reported only in the "Pink Sheets," which formerly was a daily publication of the National Quotations Bureau that was printed on pink paper. Brokers and dealers thus had to call one of the dealers in a particular OTC security to get current quotations for it, resulting in an inefficient market. Generally speaking, stocks traded on OTC markets are much more "thinly" traded than stocks that are listed on one or more national securities exchanges.

The OTC Bulletin Board. A much smaller (compared to NYSE and Nasdaq) market is the OTC Bulletin Board ("***OTCBB***"). The OTCBB is overseen by the Financial Industry Regulatory Authority, Inc. ("***FINRA***"), which is described in more detail below. According to FINRA's website, the OTCBB "is an interdealer quotation system that is used by subscribing FINRA members to reflect market making interest in OTCBB-eligible securities …." What are OTCBB-eligible securities? FINRA Rule 6530 generally provides that they include domestic equity securities that are not listed on a national securities exchange (although they may be listed on one or more regional exchanges) but whose issuers are required to file Exchange Act reports or reports with their banking or insurance regulators* and are current in their reporting obligations (subject to certain exceptions); foreign equity securities and American Depositary Receipts (ADRs) that meet certain criteria; and equity securities that are undergoing delisting from the NYSE or Nasdaq "for non-compliance with maintenance-of-listing standards" but are not subject to trading suspensions (among other eligible securities). Issuers whose securities are quoted on the OTCBB need not meet any qualitative or quantitative listing standards, as they must with Nasdaq and the securities exchanges, as discussed above.

OTC Link (also known as the "Pink Sheets"). Another OTC market is OTC Link, which before a long series of acquisitions and name changes used to be known as the "Pink Sheets." There are three marketplaces or "tiers" on OTC Link—OTCQX, OTCQB, and OTC Pink—and, according to OTC Link's website the "marketplace on which a company trades reflects the integrity of its operations, its level of disclosure, and its degree of investor engagement." OTCQX is the top tier, OTCQB is the middle tier, and OTC Pink is the bottom tier. Even in the OTCQX tier, however, companies are not required to be Exchange Act reporting companies—U.S. companies on the OTCQX tier must either be Exchange Act reporters, comply with the Regulation A reporting requirements (see Chapter 15), or comply with OTC's disclosure "guidelines." That said, OTCQX does impose certain corporate-governance requirements.** Not surprisingly, things are looser at the bottom tier: OTC Pink issuers are differentiated into three groups: those with "current" information, those with "limited" information, and those with "no" information. OTC Link's website cautions that companies in this last group "should be carefully researched before making any investment decision."

Thus, companies whose securities are quoted on the various Pink Sheets marketplaces do not have to be Exchange Act reporters or banking or insurance reporters, although some are. However, note that Exchange Act Rule 15c2-11 requires a broker-dealer to have in its records the "paragraph (a) information" specified in that rule before it publishes any quotation for an issuer's security in any "quotation medium" as defined in the rule (which excludes national securities exchanges). Further, the broker-dealer must, based upon a review of that information along with any other documents and information required by subsection (b) of Rule 15c2-11, have a "reasonable basis under the circumstances" for believing that the information is "accurate in all material respects" and that the sources of the information are reliable.

The SEC's website notes that:

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* Before 2000, OTCBB-quoted issuers did not need to be Exchange Act reporting companies or file financial reports with their banking or insurance regulators. After this rule was changed in 2000, more than 3,000 non-reporting companies were "kicked off" the OTCBB.

** See here for more information: http://www.otcmarkets.com/services/companies/otcqx-us/qualifications.

> With the exception of some foreign issuers, the companies quoted on OTC Link tend to be closely held, extremely small and/or thinly traded. Most of these issuers do not meet the minimum listing requirements for trading on a national securities exchange, such as the New York Stock Exchange or the Nasdaq Stock Market. Many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find current, reliable information about those companies. For all of these reasons, companies quoted on OTC Link can be among the most risky investments. That's why you should take extra care to thoroughly research any company quoted exclusively on OTC Link. Be aware that some broker-dealers are required by Rule 15c2-11 under the 1934 Act to have some information about the issuer. Ask your broker-dealer whether it has any Rule 15c2-11 information before you invest.

To be fair, though, in recent years OTC Link has taken admirable steps to improve the disclosure levels of its issuers, far from its days of having a "Wild West" reputation.

Electronic Communication Networks. In addition to the exchange and the OTC markets, recent years have seen the rise of "electronic communication networks," which allow institutional investors and broker-dealer firms to trade securities directly between themselves, with no broker middleman. A discussion of such ECNs is outside the scope of this textbook, if only because any such discussion would likely become quickly out-of-date. However, note that while ECNs may not be considered "exchanges," they could still be regulated by the SEC as broker-dealers, securities information processors, or clearing agencies.

The Efficient Capital Markets Hypothesis. As discussed in Chapter 8 and earlier in this chapter, if a company is an Exchange Act reporter, it continually files various documents with the SEC, such as its Forms 10-K and Forms 10-Q. Information may also be reported more quickly with a Form 8-K or due to the requirements of Regulation FD. Because this information is publicly available, the market is continually updated as to the company's financial and business performance. If it is performing well, then (all other things being equal) the price of its stock should rise; if it is performing poorly or if some adverse event happens, the price of its stock should fall. These price fluctuations are the result of the actions of the many persons who are buying and selling the company's stock on any given day on the basis of this information.

Can you make money in the stock market? Sure. The stock market is prone to wild swings and the value of any given investment could rise, or decline over a period of time or even permanently (for example, if the company goes bankrupt its stock will likely be worthless). However, if you buy shares of a mutual fund that invests in many differentcompanies (i.e., it is diversified), then your investment will likely be worth more at some point in the future. A dollar that was invested decades ago in a broad-based mutual fund is probably worth a lot more today. But can you "beat" the market? In other words, can investors or fund managers outperform the returns of the overall stock market by investing more wisely than others? There is a whole industry of mutual funds and hedge funds that argue that the answer is yes, and try to convince people to invest their money with them so as to earn superior returns. And in fact, many fund managers have impressive records of beating the market for seemingly long periods of time.

However, the "efficient capital markets hypothesis" (the "***ECM hypothesis***" or the "***ECM theory***") holds that the price of a publicly traded company's stock reflects all publicly known information about that company and the overall economy. New information will be quickly digested by the market and reflected in a change in the market price of a security. Thus, the market efficiently "prices" such shares. For example, if new information that is positive becomes publicly known, such as the company announcing better-than-expected earnings, the many hundreds or thousands of market participants will try to exploit that information by buying shares of the company at the current price, which does not—yet—reflect the new information. Of course, in this example, the price will soon rise to reflect this additional demand for the stock. In this way, any price abnormalities are short-lived.

Under the "semi-strong" version of the ECM hypothesis, which is widely accepted by economists and other academics, stock prices reflect all *publicly* known information.[*] Under that theory, if you have "inside" information, i.e., nonpublic information, you can profit from that information before it becomes publicly known. For example, if you know that a "target" company will be acquired by another company at a price much higher than the current trading price of the target's stock, you could make money by buying target stock before this news is announced. (Of course, you may go to jail for doing so; Chapter 16 discusses insider trading under Exchange Act Rule 10b-5.).

If the ECM hypothesis (in whichever form) is correct, one implication is that you can't reliably beat the market over a long period of time and you probably shouldn't try to do so. Because the current price of a publicly traded security reflects all public information (and perhaps nonpublic information as well) the only thing that can change the price is *unforeseen* information. Whether that information will be "good" or "bad" is anyone's guess. Unless you have a crystal ball, your guess as to the future changes in the price is only that—a guess. Sometimes you may guess correctly, and you may even go on a "hot steak" where your guesses are often correct. But over time, you will be wrong about as often as you are correct. In that way, your returns will be about the same as the returns of the overall stock market.

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[*] There is also a ***weak form*** of the ECM hypothesis, but it will not be discussed here. There is also a ***strong form***, which posits that stock prices also reflect *non-public* information. The strong form of the theory is much less accepted than the semi-strong version. One reason is that, if the strong version of the theory were true, inside-traders would not be able to make any money off their "inside" information (see Chapter 14) because the market would also have *already* priced this information into the value of the stock. However, there is a lot of evidence that insiders of a company trading in that company's securities earn high returns. This would be impossible if their inside information did not give them an advantage over the rest of us.

Nonetheless, as noted above, there remains an industry of professional "stock pickers" that would like for you to invest your money with them due to their supposed superior intellect or perhaps a great past track record. But as the saying goes, past performance is no guarantee of future results. For this reason, many academics argue that investors are better off investing in "index" mutual funds that attempt to mirror the performance of the entire stock market, as opposed to investing in "actively managed" mutual funds (which typically charge higher fees) or hedge funds (which typically charge even higher fees and are only open to very wealthy investors) or even trying to pick individual stocks. For a great argument in support of this view, see BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (10th ed. 2011).

FINRA. An important SRO in the securities industry is the Financial Industry Regulatory Authority, Inc., or ***FINRA***. (Again, an SRO is a self-regulatory organization, not a governmental agency.) FINRA's primary purpose is to regulate brokers and dealers that are members of it and, as its website explains, its mission is "to protect America's investors by making sure that the securities industry operates fairly and honestly." (Sounds like a tall order!) FINRA was formed by the 2007 merger of the National Association of Securities Dealers, Inc., NASD Regulation, Inc., and the NYSE's regulatory and arbitration divisions. FINRA has more than 3,500 employees and oversees nearly 4,000 brokerage firms, which in turn employ more than 600,000 registered representatives. You may learn more about FINRA, as well as SEC regulation of broker-dealers, in a course on Securities Regulation.

§ 17.03 PUBLIC COMPANY GOVERNANCE

Although a publicly traded corporation is a corporation like any other corporation formed under a state's corporate statute and therefore is subject to all of the rules that you learned in prior chapters (except Chapter 12), they are subject to some unique concerns. Moreover, *federal* law imposes many additional corporate governance rules on publicly traded companies, as discussed below.

A. SHAREHOLDER "ACTIVISM" AND THE ROLE OF THE BOARD IN PUBLIC COMPANIES

What is the purpose of a corporation? At first, you may think that is a silly question, and answer that the purpose of a corporation is to benefit its common shareholders by being as profitable as possible within the bounds of the law. Indeed, this is more or less the traditional view. However, for at least as far back as the 1930s,* there has been a debate between holders of the "traditional" view, who argue that corporate

* See Adolph A. Berle, Jr., *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

directors should not owe duties to anyone other than common shareholders, and those who argue that directors should also consider the interests of other "stakeholders" such as preferred shareholders, creditors (e.g., bond holders), employees, the communities in which the corporation operates, and even the public good. Many continue to make this argument and it is reflected to some degree in the "constituency" statutes of many states, which allow corporate directors to consider the interests of such stakeholders in some situations. Further, there are cases that hold that directors may owe duties to preferred shareholders, holders of convertible securities (i.e., securities that may be converted into common or preferred stock), and creditors in some, albeit limited, situations. (Of course, such stakeholders often have *contractual* protections as well.) Nonetheless, the traditional view is much more widely accepted. See, e.g., Section 2.01(a) of the *ALI Principles of Corporate Governance* (with some exceptions, "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.")

But even if you agree that the traditional view of the corporation's purpose is correct, another question that arises is *who* should make decisions for the corporation. As noted in Chapter 8 and elsewhere in this book, we call the shareholders the "owners" of the corporation even though it ends up being sort of a legal fiction. As you know by now, shareholders have very little control over a corporation. Instead, the board of directors is the true decision-maker. Normally, this arrangement works fairly well, because (1) directors usually make decisions by considering whether they will benefit the corporation's shareholders, at least in the long run, (2) if the directors stray too far from these goals, the shareholders could elect different directors at the next annual meeting or possibly remove the current directors before then, and (3) if the directors *really* stray too far from these goals, a shareholder could bring a derivative action against them, alleging a breach of the directors' duty of care and/or the duty of loyalty, as you learned in prior chapters.

Nonetheless, in recent years, many shareholder "activists" and legal scholars have argued for much greater shareholder control, particularly with respect to publicly traded corporations. According to this line of thinking, any change in the rules of corporate governance that increases shareholder power is likely desirable. An underlying premise of this argument is that directors and officers (i.e., "management") often do not act in the shareholders' bests interests. Instead, they may act to benefit or enrich themselves, or may just be plain lazy. Moreover, in many public companies, incumbent management faces no real threat of removal, unless another company wants to acquire the corporation and then clean house. Faced with no real prospect of losing their jobs, management may not perform as well as they would if they were always fighting to stay in office.

Wait a minute, you might say. How can the directors and officers feel so safe in office? If the shareholders truly think that management is not performing well, why don't they just elect different directors, who will then fire the officers and replace them with better ones? After all, you may say to yourself, I learned in Chapter 8 that the shareholders elect at least one-third of the directors every year. If they don't like them, they can "throw the bums out."

That conclusion could well be true if there weren't many shareholders. But think about the nature of many public companies. Assume that ABC Corp. has 20 million shares of stock outstanding, which are traded on the NYSE and that its board of directors consists of nine persons who have been "staggered" into three classes so that they serve overlapping three-year terms. The 20 million shares of ABC stock are owned by approximately 5,000 shareholders, many of whom own very small numbers of shares. In fact, the only two "big" shareholders are (1) the company's founder, Mr. Bigwig, who owns 500,000 shares and also serves as a director, and (2) the Atlantic Mutual Fund, an institutional investor that owns 300,000 shares, which it purchased one year ago. You are also an ABC shareholder, but you own only 5,000 shares. Nonetheless, these 5,000 shares represent most of your net worth of $100,000.

As discussed in Chapter 8, typically the board, or perhaps a nominating committee consisting of some board members, nominates candidates for election as directors at the annual meeting of shareholders. Often, the current directors will be re-nominated, year after year after year. Further, assuming that plurality voting is used and that the number of candidates is the same as the number of open board positions to be filled at the meeting, then each candidate would get elected if she receives as little as one vote.

Of course, shareholders could try to nominate their "own" candidates for the board and solicit proxies from their fellow shareholders in favor of these candidates. But even if ABC is not performing well and the fault may lie with management, do you think any of the shareholders will take any steps to nominate their own candidates? Clearly, Mr. Bigwig will not do so, because he is one of the current directors! What about the Atlantic Mutual Fund? Although it might do so, its more likely course of action is to follow the "Wall Street rule" and simply sell its shares of ABC stock and invest the proceeds in some other company. How about you? Again, your 5,000 shares of ABC stock represent most of your personal worth, so this is an important matter for you. Will you nominate one or more of your own candidates for election to ABC's board?

Keeping in mind that (1) ABC is a publicly traded company and thus subject to the Exchange Act's proxy rules that you learned about in Section 17.01(D) above, (2) that there are thousands of ABC shareholders that are probably spread across the country if not the world, the majority of whom have small amounts of shares and thus are "rationally apathetic," that is, not willing to invest much time figuring out how to vote their meager numbers of ABC shares, and (3) soliciting proxies is enormously expensive but the nominees of the incumbent board will not have to bear this expense, you would have to be out of your mind to mount a proxy contest. It simply is not worth your time. Not only would you likely lose (i.e., your candidates would not be elected), you would spend thousands of dollars. Further, in this example, ABC's board is staggered into three classes. Thus, even in the unlikely event that your candidates won, they would only comprise one-third of the board. You would have to repeat the process and win next year to "capture" a majority of the board.

Although the above example paints a somewhat simplistic picture of the nature of shareholdings in public companies, the boards of most public companies end up being self-perpetuating for these and other reasons. Even though the thousands of ABC shareholders collectively "own" ABC, not only do they have virtually no power to make decisions for ABC, they have almost no practical chance of electing their own director candidates. As I wrote elsewhere:

> [W]hy don't unhappy shareholders simply solicit proxies in favor of their own candidates? Time and money are the obvious answers. In the typical public corporation with thousands of widely dispersed—and small—shareholders, the solicitation of proxies is a practical necessity, as one would almost certainly be unable to muster a quorum if shareholders were permitted only to vote in person at the meeting. While nominations from the floor of the meeting are possible, they are essentially meaningless because very few shareholders will be at the meeting; the vast majority of shareholders will have previously voted via proxy. The incumbent board can solicit proxies for their nominees at no personal expense. Insurgent shareholders enjoy no such luxury (except in the rare event that they are successful, in which case their nominees, now being elected, would cause the corporation to reimburse them).
>
> Soliciting proxies is difficult and expensive; not only must one go to the expense of printing and mailing the proxy statement and engaging in other solicitation activities, but one must also ensure that any proxy materials comply with the SEC's detailed proxy rules, which almost certainly will require the assistance of expensive attorneys. The shareholder would also face potential liability for any materially false or misleading proxy materials. As a result, only the largest and most determined shareholders would consider mounting a proxy contest in favor of their own nominees, at least outside a takeover battle. Additional problems include the "free rider" problem (i.e., if a shareholder goes to the trouble and expense of soliciting proxies for directors, and those directors are elected and cause the corporation's stock price to increase, most of these gains are reaped by *other* shareholders), overcoming other shareholders' apathy and their possible suspicion of the insurgents, and the risk that new directors would not perform any better than their predecessors. Thus, the rational shareholder who owns a small number of shares and is not interested in gaining control of the board but only wants to nominate a director or two simply will not go to the trouble of soliciting proxies. ***

Molitor, *The Crucial Role of the Nominating Committee,* 11 U.C. DAVIS BUS. L. J. 97, 105-07 (2010) (footnotes omitted).

Nonetheless, in recent years, many developments have occurred that may change this situation. Perhaps.

B. RECENT MARKET DEVELOPMENTS IN PUBLIC COMPANY GOVERNANCE

Many recent developments have affected how public companies are governed. In general, there are two types of such developments. The first category consists of regulatory developments, such as the many new rules implemented as a result of the Sarbanes-Oxley Act and the Dodd-Frank Act, which are discussed in Section 17.01(C) above. Second, there have been many "market" developments, that is, changes that have occurred without any formal action by Congress or a regulatory authority such as the SEC. In this category, we will discuss the rise of the power of institutional investors and many corporate-governance reforms that companies voluntarily adopted as a result of shareholder pressure to do so.

The Growth of Institutional Shareholders. Historically, the great majority of the shares of public companies were owned by individuals. However, in recent years, institutional shareholders, such as mutual funds, pension funds, insurance companies, state and local governments, university endowments, and private foundations, have come to own very large percentages of publicly traded stocks. In 1950, for example, institutional investors owned only approximately 6.5 percent of the value of all outstanding publicly traded stocks. However, by some measures, approximately 67 percent of all publicly traded stock in the U.S. is now owned by institutions. Other statistics put the percentage even higher, depending on how one defines the terms "institution" or "institutional investor."

Many proponents of "corporate democracy" welcomed this development. Where a public company is owned by thousands of small shareholders, those shareholders will likely be rationally apathetic. And even if they are not rationally apathetic, they would face massive "collective action" problems due to their sheer numbers and the fact that they are likely widely dispersed geographically. But if a significant amount of the company's stock is owned by an institutional shareholder, that shareholder might well be able to press management to adopt shareholder-friendly reforms. Moreover, the fact that the institutional investor owns a lot of the company's stock would make it less able to follow the "Wall Street rule" and sell its stock in the company without seriously depressing the market price. (Remember the laws of supply and demand.) Even if there were several "medium" institutional investors, if they collectively own a large percentage of the company's stock, their small numbers would make it easy for them to overcome the collective action problems that plague smaller shareholders (who number in the hundreds, thousands or even tens of thousands) and coordinate their actions. Further, the typical institutional investor has a sophisticated manager who monitors its investments and can easily communicate with management. Thus, it was hoped that institutional investors might prove to be efficient overseers of public companies and that their work may benefit all shareholders. (Of course, some commentators worried that some institutional shareholders would press management to adopt policies that would benefit *them* but not the shareholders generally. The frequent example given in this regard was a labor union that might pressure the board to benefit union members with more favorable contracts.)

Others were skeptical. Mutual funds in particular were viewed as passive investors (as opposed to hedge funds, which are largely seen as more activist[*]), particularly index funds and those that have other relationships with the company that they would not want to jeopardize by antagonizing management. There were also reports over the years that suggested that many institutional investors paid little attention to corporate governance matters and that many mutual funds did not even bother to vote their shares. Further, the Exchange Act has several rules that seem designed to discourage concentrated ownership of public company shares, such as Section 13(d), which is discussed in Chapter 14, and Section 16(b), which is discussed in Chapter 16.

On the other hand, many state and private pension plans have made much use of Rule 14a-8 by submitting shareholder proposals to many companies concerning "social" as well as corporate governance issues. For example, the Cracker Barrel restaurant chain used to have a policy whereunder it would fire any employees that it learned were homosexual. In 1992, a New York-based pension fund that owned shares of Cracker Barrel stock submitted a shareholder proposal that would have recommended that Cracker Barrel end this practice. Cracker Barrel sought a no-action letter from the SEC (which was granted), arguing that the proposal could be excluded on the ground that it related to the company's "ordinary business operations" (*see* Rule 14a-8(i)(7)). The shareholder later sued, but was unsuccessful. However, in 1998 the SEC changed its position, stating that it would return to its prior "case-by-case" approach to shareholder proposals that raise social issues. A few years later, the same pension fund submitted a similar shareholder proposal to Cracker Barrel, and the proposal received 58% shareholder support. Cracker Barrel's board then voted to end its policy of firing homosexual employees.

Other examples abound. But in the end, the evidence remains mixed as to whether institutional shareholders are effective watchdogs and the debate on this issue will likely continue long into the future. However, it seems that we can say at least a few things about institutional investors with relative confidence. First, any given public company is today more likely to have a significant amount of its stock owned by more institutional investors than at any time in the past. Second, this situation likely changes the dynamic between the board and the shareholders. Although we might have difficulty quantifying

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[*] Hedge funds are similar to mutual funds in that they pool funds to invest in other companies (or other types of investments). However, most mutual funds are regulated under the federal Investment Company Act, whereas most hedge funds are exempt from such regulation because they restrict ownership to very wealthy and sophisticated investors.

this statement, and although it may vary from one company to another, the boards and management of public companies today are often more responsive to, and respectful of, shareholders than in the past.

Developments Affecting the Election of Directors in Public Companies. Even so, it often is difficult for shareholders of public companies to elect directors *of their choosing*. This difficulty is traceable to three primary reasons: (1) the fact that the board itself is in control of the process of nominating directors; (2) the use of plurality voting at most public companies; and (3) the existence of staggered boards at many public companies. While there have been some significant developments on all three of these fronts, it still is an open question whether these developments will result in greater shareholder power over the identities of the persons serving as directors.

History of SEC Attempts to Allow Shareholders to Nominate Director Candidates. As noted above, a publicly traded corporation's proxy statement typically will include only the director candidates who were nominated by the incumbent board. Traditionally, the board nominated candidates who were suggested by the corporation's CEO or other board members. Although shareholders who want to elect a director of their own choosing could solicit proxies from other shareholders in support of that candidate, doing so is rare because it is so expensive. Thus, boards in many public companies are largely self-perpetuating.

However, in 1978 the SEC required public companies to make certain disclosures about their nominating committees (if they had them) and Schedule 14A now requires detailed disclosures about the director nomination process.* Also, in the 1970s and 1980s, some influential groups started to recommend that public companies have independent nominating committees that would be receptive to shareholder nominations. Further, after the Sarbanes-Oxley Act, the stock markets got involved in the director nomination process. For example, the NYSE now requires listed companies to have a nominating and corporate governance committee that consists only of independent directors (as defined). The committee must have a charter that addresses its purposes and responsibilities, which, must include identifying board candidates and selecting, or recommending to the board, director nominees. *See* Section 303A.04 of the NYSE LISTED COMPANY MANUAL. As a result of these and other developments, 99 percent of the companies in the S&P 500 had a nominating committee by 2006, although only eight percent of public companies had had one in 1971. Nonetheless, many activist shareholders argue that most nominating committees do not seriously consider board candidates nominated by shareholders.

The SEC has historically been very attentive to these concerns. Its attempts to allow shareholder access to the corporate proxy have a long history, going back as far as

* For example, the issuer must describe the "material elements" of any policy its nominating committee (or, if it doesn't have one, the full board) follows in considering director candidates nominated by shareholders. If the issuer does not have such a policy, the proxy statement must state the basis for the board's view that it is "appropriate" not to have one. This is another example of the SEC attempting to "shame" companies into doing something.

1942. More recently, in 2003, the SEC proposed that public companies be required to include shareholder-nominated candidates in their proxy materials if certain triggering events had occurred. If a triggering event occurred, then for the next two years a shareholder (or group) that had owned more than five percent of the voting stock for at least two years, and that did not seek control of the company, could place nominees in the company's proxy materials. However, this proposal eventually was abandoned.

Then, in *American Federation of State, County and Municipal Employees v. American International Group, Inc.*, 462 F.3d 121 (2d Cir. 2006), the court held that American International Group (AIG) could *not* exclude from its proxy statement a Rule 14a-8 shareholder proposal to amend AIG's bylaws. The proposed amendment to AIG's bylaws would have established a procedure whereby some shareholders could nominate board candidates to appear in the AIG's proxy materials.

After *AIG*, the SEC proposed two alternative rules. The first proposed amending Rule 14a-8(i)(8) to make clear that shareholder proposals that might result in an election contest could be excluded. The second proposed amending Rule 14a-8 to allow shareholders (or groups) that had owned more than five percent of the voting stock for at least one year, and that did not seek control of the company, to submit Rule 14a-8 proposals to establish *procedures* for shareholder nominations of directors. The SEC ended up adopting the first release and thus amended Rule 14a-8 to allow the *exclusion* of shareholder proposals that relate "to a *nomination* or an election for membership on the company's board of directors … *or a procedure for such nomination or election*." (Emphasis added.) Thus, a company could exclude from its proxy materials director candidates nominated by a shareholder, as well as shareholder proposals that would require the company to adopt *procedures* for the nomination of board candidates by shareholders.

A little while later, following a change in Presidential administrations, the SEC proposed a new "shareholder access" rule, which was adopted in August 2010. This rule, Rule 14a-11, essentially would have required issuers to include in their proxy materials the names of board candidates nominated by eligible shareholders who followed the rule's procedures. Eligible shareholders (or groups) were those that had owned at least three percent of the issuer's outstanding voting shares for at least three years (among other requirements). If several eligible shareholders properly submitted names of viable nominees under Rule 14a-11, the issuer would have been required to include in its proxy materials a number of such nominees equal to the greater of (1) one or (2) twenty-five percent of the total number of directors on the board (rounded down to the nearest whole number). For example, if the company had ten directors, then it would only be required to include two shareholder-nominated candidates in its proxy materials (subject to some exceptions). However, in *Business Roundtable, et al. v. SEC* (No. 10-1305, July 22, 2011), the Court of Appeals for the District of Columbia Circuit vacated Rule 14a-11 for non-compliance with the federal Administrative Procedures Act.

The SEC also amended Rule 14a-8, which concerns shareholder proposals (as opposed to director nominations). As noted above, after the *AIG* case the SEC amended Rule 14a-8 to allow companies to exclude shareholder proposals that relate "to a nomination or an election for membership on the company's board of directors … or a procedure for such nomination or election." Today, however, Rule 14a-8 only allows the issuer to exclude a proposal relating to director elections if the proposal: (1) would disqualify a nominee who is standing for election; (2) would remove a director from office before her term expired; (3) questions the competence, business judgment, or character of one or more nominees or directors; (4) seeks to include a specific individual in the company's proxy materials for election to the board of directors; or (5) otherwise could affect the outcome of the upcoming election of directors. These are much narrower exclusion grounds than before.

So what now? Well, Section 971 of the Dodd-Frank Wall Street Reform and Consumer Protection Act specifically gives the SEC the authority to promulgate a proxy-access rule—Section 14(a)(2) of the Exchange Act now provides that SEC rules may include "a requirement that a solicitation of proxy, consent, or authorization by (or on behalf of) an issuer include a nominee submitted by a shareholder to serve on the board of directors of the issuer" and "a requirement that an issuer follow a certain procedure in relation to [such] a solicitation …." The SEC's next move is unclear as of the date of this textbook, although many commentators think it's only a matter of time before the SEC decides to use this authority to implement a new rule allowing shareholders to nominate director candidates and have their nominees' names appear in the company's proxy statement. In the meantime, however, some companies have voluntarily adopted proxy-access rules in response to shareholder pressure or to fend off shareholder proposals to do so.[*] Stay tuned.

Recent State-Law Development Concerning Shareholder Nominations of Director Candidates. Some state laws were recently amended to facilitate shareholder nominations of director candidates. For example, Sections 112 and 113 were added to the Delaware General Corporation Law in 2009. Section 112 provides in part that a corporation's:

> bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, 1 or more individuals nominated by a stockholder.

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[*] See Mara Lemos Stein, *The Morning Risk Report: SEC Gives Pointers on Proxy Access,* WALL ST. JOURNAL, March 8, 2016, *available at* http://blogs.wsj.com/riskandcompliance/2016/03/08/the-morning-risk-report-sec-gives-pointers-on-proxy-acess/ (noting that up to 124 companies had adopted proxy-access bylaws since the beginning of 2015, and that "many are working on implementing these ahead of the 2016 annual general meetings.").

The rest of the section goes on to detail what may be included in the "procedures and conditions" in the bylaws, including minimum ownership levels (in terms of either number, value, or percentage of shares owned, and the duration of ownership), *maximum* ownership levels, provisions "conditioning eligibility … upon the number or proportion of directors nominated by stockholders or whether the stockholder previously sought to require such inclusion," and any other "lawful" conditions. Section 113 then provides that a corporation's bylaws could also require the corporation to reimburse shareholders for their proxy solicitation expenses incurred in the election of directors, subject to the terms and conditions specified in the bylaws.

Further, subsections (c) and (d) were recently added to MBCA § 2.06. Subsection (c) is similar to Delaware Sections 112 and 113. Subsection (d) provides that if such bylaw provisions are adopted by the shareholders, they "may not limit the authority of the board of directors to amend or repeal any condition or procedure set forth in or to add any procedure or condition to such a bylaw in order to provide for a reasonable, practicable, and orderly process."

Majority Voting. Most publicly traded companies use plurality voting in the election of directors. As noted in Chapter 8, under plurality voting a shareholder typically cannot vote "against" a candidate. Instead, "for" and "withhold" are the only choices. This means that board candidates may be elected with less than a majority of the possible votes cast "for" them; to be elected under plurality voting, all a candidate needs is more votes than any other candidate for that position, not a majority. If only ten people are running for ten open board positions (i.e., there is an "uncontested election"), those ten candidates are guaranteed to be elected under plurality voting.

Because this seems unfair, in recent years many shareholder activists have submitted Rule 14-8 shareholder proposals to recommend that companies adopt some form of majority voting. (As noted in Section 17.01(D) above, to survive exclusion from the company's proxy materials under Rule 14a-8, shareholder proposals typically must be phrased in the form of recommendations, rather than mandates.) Moreover, unlike many Rule 14a-8 shareholder proposals, these proposals received strong shareholder support at many companies. Due to this shareholder pressure, the boards of many public companies in recent years have voluntarily adopted majority voting systems for director elections. For example, fewer than ten percent of companies in the S&P 100 used majority voting in 2005; by 2014, nearly ninety percent of the companies in the S&P 500 (a larger group) had adopted some form of majority voting.

If you think about it, it should be clear that a potential problem with a majority voting system is that it might result in board vacancies. For example, assume that all of ABC Corp.'s directors are elected annually. If ABC Corp. had a majority voting system and a majority of the shares were cast *against* the board candidates at this year's election, then the current directors' terms would expire, but no one would have been elected to take their places. Because board vacancies could be very damaging to corporations, most states have a "holdover rule" that provides that board members, even those who were not re-elected, maintain their seats until their successors are elected. *See* MBCA § 8.05(3).[*]

Pfizer Inc. was one of the pioneers in majority voting. Under Pfizer's current system, for a candidate to be elected to the board in an uncontested election (that is, an election where the number of candidates is equal to the number of open board positions), more votes must be cast "for" the candidate than "against" her. If an incumbent director has more votes cast against her, she must submit an irrevocable resignation to the board. However, the resignation is effective only if the board accepts it. This means that the board could reject the resignation. This would result in a director who has been "defeated" nonetheless continuing to serve on the board.[**]

There are many variations of the majority-voting theme that various public companies have adopted. The Pfizer system described above can be called a "true majority" system because the actual requirement to be elected as a director in an uncontested election is a majority vote by the shareholders. In contrast, some majority-voting systems should be called "plurality plus" because they still use plurality voting as the standard for election to the board, but then require directors who receive more "withhold" votes than "yes" votes to submit a resignation (which could then be rejected by the board). Other variations exist. As the careful reader will have noticed, due to the board's ability to fill vacancies with persons it chooses, none of the systems described above always prevent a director who received more "against" or "withhold" votes than "for" votes from serving on the board. At this point, it seems unlikely that many companies will adopt a majority voting standard that would prohibit a candidate who does not receive majority shareholder support from serving on the board *in all cases*.

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[*] The current directors usually fill vacancies on the board with persons of their choosing, even a director candidate who was not reelected to the board. See MBCA § 8.10(a).

[**] Pfizer's 2015 proxy statement describes its system thusly:

> Under our By-laws and Corporate Governance Principles, Directors must be elected by a majority of the votes cast in uncontested elections …. This means that the number of votes cast "for" a Director nominee must exceed the number of votes cast "against" that nominee. Abstentions and broker non-votes are not counted as votes "for" or "against" a Director nominee. Any [incumbent] nominee who does not receive a majority of votes cast "for" his or her election would be required to tender his or her resignation promptly following the failure to receive the required vote. Within 90 days of the certification of the shareholder vote, the Corporate Governance Committee [of the Board] would then be required to make a recommendation to the Board as to whether the Board should accept the resignation, and the Board would be required to decide whether to accept the resignation and to disclose its decision-making process. In a contested election, the required vote would be a plurality of the votes cast. ***

See also City of Westland Police and Fire Retirement System v. Axcelis Technologies, Inc., No. 594 (Del., Aug. 11, 2010) (upholding dismissal of case in which board had refused to accept resignations from directors who received less than a majority of the votes cast).

Several states, including Delaware (and the MBCA), have recently amended their corporate statutes to facilitate majority voting in the election of directors. See, e.g., MBCA § 10.22 and Sections 141(b) and 216 of the Delaware General Corporation Law. Further, the NYSE recently amended its Rule 452. Previously, that rule had allowed broker-dealers to vote shares owned by customers in the broker-dealers' discretion if (1) the customer did not timely instruct the broker-dealer how to vote the shares and (2) the issue being voted on was a "routine" matter. Traditionally, uncontested elections were considered "routine" matters. Now, uncontested director elections are not considered "routine" matters. Because broker-dealers tended to vote in favor of the candidates nominated by the incumbent board, this rule change eliminates a lot of potential "for" votes for director candidates.

De-Staggering Boards of Directors. Most corporate statutes, including MBCA § 8.06 (which you saw in Chapter 8), allow the board to be staggered into two or three classes. If a board is staggered into three classes, only one-third of the directors will be elected every year and directors will serve three year terms. Historically, most public companies had staggered boards for reasons such as promoting board continuity and making hostile takeovers more difficult.

However, many shareholder activists dislike staggered boards, arguing that because directors would only face election once every two or three years rather than annually, poor performing directors cannot be replaced by the shareholders quickly. Thus, in recent years there have been many Rule 14a-8 shareholder proposals asking that boards de-stagger themselves.[*] Many of these proposals have received high levels of shareholder support, and as a result of this shareholder pressure, by the end of 2013 only 11 percent of the companies in the S&P 500 had staggered boards, down from 52 percent in 2005, and nearly 60 percent in the early 2000s. Today, the figure is approximately 10 percent. With respect to Russell 3000 companies, only about 42% had staggered boards in 2015, compared to nearly 60% in the mid-2000s. Whatever the precise figures, the movement to de-stagger boards has had staggering success (pun intended).

[*] Because most companies with staggered boards have them as a result of provisions in their articles of incorporation, the decision to de-stagger usually rests with the board. As you learned in Chapter 8, although shareholders must vote on articles amendments, they may do so only *after* the board approves the amendment. *See* MBCA § 10.03.

PRACTICE QUESTIONS

The following appendix contains 355 practice multiple-choice questions that will allow you to assess your mastery of the law of business organizations. The questions have been organized as follows:

- **Part 1** contains 75 questions relating to Chapters 1 through 5 (choice-of-entity issues, financial statements, agency law, and partnership law, including LLPs).

- **Part 2** contains 40 questions relating to Chapters 6 and 7 (limited partnerships and limited liability companies).

- **Part 3** contains 62 questions relating to Chapter 8 (basic corporate law).

- **Part 4** contains 55 questions relating to Chapters 9 through 11 (the duty of care, the duty of loyalty, and derivative lawsuits).

- **Part 5** contains 25 questions relating to Chapters 12 and 13 (closely held corporations and controlling shareholders).

- **Part 6** contains 35 questions relating to Chapter 14 (asset sales, mergers, and other significant transactions).

- **Part 7** contains 40 questions relating to Chapters 15 and 16 (securities offerings and insider trading, including Section 16(b)).

- **Part 8** contains 23 questions relating to Chapter 17 (publicly traded companies).

You should study all of the material in the relevant part before attempting the multiple-choice questions in that part because the questions are not necessarily organized by the order in which the topics appear in the textbook.

Please note that these questions are not written in a bar-exam style. Also, I recognize that the format of some of the questions is no longer considered "state of the art." For example, the format of questions such as 1-35, 2-19, and 3-18 (and many others), in which three to five choices labeled with Roman numbers precede the lettered choices (which then give choices like "Only I, II, and III are correct" or "Only II and IV are correct") is, as I understand it, generally frowned upon these days. While I no longer use such a format on actual examinations, I thought it would be fine to leave such questions in this appendix because these questions are primarily a tool for you to use for *self-assessment*.

Speaking of self-assessment, be sure to read the explanations of each question that you attempt, as sometimes you get a multiple-choice question correct for the wrong reason or just by being lucky. ***Answer keys and explanations appear on the following pages.***

- **Part 1** answers and explanations begin on page 381.
- **Part 2** answers and explanations begin on page 404.
- **Part 3** answers and explanations begin on page 420.
- **Part 4** answers and explanations begin on page 436.
- **Part 5** answers and explanations begin on page 455.
- **Part 6** answers and explanations begin on page 463.
- **Part 7** answers and explanations begin on page 474.
- **Part 8** answers and explanations begin on page 486.

PART 1

CHOICE-OF-ENTITY ISSUES, FINANCIAL STATEMENTS, AGENCY LAW, AND PARTNERSHIP LAW

Question 1-1: Belinda and Tina want to open a new business selling sports and camping gear. Belinda and Tina will each be a 50% owner of the business. In addition, they want to make sure that (1) each owner will have an "equal say" in all business decisions, (2) the owners will not have personal liability for the debts and obligations of the business, and (3) the business will be taxed on a "flow-through" basis. Belinda and Tina have asked for your legal advice as to which form of business organization they should choose.

Which of the following is the best advice you could give them?

A. They should form a limited partnership with one owner (either Belinda or Tina) as the general partner and the other owner as the limited partner.
B. They should form a general partnership.
C. They should form an "S" corporation.
D They should form a "C" corporation.

Question 1-2: A and B are the members of AB, LLC, a limited liability company. C and D are the partners of CD, a general partnership. E and F are the shareholders of EF Corp., an "S" corporation. One day, three cars being driven by employees of these three businesses were involved in three separate car accidents. The court in each case determined that each business was liable for the accident in which its employee was involved. However, none of the three businesses has enough assets (or insurance) to pay its liability.

Assuming no other facts, which of the following statements concerning liability is correct?

A. A and B are personally responsible for AB, LLC's liability.
B. C and D are personally responsible for CD's liability.
C. E and F are personally responsible for EF Corp.'s liability.
D. Both A and B are correct.
E. Both B and C are correct.

Question 1-3: Miriam and Chloe are partners in a business that performs lawn care and other landscaping services. One day while mowing a lawn, Miriam negligently injured a customer of the business.

Assuming no other facts, which of the following statements concerning the partners' liabilities is correct?

A. If the business is a limited partnership, then neither Miriam nor Chloe will be personally liable for this tort.

B. If the business is a limited liability partnership (LLP) formed under RUPA, then neither Miriam nor Chloe will be personally liable for this tort.

C. If the business is a limited liability partnership (LLP) formed under RUPA, then Miriam will be personally liable for this tort but Chloe will not be.

D. If the business is a general partnership, then both Miriam and Chloe will be personally liable for this tort.

E. Both C and D are correct.

Question 1-4: Adam and Bob are the founding shareholders of Corporation, Inc., which they incorporated (formed) and qualified as an "S" corporation ten years ago. Today, Corporation has 100 individuals (all of whom are U.S. citizens) as shareholders, including Adam and Bob. XYZ, Inc. wants to become a shareholder of Corporation and has offered to buy all of Adam's shares from him. Following this purchase, Corporation will still have 100 shareholders.

With respect to Corporation's ability to qualify as an "S" corporation, which of the following is correct, assuming no other facts?

A. Corporation will still qualify for "S" corporation status after this transaction because it will still have 100 or fewer shareholders.

B. Corporation currently doesn't qualify for "S" corporation status because it has more than 50 shareholders.

C. Corporation will not qualify for "S" corporation status after this transaction because a corporation cannot be a shareholder in an "S" corporation.

D. Once a corporation qualifies as an "S" corporation, it retains that status forever.

Question 1-5: Partner A and Partner B are the two "50-50" (equal) partners of the AB Partnership. Shareholder C and Shareholder D are the two equal shareholders of CD Corp., a "C" corporation. Last year, the AB Partnership earned $100,000 of income but did not pay any distributions to Partner A or Partner B. Last year, CD Corp. earned $100,000 of income, and also paid $5,000 of dividends to both Shareholder C and Shareholder D.

With amounts must these persons report as taxable income for last year?

A. Partner A and Partner B do not need to report any income. Shareholder C and Shareholder D must each report $5,000 of income.
B. Partner A and Partner B must each report $50,000 of income. Shareholder C and Shareholder D must each report $5,000 of income.
C. Partner A and Partner B do not need to report any income. Shareholder C and Shareholder D must each report $50,000 of income.
D. Partner A and Partner B must each report $50,000 of income. Shareholder C and Shareholder D must each report $50,000 of income.

Question 1-6: A bank is considering making a loan to a business, but wants to make sure that the owner(s) of the business will be personally liable to repay the loan if the business cannot repay it. One common way to ensure that an owner of a business would be liable to pay a business's debt is called a personal guaranty, whereby the person signing the guaranty promises to pay the business's debts if the business does not repay them.

In which of the following business entities would the owner(s) be personally liable to repay the bank loan even if they do <u>not</u> sign a personal guaranty?

A. An "S" corporation.
B. A "C" corporation.
C. An LLC with only one member.
D. An LLC with more than one member.
E. None of the above.

Question 1-7: Which of the following statements concerning financial statements is correct?

A. The value of an asset on a balance sheet is always the fair market value of the asset.
B. All companies are required to follow generally accepted accounting principles (GAAP).
C. All expenses on an income statement were out-of-pocket payments by the company.
D. On a balance sheet, the amount of owners' equity is equal to assets minus liabilities.

Question 1-8: It is January and you are working on Corporation's financial statements for last year. You have properly completed the income statement, which shows that Corporation had $100,000 of income last year. You also know that, as of January 1 of last year, Corporation had $50,000 of cash. In the early part of last year, Corporation bought a machine for $10,000. Machine has an expected useful life of five years, after which it will be worthless scrap. Corporation uses "straight line" depreciation on its financial statements.

Assuming no other facts, Corporation's cash flow statement should show that it had how much cash at the end of last year?

A. $150,000.
B. $142,000.
C. $101,000.
D. $ 40,000.

Question 1-9: Suzy is the sole proprietor of Suzy's Electronics. Arthur is an employee of Suzy's Electronics. When he was hired, Suzy told Arthur that he could quote prices for repair work to customers only for television sets. Matthew came into the shop one day, and Arthur agreed that Suzy's Electronics would fix Matthew's DVD player for $50. Unfortunately, to fix the DVD player Arthur needed to order a part from China which cost more than $50. Together with labor, the actual repair work cost $200.

Which of the following statements is correct?

A. Suzy's Electronics does not have to repair Matthew's DVD player for $50 because Arthur only had authority to agree to repair television sets.

B. Suzy's Electronics does not have to repair Matthew's DVD player for $50 because Arthur was acting outside the scope of his employment.

C. Suzy's Electronics does not have to repair Matthew's DVD player for $50 unless Matthew can prove that he detrimentally relied on Arthur's promise. If he cannot, Suzy's Electronics can charge Matthew the full $200 repair fee.

D. Suzy's Electronics must repair Matthew's DVD player for $50.

Question 1-10: Katherine decided to sell her mint condition 1965 Ford Mustang. Katherine placed an advertisement in the newspaper stating that she would auction off the Mustang on November 20th. Mark saw the advertisement and thought: "Wow, I want that car. But Katherine would never sell that car to me. She hates me." Mark then called his assistant, Ned, and said to him: "Katherine is going to auction off her 1965 Mustang. I want you to go to the auction and bid for the car on my behalf. I want you to go because Katherine would never the sell the car to me directly. You can bid up to $125,000. If she asks, say that you're bidding on behalf of someone else, but don't say who." Ned attended the auction. Beforehand, Katherine asked Ned if he was bidding for himself. Ned said: "I'm here representing a bidder who wishes to remain anonymous. But he has authorized me to bid up to $125,000." Ned was the winning bidder at the auction, bidding $110,000.

Which of the following statements is <u>not</u> correct?

A. Mark is obligated to purchase the Mustang from Katherine for $110,000 because Ned had actual authority.
B. Mark is not obligated to purchase the Mustang from Katherine because Mark was an unidentified principal.
C. Mark is obligated to purchase the Mustang from Katherine for $110,000, but if Mark does not pay, Katherine can recover $110,000 from Ned.
D. Even if Katherine finds out that Mark was the actual purchaser of the Mustang, she is still obligated to sell the Mustang to Mark.

Question 1-11: Same facts as in Question 1-10, except that before the auction Ned revealed to Katherine that Mark was the buyer and Katherine agreed to sell the Mustang even though she did not like Mark. In addition, Katherine explained to Ned that the Mustang was not exactly in mint condition; instead, it needed new brakes and some major repairs to its transmission. Ned, who was annoyed at Mark for constantly insulting him and treating him badly, did not tell this information to Mark before Ned won the auction. When Mark found out about the needed repairs, he tried to rescind the purchase, arguing that he would not have bought the Mustang if he had known about the needed repairs.

Which of the following is correct? Assume that Mark would have a legal right to rescind the contract if Katherine had only revealed the needed repairs to Ned or Mark <u>after</u> the auction.

A. Mark may not rescind the contract because a fact known by an agent is always considered to be known by the principal.
B. Mark may rescind the contract because his agent Ned has breached his fiduciary duties to him.
C. Mark may not rescind the contract, but he does have a cause of action against Ned for the cost of the repairs.
D. Mark may rescind the purchase because he did not have actual knowledge of the needed repairs.

Question 1-12: Hank was the sole proprietor of Hank's Groceries. Hank hired Frank Jones as an employee to stock groceries on shelves and perform other odd jobs at the store. One day, after Frank had stocked several dozen cans of soup on shelves, a customer, Wanda, was severely injured after soup cans crashed down on her as she was reaching for a can of cream of broccoli soup. Wanda sued for her injuries on a negligence theory, seeking $1 million in damages.

If Hank can prove that (1) he had instructed Frank to be extremely careful in stocking soup cans but that Frank had ignored Hank's instructions and (2) the assets of Hank's Groceries are far less than $1 million, will Hank be personally liable for all or part of Wanda's claim?

A. No, because Frank ignored Hank's instructions and therefore was outside the scope of his employment.
B. No, because Hank is not liable for any debts of the business beyond the assets of the business.
C. Yes.
D. Yes, but only if Wanda can prove that Hank negligently trained Frank.

Question 1-13: Garth is a clerk in the shipping department of Empire, Inc. ("Empire"), which manufactures machine guns and other military products. Garth's job description in Empire's employee handbook provides that he is responsible for arranging transportation of Empire's products to customers. A large sign on the wall in Empire's shipping department states that "Shipping clerk may not approve shipping contracts in excess of $3,000 without supervisor approval." However, the sign is incorrect—Empire's employee handbook was recently revised to state that Garth may not enter into any shipping contracts in excess of $2,000 without approval from his supervisor. Garth has read the new employee handbook. One day, Mr. Rumsfeld, an employee of Axis, Inc. ("Axis"), visited Empire's shipping department and met with Garth. After a long discussion with Mr. Rumsfeld, Garth signed two contracts with Axis on Empire's behalf, on forms supplied by Mr. Rumsfeld. Contract #1 obligated Empire to purchase ten copy/fax machines from Axis for $4,000. Contract #2 provided that Axis would transport a shipment of 5,000 of Empire's machine guns to an Army base in Iowa for a fee of $2,500. When Garth's manager learned of these contracts, she wanted to cancel both of them.

Which of the following statements is most likely correct?

A. Empire is bound on both contracts.
B. Empire is bound on neither contract.
C. Empire is bound on Contract #1 but not Contract #2.
D. Empire is bound on Contract #2 but not Contract #1.

Question 1-14: Brett is a purchasing agent for Nell's Restaurant, a sole proprietorship. Because he tends to exceed his authority, Brett was expressly forbidden by the owner of the restaurant, Nell, to ever deal with Drew, a beer distributor. The prohibition, however, did not deter Brett; he continued to buy beer from Drew anyway. When Nell found out about Brett's insubordination, she fired him and then promptly informed Drew that all sales were off and that Drew would not be paid since Brett had no authority to buy beer from Drew.

In determining the scope of Brett's apparent authority to bind Nell's Restaurant to Drew, which of the following would <u>not</u> be important?

A. Nell's description to Drew of Brett's position in Nell's Restaurant.

B. A reaction of silence by Nell when Brett had made similar agreements in the past with Drew.

C. The express limitation placed on Brett's authority which Drew did not know about.

D. None of the above.

Question 1-15: Samantha, a rich antique collector, hired Zelda to buy for her a very rare and expensive portrait of Winston Churchill from Clive. Zelda and Samantha did not execute a written agreement since they had worked with each other in the past and they trusted each other. Clive was not to be told that Zelda was an agent for Samantha since that would greatly increase the portrait's price. Zelda told Clive that she was buying the portrait on behalf of a client, but did not reveal to Clive that her client was Samantha. Clive agreed to sell the portrait.

Which of the following is most correct?

A. Clive may, if he wishes, void the contract once he learns that Samantha is the principal.

B. Zelda's contract is void since an agency agreement with an undisclosed principal must be in writing.

C. Since Zelda did not tell Clive for whom he was buying the portrait, Samantha cannot be liable.

D. If neither Zelda nor Samantha pay Clive the agreed upon price after Clive delivers the portrait, Clive may sue Zelda even though Zelda was acting on Samantha's instructions.

Question 1-16: In which of the following circumstances will an agent <u>not</u> be personally liable to the third party with whom the agent deals?

A. If an agent with actual authority enters into a contract with the third party on behalf of an undisclosed principal.
B. If an agent with actual authority enters into a contract with the third party on behalf of an unidentified principal.
C. If an agent with actual authority enters into a contract with the third party on behalf of a disclosed principal.
D. If an agent commits a negligence-based tort while employed by the principal.

Question 1-17: Pete is the sole proprietor of Pete's Exotic Wines and Cheeses, a specialty food store. Previously, Pete often traveled around the world, looking for new wines and cheeses to sell at his store. However, Pete had a heart attack last year, and his doctor advised him not to travel any longer. Afterwards, Pete hired Annie to work at his store and to assist him in ordering products. One day, Pete asked Annie if she would like to travel to the Bordeaux region of France to "scout out" new products for the store and order them from merchants. Annie, who had never been to France, was delighted to go. Unfortunately, when she got to France on May 15th, Annie realized that very few of the wine and cheese merchants there spoke English and that the French that she had learned in school didn't help much. Annie hired Marcel, an interpreter, to assist her in negotiating with various French merchants. Marcel did not know that Annie worked for Pete.

Will Pete be liable to pay Marcel's fees?

A. Yes, because Pete will be estopped from denying liability.
B. Yes, because Annie had apparent authority.
C. Yes, because Annie had actual express authority.
D. Yes, because Annie had actual implied authority.
E. No.

Question 1-18: Same facts as in Question 1-17. On May 20th, Annie signed a contract with Claude, a French winery owner, to purchase 300 cases of Claude's wine. Annie did not reveal to Claude that she was acting on behalf of Pete (or anyone else, for that matter). Unfortunately, Pete had died from another heart attack on May 19th. Annie did not learn of Pete's death until May 21.

Is Pete's estate bound to purchase these cases of wine from Claude?

A. No, because Pete died before the contract was signed.
B. No, because Pete was an undisclosed principal.
C. Yes, but Pete's estate will be able to recover damages from Annie.
D. Yes.

Question 1-19: Principal hired Agent to sell Principal's race horse and gave Agent a written "power of attorney," which stated that it was irrevocable for one year, to sell the horse. After a few weeks, Principal changed his mind and told Agent that he was terminating Agent's power to sell the horse.

Which of the following is correct?

A. Because the power of attorney was stated to be irrevocable, Principal's attempt to terminate the agency was not legally effective, and Agent continues to have actual express authority to sell Principal's horse.

B. Because the power of attorney was in writing, any termination of it must also be in writing.

C. Agent continues to have actual implied authority to sell Principal's horse.

D. Agent no longer has either actual express or actual implied authority to sell Principal's horse.

Question 1-20: Jack authorized Joan to solicit orders on behalf of Jack, but did not give her authority to grant discounts or to collect payments on orders which she solicited. Joan then granted to Frank a 10% discount based on Frank's agreement to make immediate payment on his $10,000 order. Frank had previously dealt with Jack through Joan, but this was the first time he had been offered a discount. Frank gave Joan a check for $9,000 (reflecting the 10% discount on his $10,000 order). Joan then gave Jack the check and the order, which clearly reflected the discount. Jack shipped the order and cashed Frank's check. Jack then attempted to collect $1,000, which Jack alleged is the balance due on Frank's order.

Which of the following is correct?

A. Jack can collect $1,000 from Frank because Joan contracted outside the scope of her authority.

B. Jack cannot collect the $1,000 from Frank because Jack ratified the discount given by Joan.

C. Jack cannot collect the $1,000 from Frank because Joan will be held to have had implied actual authority to provide discounts and collect payment.

D. None of the above is correct.

Question 1-21: Nikola Motors, Inc. ("Nikola") manufactures electric automobiles. Ellen Mask is the President of Nikola. As heavily reported in the media, Nikola is currently looking at several potential locations in Texas, Arizona, and New Mexico to build a $5 billion battery factory. Each of these cities would greatly desire that Nikola build the factory there. On March 17, Ellen checked in at the Windsor Hotel (the "Hotel"), a nice hotel in Houston. When she registered at the front desk of the Hotel, Ellen explained to the Hotel's manager that she was the President of Nikola and that she was in town to discuss business with the mayor, but that she had lost her company credit card. The Hotel's manager, who was familiar with what Ellen looked like, then went to his office and called Nikola's headquarters to speak to Ellen's secretary, but was told that Ellen was travelling for business and that her secretary was also unavailable. The manager then came back to the front desk and agreed to send the bill for Ellen's room to Nikola at its headquarters in California. Ellen's room charges added up to $750.

The next morning, Ellen had disappeared. As the Hotel later learned, the person who stayed at the Hotel was not actually Ellen, but an imposter who looked just like her.

If the Hotel sues Nikola to recover the hotel charges, what is the likely outcome?

A. The Hotel will win because it had a reasonable belief that the person staying at the Hotel was Ellen.

B. The Hotel will win because it had a justifiable belief that the person staying at the Hotel was Ellen and the Hotel detrimentally relied on this belief.

C. The Hotel will win on an apparent authority theory.

D. The Hotel will lose.

Question 1-22: Player hired Agent as his sports agent to represent him in negotiations with an NBA team. Player told the team that Agent had full authority to represent him in the salary negotiations. Agent began negotiating a salary for Player. While negotiations were ongoing, Player indicated to Agent that he would not accept less than $1 million. Agent negotiated the best deal he possibly could for Player for an $800,000 salary.

Is Player bound by the $800,000 contract?

A. Yes.
B. Yes, but only if Player ratifies the contract.
C. No.
D. No, but Agent is liable to the NBA team for damages.

Question 1-23: Dr. Pain and Dr. Ouch are partners in a general partnership that operates a medical practice. The partnership hired a physician's assistant (the "PA") to help with the medical practice and treat patients. Without either doctor's knowledge, the PA misdiagnosed a common malady for a rare type of cancer and prescribed an untested drug for a patient. Unfortunately for the patient, this mistake was fatal.

Which of the following best describes the partnership's and the doctor/partners' liability if the PA is found negligent for this mistake?

A. The partnership and the doctor/partners are liable for the PA's actions.

B. The partnership is liable for the PA's actions, but neither doctor is liable unless she failed to supervise the PA adequately.

C. Neither the partnership nor either doctor will be liable unless the PA was reckless.

D. Neither the partnership nor either doctor will be liable because the PA was the tortfeasor.

Question 1-24: Paul is a land developer. Adriana works as Paul's agent. Without Paul's prior approval, Adriana signed a contract on Paul's behalf to buy land from Tammy. During negotiations, Adriana assured Tammy that she had Paul's authority to buy the land. At the time the contract was executed, Paul had not given Adriana actual authority to buy Tammy's land. Moreover, Paul had done nothing to lead Tammy to believe that Adriana had authority to act on his behalf. Nevertheless, after Paul found out about the contract and its material terms, he was thrilled. Paul immediately sent a letter to Tammy expressly ratifying the contract. Later, Tammy refused to sell the land to Paul.

If Paul sues Tammy for breach of contract, which of the following is correct?

A. Tammy will prevail, because Adriana lacked actual and apparent authority to bind Paul to the contract.

B. Tammy will prevail, because Paul was undisclosed at the time the contract was executed.

C. Paul will prevail, because Paul properly ratified the contract.

D. Paul will prevail, because Adriana had apparent authority to bind Paul to the contract.

Question 1-25: Which of the following choices is not true about an agency relationship?

A. Termination of the agency relationship is effective only if principal and agent both consent.
B. The agent must be subject to the principal's control
C. The agent has a fiduciary duty to the principal.
D. The agent acts on behalf of the principal and not herself.

Question 1-26: DFP Dentists is a general partnership with three partners: Dr. Drill, Dr. Fill, and Dr. Pain. Dr. Drill and Dr. Pain have been partners in the partnership since 2010. Dr. Fill joined the partnership in 2015. Pam the Patient filed a lawsuit against DFP Dentists and the three dentists individually. Pam claims that Dr. Pain negligently performed a root canal on her in 2014 and that, as a result, Pam now cannot chew food. The following motions were later filed in court:

Motion #1: DFP Dentists filed a motion to dismiss Pam's lawsuit on the basis that DFP Dentists is not responsible for torts that are committed by its partners.

Motion #2: Dr. Drill filed a motion to dismiss the lawsuit against him individually because he was not responsible for Pam's injury and therefore will never have any liability to Pam.

Motion #3: Dr. Fill filed a motion to dismiss the lawsuit against him individually because he is not personally liable for an event that took place before he joined the partnership.

What is the likely disposition of these motions?

A. All three motions will be denied.
B. All three motions will be granted.
C. Motion #1 will be granted; the other two motions will be denied.
D. Motion #2 will be granted; the other two motions will be denied.
E. Motion #3 will be granted; the other two motions will be denied.

Question 1-27: Cheryl and Lance formed a partnership to run a clothing store. Some time later, Lance sold his partnership interest to Alex.

Which of the following is correct?

A. Lance may not sell any part of his partnership interest unless Cheryl consents.

B. Lance is still a partner, but Alex now has the right receive distributions that Lance otherwise would have received.

C. Alex is now a partner, but he cannot vote on any partnership matters.

D. Lance's attempted sale of his partnership interest is an act of dissociation or withdrawal; thus, Lance is no longer a partner.

Question 1-28: Jason and Denard are partners and have a partnership agreement that states: "No partner shall be personally liable for the debts or obligations of the partnership." The partnership borrowed money from National Bank. Jason signed the loan agreement on behalf of the partnership. The partnership later defaulted on its obligation to repay the loan.

Upon obtaining judgment(s) against the partnership, Jason, and Denard, which of the following best describes how the bank may proceed?

A. The bank may only collect from the partnership because the partnership agreement provides that Jason and Denard are not personally liable.

B. The bank has the choice of collecting either from Jason, because he signed for the loan, or from the partnership.

C. The bank has the choice of collecting from Jason and/or Denard provided that the partnership's assets are not sufficient to repay the loan.

D. The bank has the choice of collecting from any of Jason, Denard, or the partnership.

E. The bank may only collect from Jason, because the loan was not approved by Denard and therefore was not binding on Denard or the partnership.

Question 1-29: Tara, Pepe, and Avey are partners, but do not have a partnership agreement. For the most recent year, the partnership had a profit of $18,000. Tara and Pepe want the partnership to distribute $5,000 to each of the three partners and retain $3,000 in the partnership for future growth. Avey wants the partnership to distribute $6,000 to each of the partners.

What will be the result?

A. No distributions will be made.
B. $5,000 will be distributed to each of the partners.
C. $6,000 will be distributed to each of the partners.
D. $5,000 will be distributed to each of Tara and Pepe, and $6,000 will be distributed to Avey.

Question 1-30: Yogi and Zelda are partners. Their partnership is currently insolvent, as is Yogi individually. However, Zelda has enough assets to pay all of Yogi's personal debts as well as the partnership's debts.

Which of the following statements is correct?

A. Zelda is jointly and severally liable with Yogi for Yogi's personal debts.

B. Zelda is jointly and severally liable with Yogi to partnership creditors to the extent that their claims exceed the remaining partnership assets.

C. Partnership creditors cannot recover against Zelda's personal assets beyond the amount that she contributed to the partnership.

D. None of the above is correct.

Question 1-31: Andre, Betty, Chuck, and Diane decided to form a partnership called "ABCD" to produce videogames. They did not have a partnership agreement that changes any of the rules of RUPA. Because Andre was wealthy, he contributed $990,000 of "seed money" to ABCD. Betty, Chuck, and Diane did not have much cash, but they were all computer experts and agreed to work full time at ABCD designing videogames. Andre was hesitant about being the only owner to contribute cash to the business, so he persuaded the other partners each to contribute $3,333.33 (for a total of almost $10,000) in "seed money" to ABCD (which they did). In its second year of operations, ABCD made a profit of $100,000. Andre, eager to get some of his seed money contribution back, wanted ABCD to distribute that money to the four owners. Betty, Chuck, and Diane opposed the distribution because they believed that ABCD should re-invest its profits in additional computer equipment to produce a new videogame that they wanted to design. Outraged, Andre yelled "I put in almost all the money! I can do what I want and force the business to distribute the money to me."

Is Andre correct?

A. Yes, because the voting power of the four owners is determined by the amount of money that they contributed to ABCD; thus, Andre can outvote the others 99 to 1.

B. Yes, because distributions are shared by the four owners based on the amount of money that they contributed to ABCD; thus, Andre will receive 99% of the profits and the other partners will receive 1%.

C. Both A and B are correct.

D. No, Andre is not correct.

Question 1-32: In January 2016, A, B, and C went into business as partners to run a nightclub, but did not have a partnership agreement. When the partnership was formed, A contributed $5,000, B contributed $5,000, and C contributed $10,000. The partnership incurred a $15,000 loss during 2016. It made a profit of $90,000 in 2017, and a profit of $120,000 in 2018. In 2016 and 2017, no partner took a distribution from the partnership. In 2018, A took a $50,000 distribution, B took a $40,000 distribution, and C took a $50,000 distribution.

As of the end of 2018, what are the balances in the partners' respective partnership accounts? APPLY THE 1997 VERSION OF RUPA (see page 94 of the textbook).

A. A's account is $65,000; B's account is $65,000; and C's account is $65,000.
B. A's account is $20,000; B's account is $30,000; and C's account is $25,000.
C. A's account is $25,000; B's account is $35,000; and C's account is $30,000.
D. A's account is $20,000; B's account is $30,000; and C's account is $20,000.

Question 1-33: Tenant was a sole proprietor. Landlord and Tenant agreed that Tenant would lease space from Landlord in which Tenant would operate his small engine repair business. The terms of the lease called for Tenant to pay Landlord $1,000 in rent each month, together with 5% of Tenant's revenues for that month (i.e., payments from customers that Tenant received in that month). In addition, Tenant was required to store all hazardous materials in full compliance with all environmental laws and needed Landlord's approval to use any chemicals not on a list of chemicals that was attached to the lease agreement. Later, Customer was injured by a lawnmower that Tenant had negligently repaired. Customer seeks to sue Landlord for these injuries, claiming that Landlord was a partner with Tenant.

What is the likely result of Customer's claim?

A. Customer will lose, because RUPA states that landlords are not considered to be partners with their tenants.

B. Customer will lose, because the facts of the case indicate that Landlord was not a partner with Tenant.

C. Customer will win, because Landlord will be presumed to be a partner with Tenant on these facts, and will not be able to rebut that presumption.

D. Customer will win, because the facts of the case indicate that Landlord was a partner with Tenant.

Question 1-34: Under RUPA, the primary test to determine whether a partnership exists is:

A. whether the partnership's profits are allocated equally among the partners.
B. whether the partners have equal rights to manage the partnership.
C. whether the partners are sharing profits.
D. whether the partners own the partnership's assets.
E. whether the partnership is profitable.

Question 1-35: Mr. Brown, Mr. Blue, and Mr. Pink formed a partnership. Mr. Brown, who contributed most of the "start up money," insisted that the three partners enter into a written partnership agreement that included the following provisions:

I. On all matters in the ordinary course of business, Mr. Brown shall have 10 votes and Mr. Blue and Mr. Pink shall have 1 vote each.

II. The admission of a new partner to the partnership shall require the unanimous consent of all of the partners.

III. No partner may withdraw (dissociate) from the partnership without the consent of all of the partners.

IV. The partnership shall continue until the partners vote to dissolve it.

Which of the above provisions of the partnership agreement (if any) are permissible under RUPA?

A. I and II only.
B. I, II, and IV only.
C. II and III only.
D. II and IV only.

Question 1-36: Betty, Tammy, and Sue orally decided to form a partnership to operate a hair salon. Betty specialized in a haircut called the "Mohawk," Tammy specialized in a haircut called the "Mullet," and Sue specialized in a haircut called the "Comb Over." Things went well for several years until Sue became ill from inhaling harmful fumes from hair dye. Unable to pay enormous medical bills, Sue sold her interest in the partnership to Bill, who also specialized in "Comb Over" haircuts. Bill arrived at the hair salon the following day, informed Betty and Tammy that he was their new partner because he bought Sue's interest in the partnership, and started cutting a client's hair. Betty and Tammy then called you for advice, because they immediately disliked Bill and did not want to be partners with him.

Which of the following would be correct advice you could give Betty and Tammy?

A. As a transferee of Sue's partnership interest, Bill has no right to participate in the partnership business without the consent of Betty and Tammy.
B. Bill cannot be admitted as a new partner in the partnership without the consent of Betty and Tammy.
C. Bill is entitled to Sue's distributions from the business, even if Betty and Tammy do not consent.
D. All of the above are correct.

Question 1-37: The Downtown Rockers is a rock band that has been formed as a partnership. The members are Mick (vocals), Rocco (Guitar), Little Joe (bass), Big Steve (keyboards), Brutus (drums), and Jeremy (manager). There is no partnership agreement, except that the partners have agreed that Jeremy will be paid 10% of any distributions and the other five partners will each be paid 18% of any distributions. The partnership owns a van and various amplifiers, equipment, and musical instruments.

Which of the following statements is correct?

A. When the partners must vote on something, Jeremy will have 10 votes and each of the other partners will have 18 votes.
B. If Jeremy signs a contract to have the partnership play at Madison Square Garden, the partnership can refuse to perform if the contract wasn't approved by the other partners.
C. Rocco has the right to use the partnership's van to help his mother move into a new house.
D. Little Joe must obtain approval from the partnership to sell the bass guitar that he plays.

Question 1-38: Same facts as Question 1-37. ***Which of the following statements is true about Little Joe's rights with respect to the partnership?***

A. Little Joe's approval would not be needed to admit a new partner to the partnership, assuming that a majority of the current partners vote to admit the new partner.
B. Little Joe's creditors can seize partnership property to satisfy Little Joe's personal debts.
C. Little Joe has a "veto power" over partnership decisions that are outside the ordinary course of business.
D. Little Joe will be liable for partnership debts only to the extent that he has made contributions to the partnership.

Question 1-39: Same facts as Question 1-37. One day, Brutus was driving the partnership's van after having imbibed too many alcoholic beverages. The police and the court system found that Brutus's driving was reckless.

Which of the following statements is true?

A. Brutus has breached his fiduciary duty of loyalty to the partnership.
B. Brutus has breached his fiduciary duty of care to the partnership.
C. Both A and B are correct.
D. Brutus did not breach his fiduciary duties to the partnership unless he is found to have engaged in a knowing violation of law.

Question 1-40: Same facts as Question 1-37. Rocco wants to start a "side project," that is, a new rock band with some of his other friends, while remaining a member of the Downtown Rockers. The other partners are opposed to this idea because they believe that Rocco's new band would result in the Downtown Rockers getting fewer "gigs."

Which of the following statements is most likely true?

A. Rocco is free to start a new band while remaining a member of the Downtown Rockers because partners are not required to devote their full-time efforts to the partnership.
B. Rocco is free to start a new band while remaining a member of the Downtown Rockers as long as he is still available to play at any gigs that the Downtown Rockers have.
C. If Rocco writes a new song, he must give the Downtown Rockers a right of first refusal to use it.
D. If Rocco quits the Downtown Rockers, then he may join the other band.

Question 1-41: Kate has for many years been a "silent partner" in a partnership, which does not have a partnership agreement under RUPA. Recently, however, Kate has decided she wants to take a more active role in the partnership's affairs.

Which of the following is correct?

A. Kate's vote will be proportional to her capital contribution to the partnership.
B. Kate has an equal voice in the partnership management regardless of her capital contribution.
C. Even ordinary partnership decisions require unanimous agreement by the partners.
D. Admitting a new partner requires a 75% vote by the current partners.

Question 1-42: Clark and Helen opened a restaurant as partners and together managed the day-by-day operations of their restaurant. One day, Clark, while driving to work, was severely injured in an accident and was unable to work for six months. Meanwhile, to save money, Helen performed Clark's normal duties at the restaurant. Since they had been friends for years and trusted each other, Clark and Helen did not have a partnership agreement under RUPA.

Can Helen receive a salary for performing Clark's job?

A. She may receive a salary based on a fair market value of Clark's services.
B. She may not receive a salary for filling in for Clark unless Clark agrees.
C. She may receive a salary if she can prove she is devoting substantial time to the business and that Clark's inactivity was unexpected.
D. She may not receive a salary unless her capital contribution exceeds one-half the total of all contributions to the partnership.

Question 1-43: Allen, Beth, and Carol are partners in a hardware store. The three partners have previously discussed selling the business, but have not made a final decision. One day, Carol received an offer to sell all of the partnership's inventory to Dave. Carol thought that the offer was excellent, but could not contact her partners to inform them. Fearing Dave would revoke the offer, Carol signed the contract conveying the partnership's inventory to Dave. Upon hearing of the deal later, Allen and Beth are angry and do not wish to sell the inventory to Dave.

Under RUPA, the partnership:

A. is not bound by Carol's actions.
B. is bound by Carol's actions.
C. is bound if an appraiser determines that the price is reasonable.
D. is bound unless Dave knew Carol had not contacted Allen and Beth before signing the contract.

Question 1-44: The partnership agreement of Real Estate Partners provides that "No partner may, without the written consent of the other partners, enter into any real estate transaction, including any sale of real property, on behalf of the partnership." Real Estate Partners owns 100 parcels of real estate and regularly buys and sells property. Adam, a partner, signed a contract on behalf of the partnership to sell a small piece of property to a buyer (the "Buyer"). Before signing the contract, the Buyer checked the office of the county register of deeds for any filings made by the partnership, but found none. However, now the partnership wants to avoid the sale.

Which one of the following statements is most likely correct?

A. The partnership has no liability because the Buyer had a duty to ask for the partnership agreement, which would have shown Adam's lack of authority.

B. The partnership is liable because it failed to register its partnership agreement with the county clerk's office as required under RUPA § 303.

C. The partnership is not liable because of the language contained in the partnership agreement.

D. The partnership is liable but could have avoided liability if it had put the public on notice of Adam's lack of authority by filing a certificate of authority with the secretary of state and the county register of deeds.

Question 1-45: Person 1 runs a business. Person 2 has some sort of a business relationship with Person 1, but it is not clear whether Person 2 is a partner with Person 1.

In deciding whether Person 2 is a partner with Person 1, which of the following is <u>not</u> an important factor for a court to consider?

A. Whether Person 2 is receiving a share of the revenues of the business.

B. Whether Person 2 is receiving a share of the profits of the business.

C. Whether Person 2 has the power to make decisions for the business.

D. Whether Person 2 has made a contribution of money or other property to the business.

Question 1-46: A, B, C, and D are partners of a partnership. The partners do not have a partnership agreement, except that they did agree that Partner A will be paid 40% of any distributions paid by the partnership and that each other partner will be paid 20% of any distributions. Further, when the partnership was formed, Partner A contributed $30,000 and each other partner contributed $10,000.

Which of the following statements is correct?

A. When the partners must vote on something, each partner has an equal vote.

B. When the partners must vote on something, Partner A has <u>two</u> votes, and each other partner has <u>one</u> vote.

C. When the partners must vote on something, Partner A has <u>three</u> votes, and each other partner has <u>one</u> vote.

D. It doesn't matter how many votes each partner has, because all partnership decisions must be made unanimously.

Question 1-47: Larry, Moe and Curly are partners who run Stooges Bar. Larry was given express authority to order $5,000 worth of liquor per month. Each month from January to August, Larry ordered $5,000 of liquor from Bill's Beverages. Each time, Bill's sent a $5,000 monthly bill to Stooges, Moe promptly paid the bill. During a September meeting between Larry, Moe and Curly, Curly complained that Larry was not doing a good job ordering the liquor and wanted to order it himself. In the vote on this proposal, Moe and Curly voted that Curly would order the liquor starting in September. (Larry voted no.) Larry was upset at this lack of confidence by his partners and still went ahead and ordered $5,000 worth of liquor from Bill's in September, which Bill's delivered. When Bill's sent a $5,000 bill to Stooges for Larry's September order, Moe refused to pay the bill. Bill's brought suit against the partnership for payment.

Assuming no other facts, what is the likely result of such suit?

A. The partnership will win the case because Larry no longer had actual authority to make the September order.

B. The partnership will win the case because Bill's was required to determine, in advance, whether Larry was authorized to make the September order.

C. Bill's will win the case unless it had been notified that Larry no longer had authority to make the September order.

D. Bill's will win the case because it would take a unanimous vote by the partners to change who had authority to order the liquor.

Question 1-48: A, B, C, and D are partners of a partnership that operates a restaurant. Partner B negligently injured a customer. The customer sued the partnership, as well as all four partners. The jury determined that Partner B was negligent and that this negligence caused the customer's injuries. Thus, the customer won the case, and was awarded $20,000 in damages. The partnership has $400,000 of assets, including $60,000 in cash.

Assuming no other facts, which of the following statements is correct?

A. The customer may collect the entire $20,000 from any partner.

B. The customer may only collect a maximum of $5,000 from each partner.

C. The customer must first "exhaust" partnership assets before he may collect from any partner.

D. The customer may collect the entire $20,000 from Partner B or the partnership.

E. The customer may <u>only</u> collect from Partner B.

Question 1-49: Robert, Sam, and Toni formed a partnership to build and manage a health club, but did not have a partnership agreement. After construction started but before the health club was finished, Robert told Toni he quit the partnership.

Which of the following is correct?

A. Robert may not dissociate until the health club is completed; thus, he is still a partner.
B. Robert's dissociation is wrongful because this is a partnership for a term or undertaking, but the partnership will continue in existence.
C. Robert's dissociation is wrongful because this is a partnership for a term or undertaking, but the partnership will dissolve.
D. Robert's dissociation will cause the partnership to dissolve.

Question 1-50: After many years as a partner, Partner A has decided to retire from the ABC partnership (which until now had consisted of Partners A, B, and C). Assume that this dissociation did not cause the dissolution of the partnership.

As a former partner, Partner A:

A. Remains liable for the partnership's debts that were incurred before her dissociation, unless the partnership agrees to release her.
B. Remains liable for the partnership debts that were incurred before her dissociation, unless the partnership creditors agree to release her.
C. Remains liable for the partnership debts that were incurred before her dissociation, unless both the partnership and the partnership creditors agree to release her.
D. None of the above.

Question 1-51: Last year, Rich, Devin, Peter, and Roxanne formed a partnership to run a nightclub. The partners agreed that the partnership would have a six-year term, but did not otherwise have a partnership agreement. This year, Devin filed bankruptcy. Also this year, the partners obtained a court order expelling Peter from the partnership because he was sexually harassing nightclub employees, many of whom had either quit working for the nightclub or threatened to sue.

Which of the following is correct?

A. Devin has not dissociated; Peter's dissociation is wrongful.
B. Both Devin's dissociation and Peter's dissociation are wrongful.
C. Neither Devin's dissociation nor Peter's dissociation is wrongful.
D. Devin's dissociation is wrongful, but Peter's dissociation is not wrongful.
E. Peter's dissociation is wrongful, but Devin's dissociation is not wrongful.

Question 1-52: Same facts as the previous question, except that the partnership was an at-will partnership.

Which of the following is correct?

A. Devin has not dissociated; Peter's dissociation is wrongful.
B. Both Devin's dissociation and Peter's dissociation are wrongful.
C. Neither Devin's dissociation nor Peter's dissociation is wrongful.
D. Devin's dissociation is wrongful, but Peter's dissociation is not wrongful.
E. Peter's dissociation is wrongful, but Devin's dissociation is not wrongful.

Question 1-53: Larry, Mary, Nancy, Otis, and Paul formed a partnership to operate a hotel. Because the partners were good friends, they did not hire an attorney to draft a partnership agreement. However, Paul, who had attended law school for a year, thought it would be a good idea to write down two issues that the partners had discussed. To that end, Paul wrote the following on a piece of paper, which was an accurate reflection of what all the partners had orally agreed.

> *El-Em-En-Oh-P Partnership Agreement: The partners agree that the partnership shall operate a hotel for 10 years. The partnership may not hire an employee or make an expenditure of more than $1,000 without the consent of all the partners.*

Only Paul signed this piece of paper.

A few months later, four of the partners wished to hire an employee, Bob, to be the hotel's manager. However, Nancy strongly objected and told the other partners that if they hired Bob, she would quit the partnership. The next day, the other partners hired Bob to be the manager of the hotel. Later that day, Nancy told Otis: "I quit."

Which of the following statements is correct? You may assume that the decision whether to hire an employee is a matter in the "ordinary course of business."

A. The partners validly hired Bob by a majority vote.
B. By informing Otis that she was quitting the partnership, Nancy dissociated from the partnership, but her dissociation will not cause a dissolution of the partnership.
C. By informing Otis that she was quitting the partnership, Nancy dissociated from the partnership, and her dissociation will cause a dissolution of the partnership unless at least two of the remaining partners decide to continue the business within 90 days.
D. By informing Otis that she was quitting the partnership, Nancy dissociated from the partnership, and her dissociation will cause a dissolution of the partnership unless at least three of the remaining partners decide to continue the business within 90 days.

Question 1-54: Don, Paul, and John went into business as partners to run an automobile repair business. The three partners did not have a partnership agreement, nor did they agree that the partnership would exist only for a specific period of time. Upon formation, the partnership obtained a $100,000 loan from Last National Bank (the "Bank") which it used to buy equipment. Don, Paul, and John each signed documents personally guaranteeing the repayment of this loan. The loan agreement required the partnership to make monthly payments of interest, and fully pay off the loan in five years. The partnership also signed a lease with Slumlord Corp. ("Slumlord"). The lease required monthly rent payments for three years. No partner signed a guaranty of the lease.

Two years later, Paul was involved in a serious automobile accident. Although he did not die, doctors determined that Paul would never regain consciousness, and would remain in a coma. A short time later, the probate court appointed Paul's wife Marie as Paul's guardian and conservator. Paul currently remains alive, but in a coma on life support machines.

Which of the following statements is correct?

A. The appointment of Marie as Paul's guardian and conservator dissolved the partnership.
B. The appointment of Marie as Paul's guardian and conservator dissolved the partnership, unless both Don and John voted to continue the partnership within 90 days.
C. The appointment of Marie as Paul's guardian and conservator did not dissolve the partnership, but it did result in Paul's dissociation from the partnership.
D. The appointment of Marie as Paul's guardian and conservator did not dissolve the partnership, but it does mean that Marie replaces Paul as a partner.

Question 1-55: Same facts as the previous question. Regardless of how you answered the previous question, assume that the appointment of Marie as Paul's guardian/conservator dissolved the partnership.

In that case, which of the following statements would be correct if the partnership does not have enough assets to pay its liabilities?

A. The three partners will be liable to repay the loan to the Bank, but not the remaining rent payments to Slumlord.
B. The three partners will be liable to repay both the loan to the Bank and the remaining rent payments to Slumlord.
C. The three partners will not be liable to repay either the loan to the Bank or the remaining rent payments to Slumlord.
D. Don and John will be liable to repay both the loan to the Bank and the remaining rental payments to Slumlord, but Paul will only be liable for payments that would be due within the next three years.

Question 1-56: Green, Cash, and Loot is a large law firm that has 300 partners, including Sally. It has a detailed partnership agreement, but the agreement does not contain any provisions concerning dissociation or dissolution. One day, Sally went into the managing partner's office and said: "I quit."

Which of the following is correct?

A. Sally has dissociated, but the partnership will not dissolve because her notice was not in writing.

B. Sally has dissociated, but the partnership will not dissolve if it pays her cash equal to that amount she would get if the partnership were liquidated and its assets were sold at a price equal to the greater of liquidation value or the value based on a sale of the entire business as a going concern without her as a partner, minus any damages caused by her dissociation. The deadline for payment is within 120 days.

C. Same as Answer B, except that the deadline for payment is within one year.

D. Sally has dissociated, and her dissociation will cause the partnership to dissolve unless she and all of the others partners agree that it will not dissolve.

Question 1-57: Same facts as the previous question. Regardless of how you answered the previous question, assume for purposes of this question that the partnership did <u>not</u> dissolve when Sally dissociated from it. Four months later, Sally was walking down the street when she saw Sam, who was the owner of a sole proprietorship that supplies the law firm's paper and office supplies. Sam and Sally had known each other for several years, but Sam did not know that she had quit the partnership. Sam asked Sally whether the partnership wanted to continue its supply contract with Sam's business for an additional year. She replied: "Sure, if you give us a five percent discount." Sam agreed.

Assuming no other facts, and that there are no statutes of frauds issues in this problem, is the partnership bound on this contract?

A. The partnership is not bound, because Sally was not a partner at the time of this contract.

B. The partnership is not bound, because Sally did not have actual authority to agree to this contract.

C. The partnership is not bound, because this conversation took place more than 90 days after Sally dissociated from the partnership.

D. The partnership is bound.

Question 1-58: Glenn, Ben, Pam, and Sam formed a partnership to run a farm. They did not have a written partnership agreement, but they did agree that the partnership would have a five-year term. After one year, Glenn quit the partnership. The remaining partners decided to continue running the farm. Glenn then demanded that the partnership pay him the value of his interest in the partnership.

Which of the following is correct?

A. Glenn's dissociation was wrongful; thus, he is not entitled to anything.

B. Glenn is entitled to the fair market value of his partnership interest, minus any damages caused by his dissociation. The partnership must pay this amount to Glenn within 120 days.

C. Glenn is entitled to cash equal to that amount he would get if the partnership were liquidated and its assets were sold at a price equal to the greater of liquidation value or the value based on a sale of the entire business as a going concern without Glenn as a partner, minus any damages caused by Glenn's dissociation. The partnership must pay this amount to Glenn within 120 days.

D. Same as Answer C, except that the partnership is not obligated to pay this amount to Glenn until the end of the five-year term unless Glenn can show that earlier payment would not cause the partnership undue hardship.

Question 1-59: A, B, C, and D are partners of a partnership that operates a restaurant and that is an "at will" partnership. One day, Partner A filed for bankruptcy.

Assuming no other facts, which of the following statements is correct?

A. Partner A has not dissociated.

B. Partner A has dissociated, but it was not wrongful. The partnership will continue in existence, without Partner A.

C. Partner A has dissociated wrongfully. The partnership will continue in existence, without Partner A.

D. Partner A has dissociated, but it was not wrongful. The partnership will dissolve.

E. Partner A has dissociated wrongfully. The partnership will dissolve.

Question 1-60: The Bird Family rock and roll band, a partnership, owns a reconditioned school bus and various items of musical equipment. The partners consist of Shirley, Keith, Laurie, Danny, Christopher, and Tracy (all of whom are adults).

Which of the following statements is correct with respect to the Partridge Family's bus?

A. Keith has an ownership interest in the bus as well as the right to use the bus for dates.
B. Shirley cannot use the bus to haul equipment to the Bird Family's concerts without the permission of Keith, Laurie, Danny, Christopher, and Tracy.
C. The bus is not subject to attachment or execution, except on a claim against the partnership.
D. All of the above are correct.

Question 1-61: Same facts as the previous question. Laurie, a partner in the Bird Family, is retiring so that she can attend law school. She decides to sell her partnership interest to Ricky Stevens, a friend of the family, for $400,000.

In this situation:

A. Ricky does not have the status of a partner, but he can demand to see the partnership records at any time.
B. Ricky is a partner and has all the rights Laurie had.
C. The partnership dissolves.
D. Ricky is entitled to receive the distributions to which Laurie would otherwise be entitled.

Question 1-62: Same facts as the previous two questions. Tracy, a partner in the Bird Family, has been told a number of things about her rights and obligations by Danny, another partner in the Bird Family. There is no written partnership agreement or express agreement of any kind concerning the issues discussed by Tracy and Danny. Tracy is uncertain whether to believe Danny.

Which of the following statements made by Danny is <u>not</u> correct?

A. Tracy is not entitled to a salary even if she works full time for the Bird Family.
B. Danny is personally liable only for those debts he personally contracts on behalf of the partnership.
C. The admission of a new partner will require unanimous consent from the existing partners.
D. The partners share equally in any distributions.

Question 1-63: Boris and Natasha opened a catering business. Boris and Natasha were partners and together managed the day-by-day operations of the business. Since they had been friends for years they based their working relationship on trust, they had no written partnership agreement. One day, Boris, while driving to deliver food to a customer, was injured in an auto accident. Boris had been negligent in his driving and had "totaled" the partnership's van. Boris was in the hospital for six months. Meanwhile, Natasha performed Boris's normal duties.

Which of the following is correct?

A. Boris breached his duty of care to the partnership. However, Natasha is entitled to receive a salary for filling in for Boris while he cannot work.
B. Boris did <u>not</u> breach his duty of care to the partnership. However, Natasha is entitled to receive a salary for filling in for Boris while he cannot work.
C. Boris breached his duty of care to the partnership. However, Natasha is <u>not</u> entitled to receive a salary for filling in for Boris while he cannot work.
D. Boris did <u>not</u> breach his duty of care to the partnership. Natasha is <u>not</u> entitled to receive a salary for filling in for Boris while he cannot work.

Question 1-64: If Boris and Natasha had organized their restaurant as a limited partnership, the general partner:

A. is personally liable for the debts and obligations of the limited partnership.
B. does not have to be an individual.
C. owes fiduciary duties to the limited partner(s).
D. All of the above.

Question 1-65: Sherman and Herman made contributions of 60% and 40%, respectively, to their newly formed partnership. Because they were close friends, they felt that they did not need a written partnership agreement. At the end of the first year, the partnership <u>either</u> earned a profit or incurred a loss.

Which of the following is correct?

A. In the case of either a profit or a loss, each partner would report half of it on his income tax return.
B. In the case of either a profit or a loss, Sherman would report 60% of it on his income tax return and Herman would report 40% of it on his income tax return.
C. In the case of a profit, each partner would report half of it on his income tax return. In the case of a loss, Sherman would report 60% of it on his income tax return and Herman would report 40% of it on his income tax return.
D. In the case of a loss, each partner would report half of it on his income tax return. In the case of a profit, Sherman would report 60% of it on his income tax return and Herman would report 40% of it on his income tax return.

Question 1-66: Moe and Burns entered into an oral partnership agreement to manage and operate a bar. Moe had previously managed a bar and was very familiar with the bar business. Moe, however, did not have much money to place into the venture. For this reason, Moe made a contribution of $10,000, while Burns made a contribution of $800,000. Because Moe had the know-how, the parties agreed that Moe would have the exclusive right to manage the partnership's business. The partners agreed to share profits and losses equally. The venture proved to be extremely profitable. Moe, however, was required to work nearly 70 hours a week managing the bar. Meanwhile, Burns continued to collect one-half of the profits. Burns was paid back his initial investment in four years. As such, Moe believed that he should be compensated additionally for his efforts. Moe requested that Burns approve an annual salary of $100,000, to which Burns steadfastly refused.

What is the result under RUPA?

A. Moe will prevail, because he is entitled to additional remuneration for his efforts in managing the business.

B. Moe will prevail, because Burns may not unreasonably refuse to approve Moe's salary.

C. Burns will prevail, because a partner is not entitled to a salary without the approval of the other partners.

D. Burns will prevail, because a partner may never receive a salary.

Question 1-67: Adam, Betty, and Cindy formed a partnership, with Adam contributing all of the cash and Betty and Cindy contributing services. They have not entered into a partnership agreement nor have they discussed how profit and loss will be allocated.

Which of the following statements is most correct?

A. Adam alone will be liable for any losses since he contributed all of the capital.

B. Adam, Betty, and Cindy will be liable jointly and severally to creditors of the partnership, but Adam will be required to indemnify Betty and Cindy for any amounts they are required to pay out.

C. Betty and Cindy will be liable to creditors only for partnership losses in excess of the amount of Adam's cash contribution.

D. Adam, Betty, and Cindy will each be liable to creditors for all liabilities that the partnership cannot pay.

Question 1-68: Walter, Xavier, and Yolanda formed a partnership to run a bookstore near the campus of State University. Upon formation of the partnership, the partners verbally agreed that the partnership would limit its business to the bookstore. Walter was a rich real estate attorney, and Xavier was the wealthy owner of a chain of electronics stores. Yolanda, on the other hand, was of more modest means. She worked part-time as disc jockey at the university radio station. As a result, Walter contributed $50,000 to the partnership, Xavier contributed $40,000, while Yolanda contributed $10,000.

At a meeting of the partners, Xavier and Yolanda voted to expand the partnership's business by purchasing a large house near the university with the idea of renting the house to a fraternity. Walter voted against the idea.

Did the vote to expand the business to purchase and rent the house pass under RUPA, assuming the partners did not agree in advance as to voting rights?

A. Yes, because a majority of the partners voted to pass the measure.
B. Yes, because the verbal agreement to limit the business to the bookstore was unenforceable.
C. No, because the expansion of the business to real estate investing was in contravention of the partnership agreement and required unanimous vote.
D. No, because the vote was deadlocked, as partners representing 50% of the capital voted for the measure, while a partner representing 50% of the capital voted against it.

Question 1-69: Mike and Nick are partners (and drivers) in a limousine business that owns two limousines. One day, Mike took a job driving a group of high school students to their prom. He charged them $200 for his services, but told Nick that he had only charged $150 (Mike kept the extra $50 for himself). While driving the students to the prom in one of the partnership's limousines, Mike was involved in an accident due to his gross negligence. All of the students were injured as well, and have sued the partnership, Mike, and Nick.

Which of the following is correct?

A. Only Mike is liable to the students for their injuries because he was grossly negligent.
B. Only Mike and the partnership are liable to the students for their injuries. Nick is not liable.
C. Each of the partnership, Mike and Nick are liable to the students. In addition, Mike has breached his duty of care, but not his duty of loyalty, to the partnership.
D. Each of the partnership, Mike and Nick are liable to the students. In addition, Mike has breached his duty of care and his duty of loyalty to the partnership.

Question 1-70: Paula was a partner of Mega Law Firm, L.L.P., a limited liability partnership ("Mega"). One day, Charlie asked Paula for her legal advice about an automobile accident in which Charlie was severely injured. When Paula investigated, she found that Charlie was not at fault. In fact, Paula discovered that a delivery truck for the National Express Corporation caused the accident. Furthermore, the driver of the truck was drunk at the time of the accident. Paula was absolutely thrilled. This was a "can't lose" case. Mega's executive committee authorized Paula to file Charlie's lawsuit. Shortly thereafter, Paula filed a suit against National Express Corporation on Charlie's behalf. Paula sought to depose Natasha, who was a key witness to the accident. Natasha recently immigrated to the United States and could only speak Russian. In such instances, it is common for a law firm seeking to depose a non-English speaking person to hire and pay an interpreter for the deposition. Therefore, Paula hired Ivan, a, Russian interpreter, to translate during Natasha's deposition. Paula explained to Ivan that she was a partner of Mega and that Mega would pay Ivan's fees. When Ivan sent a bill to Mega, Mega refused to pay the bill, contending that Paula had no authority to hire Ivan.

What is the likely result of a suit Ivan files against Mega for payment of the bill?

A. Mega will prevail because Paula's hiring of Ivan was not apparently for the carrying on the ordinary business of Mega.
B. Mega will prevail because partners of a limited liability partnership are not agents of the limited liability partnership.
C. Ivan will prevail because Mega's executive committee expressly authorized Paula to hire Ivan.
D. Ivan will prevail because Paula, as a partner of Mega, had authority to hire Ivan in apparently carrying on the ordinary business of Mega.

Question 1-71: Same facts as the prior question. Paula procrastinated in filing Charlie's lawsuit. When she finally got around to filing the complaint, the statute of limitations had run. Charlie brought suit against Paula, individually. Charlie did not bring suit against the other partners of Mega or Mega itself.

What is the likely result of the lawsuit of Charlie against Paula?

A. Paula will prevail, because Charlie must bring suit against all of the partners of Mega.
B. Paula will prevail, because a partner of a limited liability partnership cannot be held liable for debts of the partnership.
C. Charlie will prevail, because all partners of a limited liability partnership are personally liable for the malpractice of any partner.
D. Charlie will prevail, provided Paula committed malpractice in failing to file the complaint, thereby causing damages to Charlie.

Question 1-72: The Big Law Firm, which consists of Partners A through Z, was formed as a general partnership ten years ago. However, at the start of this year, the Big Law Firm properly converted into and qualified as a limited liability partnership (LLP) under RUPA. Last year, Partner A committed malpractice in a lawsuit ("Lawsuit 1"). This year, Partner B committed malpractice in a lawsuit ("Lawsuit 2").

Which, if any, of the partners of the Big Law Firm are liable for the malpractice committee by Partner A in Lawsuit 1 and the malpractice committed by Partner B in Lawsuit 2?

A. All of the partners are liable for Lawsuit 1 and Lawsuit 2.
B. All of the partners are liable for Lawsuit 1. Only Partner B is liable for Lawsuit 2.
C. Only Partner A is liable for Lawsuit 1, and only Partner B is liable for Lawsuit 2.
D. No partner is liable for either Lawsuit 1 or Lawsuit 2; only the firm itself is liable.

Question 1-73: The balance sheet of a limited liability partnership (LLP) is as follows: (1) total assets of \$200,000, consisting of \$100,000 of cash and \$100,000 of various other assets; (2) total liabilities of \$120,000; and (3) owners' equity of \$80,000. The only partners in the LLP are "regular" partners; there are no partners or transferees who have preferential rights upon dissolution of the LLP.

What is the maximum amount of distributions that this LLP could legally pay to its partners, assuming that it would continue to be able to pays its debts as they become due in the ordinary course of business?

A. \$ 80,000.
B. \$100,000.
C. \$120,000.
D. Any amount it wants, because the partners will be liable for any unpaid debts anyway.

Question 1-74: The partners of Poison, LLP, a limited liability partnership that was headquartered in New York City and that had manufactured various poisonous substances for many years, properly approved its dissolution on April 1, 2016. Three days later, the LLP published the following notice in *The New York Times*.

> **Notice of Dissolution of Poison, LLP**
>
> Please be advised that Poison, LLP (the Company) has dissolved. Any persons who have claims against the Company are hereby advised to submit such claims to the Company no later than April 4, 2019, at the following address: Poison, LLP, 111 Main Street, New York City, NY, Attn: Managing Partner. Each claim shall describe the claim in reasonable detail, including the name of the creditor and the reason for the alleged claim. A claim against the Company will be barred unless a proceeding to enforce the claim is commenced no later than April 4, 2019.

Will this notice be sufficient to bar a claim against Poison, LLP if the holder of the claim does not sue Poison before April 4, 2019?

A. Yes.
B. Yes, but the partners will remain liable even if the partnership has dissolved.
C. No, because the notice must give claimants at least five years to sue Poison, LLP.
D. No, unless the holder of the claim actually saw this newspaper notice.

Question 1-75: Which of the following statements concerning dissolution of a partnership is correct?

A. A limited liability partnership (LLP) will only dissolve upon the consent of a majority of its partners.

B. When an LLP dissolves, it cannot distribute any amounts to its partners without first getting court approval.

C. Regardless of whether a partnership is a “regular” general partnership or an LLP, if it is an at-will partnership, it will dissolve upon the death of one its partners.

D. None of the above is correct.

PART 2

LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

NOTE: In each of the following problems: (1) the ULPA or the ULLCA, as applicable, applies and (2) the business does not have an agreement that changes the applicable rules of the ULPA or the ULLCA, unless otherwise noted.

Question 2-1: Blue Crab, L.P., is a limited partnership that runs a seafood restaurant. Karen is the general partner, but due to major surgery has been unable to leave the hospital for several weeks. As a result, Rufus, a limited partner, has "stepped up" and begun managing the restaurant, with Karen's blessing. (Before this, Rufus worked as the restaurant's main chef and bottle washer.) One day, an employee of Fresh Fish, Inc., the limited partnership's main supplier, made a delivery to the restaurant. Rufus, who was wearing a name tag that said "Rufus Smith, General Partner," signed the receipt. He then told the delivery person that he was "running" the restaurant and that Fresh Fish, Inc. should deliver one hundred pounds of salmon and one hundred pounds of shrimp the following day.

If Blue Crab, L.P. is unable to pay for this order, which of the following is correct?

A. Rufus is liable for the order because he breached his implied warranty of authority.

B. Rufus is liable in his capacity as a limited partner because he participated in the control of the business and, based on his conduct, Fresh Fish, Inc. reasonably believed that he was a general partner.

C. Blue Crab, L.P. is not liable for this order because limited partners may not conduct business on behalf of a limited partnership.

D. Karen is liable as a general partner.

E. Both A and D are correct.

Question 2-2: Red Engine, L.P., is a limited partnership that operates an automobile parts supply store. Five months ago, Jessica resigned as general partner and was replaced by Johnny. Today, Jessica was walking down the street when she saw Buford, who was the owner of a sole proprietorship that supplies the spark plugs and carburetors that Red Engine, L.P. sells at its store. Buford and Jessica had known each other for several years, but Buford did not know that Jessica had resigned as the general partner of Red Engine, L.P. Buford asked Jessica whether the limited partnership wanted to continue its supply contract with Buford's business for an additional year. She replied: "Sure." When Johnny found out about the contract, he was very upset and refused to honor it.

Assuming no other facts and that there are no statute-of-frauds issues in this problem, which of the following is correct?

A. Red Engine, L.P. is not bound because Jessica was not a general partner at the time of this contract.

B. Red Engine, L.P. is not bound because her conversation with Buford took place more than 90 days after she resigned as the general partner.

C. Red Engine, L.P. is bound on this contract but may recover damages from Jessica.

D. Red Engine, L.P. is bound on this contract, but if it does not perform the contract Johnny would not be liable to Buford for damages.

E. Both C and D are correct.

Question 2-3: Purple, L.P., is a limited partnership that has the following partners: General Partner 1, General Partner 2, Limited Partner A, Limited Partner B, and Limited Partner C. Each of the partners is an individual. Today, General Partner 1 dissociated by express will; Limited Partner A dissociated by express will; and Limited Partner B filed bankruptcy.

Which of the following is correct?

A. None of the dissociations was "wrongful."

B. Only General Partner 1's dissociation was "wrongful."

C. General Partner 1's dissociation was "wrongful" and Limited Partner A's dissociation was "wrongful."

D. General Partner 1, Limited Partner A, and Limited Partner B each dissociated and all of these dissociations were "wrongful."

E. General Partner 1, Limited Partner A, and Limited Partner B each dissociated, but only the dissociations of General Partner 1 and Limited Partner B were "wrongful."

Question 2-4: Yellow, L.P., is a limited partnership that has the following partners: General Partner, Limited Partner A, Limited Partner B, and Limited Partner C. When Yellow, L.P. was formed, the partners made the following contributions: General Partner ($10,000); Limited Partner A ($20,000); Limited Partner B ($20,000); and Limited Partner C ($50,000). Currently, the balance sheet of Yellow, L.P. shows that it has $300,000 of assets and $170,000 of liabilities.

Which of the following is correct? You may assume that Yellow, L.P. would remain able to pay its debts as they come due in the ordinary course of business.

A. Yellow, L.P. may pay a maximum of $130,000 in distributions. If it pays that amount, then General Partner would receive $13,000; Limited Partner A would receive $26,000; Limited Partner B would receive $26,000; and Limited Partner C would receive $65,000.

B. Yellow, L.P. may pay a maximum of $130,000 in distributions. If it pays that amount, then each partner would receive an equal amount because partners share profits and distributions equally unless otherwise agreed.

C. Yellow, L.P. may pay a maximum of $170,000 in distributions. If it pays that amount, then General Partner would receive $17,000; Limited Partner A would receive $34,000; Limited Partner B would receive $34,000; and Limited Partner C would receive $85,000.

D. Yellow, L.P. may pay a maximum of $170,000 in distributions. If it pays that amount, then each partner would receive an equal amount because partners share profits and distributions equally unless otherwise agreed.

E. None of the above is correct.

Question 2-5: Brown, L.P., is a limited partnership that has the following partners: General Partner, Limited Partner A, Limited Partner B, and Limited Partner C. When Brown, L.P. was formed, the partners made the following contributions: General Partner ($0); Limited Partner A ($10,000); Limited Partner B ($10,000); and Limited Partner C ($10,000). Recently, two of the limited partners voted to dissolve Brown, L.P., but one limited partner, as well as General Partner, voted against this proposal.

Which of the following is correct?

A. Brown, L.P. will not be dissolved because General Partner did not consent to dissolution.

B. Brown, L.P. will not be dissolved because the partners did not unanimously consent to dissolution.

C. Brown, L.P. will not be dissolved because the limited partners did not unanimously consent to dissolution.

D. Brown, L.P. will be dissolved.

Question 2-6: Same facts as Question 2-5, except that General Partner dissociated by express will and, 120 days later, two of the limited partners voted to continue the existence of Brown, L.P. and admit a new general partner. The other limited partner voted against this proposal.

Which of the following is correct?

A. Brown, L.P. will not be dissolved.

B. Brown, L.P. will be dissolved because the vote by the limited partners was not unanimous.

C. Brown, L.P. will be dissolved because the vote by the limited partners did not occur within 60 days.

D. Brown, L.P. will be dissolved because the vote by the limited partners did not occur within 90 days.

Question 2-7: Orange, L.P., is a limited partnership that has the following partners: General Partner, Limited Partner A, Limited Partner B, and Limited Partner C. When Orange, L.P. was formed, the partners made the following contributions: General Partner ($5,000); Limited Partner A ($10,000); Limited Partner B ($20,000); and Limited Partner C ($15,000). Upon dissolution, Orange, L.P. distributed all of its assets, consisting of $100,000, to its partners. However, Orange, L.P. did not pay or take any steps to bar a $10,000 claim held by Loan Shark, Inc.

Which of the following is correct?

A. Loan Shark, Inc. may recover $2,500 from each partner.

B. Loan Shark, Inc. may recover $10,000 from General Partner, or $1,000 from General Partner, $2,000 from Limited Partner A, $4,000 from Limited Partner B, and $3,000 from Limited Partner C.

C. Loan Shark, Inc. may recover $10,000 from General Partner or $2,500 from each partner.

D. All four partners are jointly and severally liable to Loan Shark, Inc. for $10,000.

E. Loan Shark, Inc. may only recover the $10,000 from General Partner.

Question 2-8: Same facts as Question 2-7, except that Orange was formed as a limited liability limited partnership (LLLP).

Which of the following is correct?

A. Loan Shark, Inc. may recover $1,000 from General Partner, $2,000 from Limited Partner A, $4,000 from Limited Partner B, and $3,000 from Limited Partner C.

B. Loan Shark, Inc. may recover $10,000 from General Partner or $2,500 from each partner.

C. Loan Shark, Inc. may only recover the $10,000 from General Partner.

D. Loan Shark, Inc. may not recover its claim from any of the partners

Question 2-9: Chad is the general partner of Country Club, L.P., a limited partnership. There are fifteen limited partners, including Susan, who is a multi-millionaire. The limited partnership agreement requires the majority of all partners to approve any borrowing of more than $50,000. Last year, all of the partners unanimously voted to approve borrowing $1 million from the Gopher Bank to fund an expansion of the limited partnership's golf course. This year, the limited partnership defaulted on the loan and filed for bankruptcy. Gopher Bank filed suit against Susan and Chad but did not file suit against the limited partnership.

Which one of the following is correct?

A. Susan will be personally liable for this claim, because limited partners who vote or otherwise participate in management of the business are deemed to be general partners.

B. Susan will not be personally liable for this claim because limited partners can vote on matters that require their approval without being deemed to be general partners.

C. Chad will not be personally liable for this claim because a general partner will not be personally liable for matters that are approved by the limited partners.

D. Chad will be personally liable for this claim because Gopher Bank need not exhaust the limited partnership's assets in this situation.

E. Both B and D are correct.

Question 2-10: Which of the following is true concerning limited partnerships?

A. A limited partnership must have at least one general partner and at least one limited partner.

B. A limited partnership is a "default" entity that does not require the filing of any documents with the state in order to exist.

C. A limited partnership offers the protection of limited liability for both general and limited partners.

D. All of the above are true.

Question 2-11: As to the personal liability of a limited partner for the limited partnership's debts, which of the following statements is correct? Assume that the 1985 version of RULPA is in effect for purposes of this question only.

A. A limited partner will be personally liable if he works as an employee of the limited partnership.

B. A limited partner will be personally liable if he consults with the general partner on the firm's business.

C. A limited partner will be personally liable if he requests a meeting of the partners.

D. None of the above will make a limited partner personally liable.

Question 2-12: The Smith family formed a limited partnership, with Joe Smith as the general partner and his daughters Daniella and Veronica as the limited partners. The limited partnership planned to open a combination clothing store and record store specializing in techno records. Daniella has a very good "eye" for fashion and Veronica is a "connoisseur" of techno music; Joe doesn't know much about either area, but is an accountant and has a great deal of business experience. As such, they want to put Daniella in charge of ordering clothes to stock at the store and Veronica in charge of ordering records to stock at the store.

Is this a permissible way to run a limited partnership?

A. No, because the general partner must be in charge of all business decisions.

B. Yes, but only if the certificate of limited partnership agreement specifically provides that Daniella is in charge of ordering clothes and Veronica is in charge of ordering records.

C. Yes, but doing this could jeopardize the limited liability of Daniella and Veronica.

D. Yes.

Question 2-13: Same facts as Question 2-12. Joe has decided that he does not want to be the general partner because he has substantial personal assets and does not want his assets subject to the risk of liability for the limited partnership's debts if the business fails. Joe then asks you whether he could form a corporation to serve as the general partner of the limited partnership so that no one will have personal liability. Joe and his daughters will serve as the directors and officers of the corporation.

Is this a good idea?

A. Yes, but Joe should be aware of the dangers of veil-piercing.

B. No. General partners must be individuals.

C. No. Although general partners can be corporations, the shareholder(s) of a corporate general partner will be personally liable for the debts and obligations of the limited partnership.

D. No. Although general partners can be corporations, if a limited partner serves as an officer or director of a corporate general partner, she will be personally liable for the debts and obligations of the limited partnership.

Question 2-14: Same facts as Questions 2-12 and 2-13, except that Joe remained as the general partner. Business did not go well, and Joe wants to dissolve the limited partnership. At a meeting of the partners, Joe and Daniella voted to dissolve the limited partnership. Veronica voted against dissolving the limited partnership.

Did the limited partnership dissolve?

A. Yes, because the only general partner voted to dissolve the limited partnership.

B. Yes, but only if Daniella owns a majority of the rights to receive distributions as limited partners.

C. No, because the dissolution was not unanimously approved by the partners.

D. No, because dissolution of a limited partnership requires court approval.

Question 2-15: Terri and Mike formed Sidetracks, L.P., a limited partnership, to operate a pub. Initially, Terri acted as the general partner and dealt with the day-to-day operations of the pub, whereas Mike was a "passive" limited partner. After a few years of operation, Terri became ill. As a result, Mike took over management of the pub for six months. During this six-month period, Mike ordered $10,000 worth of liquor from Mohawk Liquor Distributors ("Mohawk"). Mohawk reasonably believed Mike was a general partner. Before Mike's involvement in the management of the pub, Terri ordered $20,000 worth of beer from Rotgut Beer Co. ("Rotgut"). When the limited partnership went bankrupt, Mohawk and Rotgut sought to hold Mike personally liable for payment.

What is the extent of Mike's personal liability, if any? In answering this question, assume that the 1985 version of RULPA is applicable.

A. Mike has no personal liability because he was a limited partner.

B. Mike is personally liable to Mohawk for $10,000, but he has no personal liability to Rotgut.

C. Mike is personally liable to Rotgut for $20,000, but he has no personal liability to Mohawk.

D. Mike is personally liable to Mohawk for $10,000 and Rotgut for $20,000.

Question 2-16: Which of the following general statements about LLCs is correct?

A. An LLC must pay taxes on its income unless it meets the same requirements that are imposed on "S" corporations under the Internal Revenue Code.

B. Although members of an LLC usually are not personally liable for the LLC's debts, the managers of a manager-managed LLC are personally liable for the LLC's debts.

C. Unlike a sole proprietorship or a partnership, a filing with the state government is required to form an LLC.

D. A member of an LLC may be held liable for the LLC's debt to a third party if (1) the member participates in the control of the LLC's business and (2) the third party reasonably believed that the member was a manager of the LLC.

Question 2-17: Which of the following statements about the formation of an LLC is correct under the ULLCA?

A. An LLC must have at least one member to be formed.

B. The ULLCA requires that the LLC's certificate of organization must state whether the LLC is member-managed or manager-managed.

C. The ULLCA does not allow LLCs to be formed for non-business purposes.

D. An LLC is presumed to be manager-managed unless its operating agreement provides that it is member-managed.

Question 2-18: Which of the following correctly describes the characteristics of member-managed LLCs and manager-managed LLCs?

A. In a member-managed LLC, ULLCA presumes that the relative voting power of members will be based on the contributions that they have made to the LLC. However, in a manager-managed LLC, ULLCA presumes that each manager will have equal voting power.

B. In a manager-managed LLC, a member has actual or apparent authority to bind the LLC to a contract with a third party.

C. In a manager-managed LLC, it is permissible for a manager also to be a member.

D. In a member-managed LLC, the members have the right to vote on all major decisions affecting the LLC. However, in a manager-managed LLC, only the managers have the right to vote on major decisions affecting the LLC.

Question 2-19: Which of the following correctly describes fiduciary duties in LLCs under the ULLCA?

I. In a manager-managed LLC, a member who is not a manager does not owe the fiduciary duties of care or loyalty to the LLC.

II. In a member-managed LLC, members owe fiduciary duties to the LLC.

III. An LLC's operating agreement may completely eliminate the fiduciary duties of loyalty and care.

A. All of the above are correct.

B. Only I is correct.

C. Only II is correct.

D. Only I and II are correct.

E. Only I is III are correct.

Question 2-20: Which of the following correctly describes agency authority in LLCs?

A. In Delaware, members of a member-managed LLC have authority to bind the LLC to contracts with third parties due to their status as members.

B. Under the ULLCA, members of a member-managed LLC have authority to bind the LLC to contracts with third parties due to their status as members.

C. In Delaware, members of a manager-managed LLC do not have authority to bind the LLC to contracts with third parties due to their status as members.

D. Under the ULLCA, managers of a manager-managed LLC have authority to bind the LLC to contracts with third parties due to their status as managers.

E. All of the above are correct.

Question 2-21: Which of the following correctly describes how distributions from an LLC are made under the ULLCA?

A. Distributions must be made based on the relative values of contributions that members have made to an LLC, unless the operating agreement provides otherwise.

B. Distributions must be made in equal shares among members unless the operating agreement provides otherwise.

C. On or before April 15 of each year, a member has a right to demand a distribution from an LLC equal to the amount of her tax liability for the LLC's profits for the preceding year.

D. Both A and C are correct.

E. Both B and C are correct.

Question 2-22: Three years ago, Maggie, Charlie, and Ivy formed an LLC under the ULLCA to run a health food store. The LLC's operating agreement does not have any provisions that would change the "default" rules of the ULLCA, but does state that the LLC was to exist for only five years and that the LLC is manager-managed. Maggie, Charlie, and Ivy are the three members of the LLC. In addition, Charlie has been properly appointed as the manager of the LLC.

Which of the following statements concerning dissociation and dissolution is correct?

A. If a guardian or conservator is appointed for Maggie, then Maggie will have dissociated from the LLC.

B. If Maggie were to dissociate from the LLC by express will, her dissociation is wrongful and will cause the LLC to dissolve.

C. If Maggie and Ivy vote to dissolve the LLC before the end of its five-year term, it must dissolve.

D. A court could order the dissolution of the LLC if Maggie proves that Charlie is "oppressing" her.

E. None of the above is correct.

Question 2-23: Which of the following statements about LLCs is correct?

A. If a member of an LLC wishes to bring a derivative lawsuit on behalf of the LLC, she must always make a demand on the managers or other members beforehand.

B. Members of an LLC will never be personally liable for an LLC's debts and obligations unless they were personally responsible for causing the debt or obligation.

C. An LLC may convert into a different type of business organization; however, unanimous consent of the members is required to do so.

D. In a manager-managed LLC, members typically only have the right to inspect the LLC's financial statements and its annual report that the LLC must file with the state.

Question 2-24: Andy, Deb, Neil, and Finn formed an LLC three years ago. The LLC's operating agreement does not have any provisions that would change the "default" rules of the ULLCA. When the LLC was formed, Andy contributed equipment worth $30,000, Deb contributed $30,000 in cash, Neil contributed $20,000 in cash, and Finn agreed to contribute $20,000 worth of services. (It took Finn two years after the LLC was formed to complete those services.) None of these contributions has been returned, except that $10,000 has been returned to Neil.

If this LLC dissolves and (1) owes no amounts to creditors and (2) has either $45,000 or $180,000 of assets remaining, which of the following would be correct, applying <u>Delaware</u> law?

A. If the LLC has $45,000 of assets remaining, then (1) Andy and Deb would each receive $15,000, (2) Neil would receive $5,000, and (3) Finn would receive $10,000.

B. If the LLC has $180,000 of assets remaining, then (1) Andy and Deb would each receive $60,000, (2) Neil would receive $20,000, and (3) Finn would receive $40,000.

C. If the LLC has $180,000 of assets remaining, then (1) Andy and Deb would each receive $52,500, (2) Neil would receive $32,500, and (3) Finn would receive $42,500.

D. Both A and B are correct.

E. Both A and C are correct.

Question 2-25: Same facts as Question 2-24 above.

What member vote was necessary to dissolve the LLC, applying either the ULLCA or the Delaware statute?

I. In Delaware, dissolution would have required the unanimous consent of the members.

II. In Delaware, dissolution would have required the approval of members who own at least two-thirds of the then-current interest in the profits of the LLC owned by all members.

III. Under the ULLCA, dissolution would have required the unanimous consent of the members.

IV. Under the ULLCA, dissolution would have required the approval of a majority of the members, with votes weighted according to the unreturned contributions the members have made to the LLC.

A. I and III are correct.

B. II and IV are correct.

C. I and IV are correct.

D. II and III are correct.

Question 2-26: An LLC is organized in the State of Circle, which has adopted the ULLCA. However, its headquarters and all of its employees are located in the State of Square, which has also adopted the ULLCA.

Which of the following is correct?

A. The LLC must register to do business in the State of Square.

B. If a customer sues the LLC for products liability, the law of the State of Circle will apply to the case.

C. If an employee sues the LLC for employment discrimination, the law of the State of Circle will apply to the case.

D. Both A and C are correct.

Question 2-27: ABC, LLC, is a manager-managed LLC that manufactures and sells widgets. Adam (who is not a member) is the manager, and Brenda, Carl, and Dave are the three members. Recently, the LLC received an offer from Buyer to purchase all of its assets for $3 million. Adam and the member then met to discuss and debate Buyer's offer. At the meeting, Adam, Brenda, and Carl voted to sell the LLC's assets to Buyer. Dave voted against the proposal.

Has the proposal to sell the LLC's assets been properly approved?

A. Yes, because Adam is the sole manager and has the authority to approve the sale.

B. Yes, because a majority of the members voted in favor of the sale.

C. No, because the members did not approve the sale unanimously.

D. No, unless Brenda and Carl own membership interests that would entitle them to receive a majority of the distributions paid by the LLC.

Question 2-28: The members of Poison, LLC, a limited liability company that was headquartered in Albany, New York, and that had manufactured various poisonous substances for many years, properly approved its dissolution on April 1, 2016. Three days later, the LLC published the following notice in the local newspaper in Albany.

Notice of Dissolution of Poison, LLC

Please be advised that Poison, LLC (the Company) has dissolved. Any persons who have claims against the Company are hereby advised to submit such claims to the Company no later than April 4, 2018, at the following address: Poison, LLC, 111 Main Street, New York City, NY, Attn: Claims Department. Each claim shall describe the claim in reasonable detail, including the name of the creditor and the reason for the alleged claim. A claim against the Company will be barred unless a proceeding to enforce the claim is commenced no later than April 4, 2018.

Will this notice be sufficient to bar a claim against Poison, LLC if the holder of the claims does not sue Poison before April 4, 2018?

A. Yes.
B. No, because the notice must give claimants at least three years to sue Poison.
C. No, because the notice must give claimants at least five years to sue Poison.
D. No, because the notice must be in a newspaper of national circulation.

Question 2-29: Restaurant LLC is a manager-managed LLC. Julia serves as the sole manager of Restaurant. For many years, Restaurant was very successful and its members were paid handsome distributions. Last year, however, Restaurant's head chef, Mario, resigned. Julia hired Guy to replace Mario as the head chef. Unfortunately, Guy was a terrible chef and Restaurant's business suffered greatly, resulting in lost profits. Frank is a long-time member of Restaurant. Frank wants to sue Julia for breaching her duty of care to the LLC. Specifically, Frank believes that Julia was negligent in hiring Guy. As Frank put it: "Julia has no taste. She should have asked the members what we thought of Guy's cooking." Frank filed a lawsuit without first making a demand on Julia.

Which of the following is the most likely procedural outcome?

A. The court will dismiss the case because this would be a derivative lawsuit and Frank was required to make a demand before filing suit.
B. The case will proceed because, even though this would be a derivative lawsuit, Frank would likely be able to show that a demand was futile.
C. The case will proceed because this would be a direct lawsuit because Frank has been harmed by Julia actions.
D. The court will dismiss the case unless a majority in interest of the members joins the lawsuit.

Question 2-30: Same facts as Question 2-29. Regardless of how you answered the previous question, assume for purposes of this question that this was a derivative lawsuit and that Frank was excused from making a demand before filing the lawsuit. While the lawsuit was still pending, Julia formed a committee, which she named the "Special Litigation Committee," and appointed Mr. Jones and Ms. Smith, two members of Restaurant, to the committee. After several lengthy meetings during which they reviewed the merits of the case, the two members of the Special Litigation Committee determined that Restaurant should move to dismiss the derivative lawsuit because it is not in the best interests of the LLC.

How will the court likely rule on this motion to dismiss?

A. The motion will be denied because the LLC has no right to dismiss a derivative lawsuit after it has been properly filed by a member.

B. The motion will be denied because Julia, as a defendant, had no right to appoint a Special Litigation Committee.

C. The court will grant the motion if it finds that the Special Litigation Committee was disinterested and determined in good faith, after conducting a reasonable inquiry, that maintaining the derivative lawsuit is not in the best interests of the LLC.

D. The court will grant the motion only if the court finds that the lawsuit is not in the best interests of the LLC.

Question 2-31: Which of the following provisions of an operating agreement would be permissible under the ULLCA?

A. A provision that states that only the manager of a manager-managed LLC may bring a derivative lawsuit on behalf of the LLC.

B. A provision that eliminates the contractual obligation of good faith and fair dealing.

C. A provision that states that the internal affairs of the LLC will be governed by the law of a state other than the state in which the LLC is organized.

D. None of the above would be permissible under the ULLCA.

Question 2-32: Your client was a subcontractor on a construction project and is owed $10,000 by Construction LLC. ("<u>Construction</u>"). However, Construction is insolvent and unable to pay its bills. Smith is the manager of Construction. Smith and his wife are the two members of Construction.

Which of the following facts, if true, would help your client to convince a court to "pierce the veil" of Construction and hold Mr. Smith liable for this debt?

A. Smith used Construction's funds to pay the mortgage payments on his house.

B. Construction's members have never held a meeting to formally appoint Smith as the manager.

C. Construction has several other unpaid creditors.

D. All of the above.

E. None of the above.

Question 2-33: Four years ago, Adam, Bailey, and Chuck formed an LLC under the ULLCA. The LLC's operating agreement provides that the LLC will have a ten-year term and that the LLC is manager-managed. Adam, Bailey, and Chuck are the three members of the LLC. In addition, Adam has been properly appointed as the manager of the LLC.

With respect to the sale of a member's interest in the LLC to a third party, which of the following is correct?

A. No member may sell any part of his membership interest in the LLC unless Adam approves.
B. Any member can sell his entire membership interest in the LLC to a third party without Adam's approval. The transferee in such a case would become a member of the LLC.
C. Any member can sell his entire membership interest in the LLC to a third party without Adam's approval. The transferee in such a case would <u>not</u> become a member of the LLC.
D. If Adam sells his membership interest to a third party, he will be removed from his position as manager of the LLC.
E. None of the above is correct.

Question 2-34: Two years ago, Alex, Bart, and Carlie formed an LLC under the ULLCA. The LLC's operating agreement provides that the LLC is manager-managed. Alex, Bart, and Carlie are the three members of the LLC, and Carlie also serves as the manager of the LLC. The operating agreement provides that each member would contribute \$50,000 to the LLC within one year after its formation. Shortly after its formation, the LLC borrowed \$100,000 from Bank. Bank made the loan only after reviewing the operating agreement. Bart and Carlie made their \$50,000 contributions. Alex, however, has only contributed \$30,000 so far.

With respect to whether Alex must contribute the remaining \$20,000 to the LLC, which of the following is correct?

A. Alex's obligation to contribute the remaining \$20,000 to the LLC can be waived by a unanimous vote of the members.
B. Alex's obligation to contribute the remaining \$20,000 to the LLC can be waived by a unanimous vote of the members. However, Bank could still enforce the obligation.
C. If Alex were to become disabled, he would be excused from having to contribute the remaining \$20,000 to the LLC.
D. As the LLC's manager, Carlie can waive requiring Alex to contribute the remaining \$20,000 to the LLC. However, Bank could still enforce the obligation.
E. Both B and D are correct.

Question 2-35: Mike, Johann, and Bill are the members of Dive Bar, LLC, a member-managed LLC. The members voted to put Mike in charge of ordering liquor for the bar, but limited his authority to buying no more than $5,000 worth of liquor per month. Each month from January to June, Mike ordered $5,000 of liquor from Beverages, Inc. ("Beverages"). Each time, Beverages sent a monthly bill to the LLC and the LLC promptly paid it. During a member meeting in late June, Johann and Bill voted to limit Mike's authority to ordering only $3,000 of liquor per month, starting in July. (Mike voted no.) Mike nonetheless ordered $5,000 worth of liquor from Beverages in July.

Is the LLC obligated to purchase all $5,000 of the liquor in the July order?

A. Yes, because the LLC is a member-managed LLC, which means that each member is an agent of the LLC and has apparent authority to act on its behalf for things that are in the ordinary course of business.

B. Yes, because Beverages had not been notified that Mike no longer had authority to order $5,000 of liquor per month.

C. Yes, because it would take a unanimous vote by the members to limit Mike's authority to order liquor.

D. No, because Mike no longer had actual authority to make the July order.

Question 2-36: Which of the following events would cause a member who is an individual to be dissociated from an LLC?

I. If the LLC is member-managed and the member files bankruptcy.

II. If the LLC is member-managed and the member transfers her transferable interest in the LLC to a third party.

III. If the LLC is member-managed and a guardian or conservator is appointed for the member.

IV. If the LLC is manager-managed and a guardian or conservator is appointed for the member.

A. I, II, and III only.
B. I and III only.
C. II and III only.
D. III only.

Question 2-37: Keith, Sally, and Roger are the members of Resort, LLC, a manager-managed LLC. Each of them owns a one-third interest in the LLC. Keith is the manager of the LLC. One day, Keith informed the other two members that he was withdrawing as a member.

Which of the following correctly describes the effects of Keith's actions?

A. Keith is no longer a member, but remains as manager. The LLC did not dissolve. Keith is entitled to be paid the value of his interest in the LLC within 90 days.

B. Keith is no longer a member or the manager. The LLC did not dissolve. Keith is entitled to be paid the value of his interest in the LLC only when it dissolves.

C. Keith is no longer a member, but remains as manager. The LLC did not dissolve. Keith is entitled to be paid the value of his interest in the LLC only when it dissolves.

D. Keith's dissociation caused the LLC to dissolve.

Question 2-38: Same facts as Question 2-37, except that the LLC has dissolved. During its winding up process, the LLC sold all of its assets for $100,000 in cash and distributed all of this money to its members, but took no steps to pay or bar any creditors' claims. A few months after the LLC dissolved, an unpaid creditor ("Creditor") sued the former members of the LLC to recover $20,000 that the LLC owed Creditor. The court found that the claim was valid and that Creditor had not been notified that the LLC was dissolving.

What amount, if any, must each member of the LLC pay to Creditor?

A. Nothing, because members are not liable for the LLC's debts.

B. Only Keith would be liable for the unpaid $20,000 because he was the manager.

C. Creditor could recover $20,000 from any member, but that member could then seek contribution from the other two members.

D. $6,666.67.

Question 2-39: Your client is going to form a business and is choosing between forming it as an LLC or as a limited partnership.

Which of the following would be correct advice to your client?

A. An LLC may have a single member, whereas a limited partnership must have at least two partners.

B. An LLC has the advantage of "flow-through" taxation but a limited partnership does not.

C. A limited partnership provides for a better liability "shield" than does an LLC.

D. An LLC may have foreign owners, whereas a limited partnership may not.

E. All of the above are correct.

Question 2-40: Your client is going to form a business and is choosing between forming it as an LLC or as an "S" corporation.

Which of the following would be correct advice to your client?

A. An LLC may have a single member, whereas an "S" corporation must have at least two shareholders.

B. An LLC has the advantage of "flow-through" taxation but an "S" corporation does not.

C. An LLC may have foreign owners, whereas an "S" corporation may not.

D. An LLC has perpetual life (i.e., duration), whereas an "S" corporation may only exist for 30 years.

E. None of the above is correct.

PART 3

BASIC CORPORATE LAW

Question 3-1: Mattress Corp. has three shareholders: Mr. Sleep, Ms. Slumber, and Mr. Dream. Each shareholder owns 100 shares of common stock, and also serves as one of the three directors of the corporation. Last year, Mr. Sleep and Ms. Slumber signed an agreement that provided that they would each vote their shares so that each of them would be elected to the board of directors every year. This year, Mr. Sleep and Ms. Slumber had a serious argument, resulting in a "falling out." As a result, Mr. Sleep orally agreed with Mr. Dream that they would each vote their shares at this year's shareholder meeting so that Ms. Slumber would not be re-elected to the board. At the shareholders meeting, Ms. Slumber demanded that Mr. Sleep vote his shares as he had agreed with her. Meanwhile, Mr. Dream demanded that Mr. Sleep vote his shares as he had agreed with him.

What will be the result of this dispute?

A. Mr. Sleep is not bound by his agreement with Mr. Dream because it was not in writing.

B. Mr. Sleep is not bound by his agreement with Ms. Slumber or his agreement with Ms. Slumber because fewer than all of the shareholders signed those agreements and they were not included in the bylaws.

C. Mr. Sleep must vote his shares in accordance with his agreement with Ms. Slumber.

D. Mr. Sleep must vote his shares in accordance with his agreement with Mr. Dream.

E. Both A and C are correct.

Question 3-2: Builder Corp., which is in the business of building and remodeling homes, has 125 shareholders. One of the shareholders is Joe Smith, who owns approximately 0.5% of the outstanding shares. Joe is currently in the process of forming his own corporation that will be in the construction business. Joe is seeking to inspect and copy the following two items relating to Builder Corp.: (1) its bylaws and (2) its list of shareholders. Joe plans to use the bylaws as a "model" for the bylaws for his corporation and to use the shareholder list to send advertising flyers concerning his new company to the other 124 shareholders.

Assuming that Joe follows any applicable procedures to seek inspection of these documents, which of the following is correct?

A. Joe will be entitled by right to inspect and copy both the bylaws and the shareholder list.

B. Joe will be entitled by right to inspect and copy the bylaws, but likely will not be permitted to inspect the shareholder list because he does not have a proper purpose for doing so.

C. Joe will be entitled by right to inspect and copy the shareholder list, but likely will not be permitted to inspect the bylaws because he does not have a proper purpose for doing so.

D. Joe likely will not be permitted to inspect either the bylaws or the shareholder list because he does not have a proper purpose for doing so.

Question 3-3: The board of directors of Corporation consists of nine directors, all of whom are elected annually by the shareholders. The only outstanding shares of Corporation stock are 10,000 shares of common stock. Corporation's articles of incorporation provide that directors are elected by cumulative voting.

Under cumulative voting, how many shares of common stock would a shareholder need to own to make sure that she is able to elect at least one member of the board of directors? Assume that all 10,000 shares will be voted.

A. 1,000 shares.
B. 1,001 shares.
C. 1,111 shares.
D. 1,112 shares.

Question 3-4: BBQ Sauce, Inc. ("BBQSI") is a corporation that has 100,000 shares of common stock outstanding, owned by five individuals, each of whom owns 20,000 shares. On August 1, the corporate secretary of BBQSI personally delivered to all five shareholders written notice of a special shareholder meeting to be held on August 13. The notice did not state the purpose of the meeting, but did state the date, time, and place of the meeting. All five shareholders attended the meeting and were asked to vote on a proposal to sell all of BBQSI's assets, including its factory, to another company. Three of the shareholders present at the meeting voted yes, and the other two voted no.

Was the shareholder approval of the sale of BBQSI's assets valid?

A. Yes.
B. No. The action was invalid because notice of the meeting was not given at least sixty days before the meeting.
C. No. The action was invalid because the notice of the meeting did not specify the purpose of the meeting.
D. Yes, because any defect in the notice was cured by the fact that a majority of the shares were voted in favor of the proposal.

Question 3-5: On April 1, the corporate secretary of Bug Control, Inc. ("Bug Control") personally delivered to all nine members of Bug Control's board of directors written notice of a special board meeting to be held on April 2. The notice did not state the purpose of the meeting, but did state the date, time, and place of the meeting. Five directors attended the meeting and were asked to vote on a proposal to sell all of Bug Control's assets to Bug Zapper, Inc. Three of the directors present at the meeting voted yes, and the other two directors voted no.

Was the board's action valid?

A. No. The board's action was invalid because the notice was not given at least two days before the meeting.

B. No. The board's action was invalid because the notice was not given at least ten days before the meeting.

C. No. The board's action was invalid because the notice did not specify the purpose of the meeting.

D. Yes. The board's action was valid because the five directors who attended the meeting were a quorum, they waived any defect in notice by attending the meeting, and a majority of the directors present at the meeting voted to approve the asset sale.

Question 3-6: The board of directors of Square Corp. consists of seven directors. Neither Square Corp.'s articles of incorporation nor its bylaws contain any provisions concerning director meetings, except that its bylaws provide that regular meetings of the board shall be held at 10:00 a.m. on the first business day of each month at the company's offices and that the President of the Corporation has the power to call special meetings of the board. Because Square Corp. needed quickly to approve a loan agreement with Moneybags Bank, Mr. Triangle, Square Corp.'s President, sent the following notice to each of the directors on June 7 via facsimile (fax), in each case to the fax number that the director had previously provided to the corporation:

> June 7, [year]
> Notice of Special Meeting of the Board of Directors of Square Corp.
>
> Dear [Director's Name]: Please be advised that the board of directors of Square Corp. will hold a special meeting on June 13 at 8:00 a.m. at the company's offices. Please let me know as soon as possible if you will not be able to attend.
>
> Very Truly Yours, Mr. Triangle, President

At the June 13, board meeting, three directors and Mr. Triangle (who was not a director) appeared in person. At the meeting, all three directors present voted to approve the loan agreement. Mr. Triangle then presented a written proxy signed by Mr. Octagon (who was a director) which said that Mr. Octagon delegated authority to vote in favor of the loan agreement to Mr. Triangle. Mr. Triangle then said to the other directors, "Your three votes, plus this proxy from Mr. Octagon, means that the loan agreement is approved." You represent Moneybags Bank, which has asked for your opinion as to whether the loan agreement was properly approved by the board of directors of Square Corp.

You correctly tell the bank:

A. The loan agreement was not properly approved because a quorum of directors was not present at the meeting and because the notice of the directors' meeting was sent fewer than 10 days before the meeting.
B. The loan agreement was not properly approved because a quorum of directors was not present at the meeting.
C. The loan agreement was not properly approved because, even though a quorum of directors was present at the meeting, the notice of the directors' meeting did not state what the purpose of the meeting was.
D. The loan agreement was properly approved.

Question 3-7: The board of directors of Yellow Corp. consists of eleven directors. Neither Yellow Corp.'s articles of incorporation nor its bylaws contain any provisions concerning director meetings, except that its bylaws provide that regular board meetings shall be held at 9:00 a.m. on the first business day of January, April, July and October each year at the company's offices. No notice of the October 1, meeting was given to the directors. At the October 1 board meeting, five directors appeared in person, and called another director from the conference telephone and put him on speakerphone so that he could hear what was being discussed at the meeting and speak to the other directors. At the meeting, four directors voted to approve a new employment agreement with Yellow Corp.'s president. Shortly after the vote was taken, another director, Mr. White, burst through the doors of the room where the meeting was being held and yelled: "I object to this meeting. The approval of that employment agreement is invalid because I didn't receive notice of this meeting, there's no valid quorum and only four directors voted for it!"

Is Mr. White correct?

A. Yes, because he didn't receive notice of the board meeting.

B. Yes, because a quorum of directors wasn't present at the meeting.

C. Yes, because only four directors out of eleven voted to approve the employment agreement.

D. No.

Question 3-8: Regular Corp.'s annual shareholder meeting will be held on December 1 and proper notice was mailed to all of its shareholders on November 3. The record date for voting at the meeting is November 1. On November 25, a shareholder named Allie signed a proxy card that stated that it was "irrevocable" and that authorized Buffy to vote Allie's shares at the meeting. Buffy is also a shareholder of Regular Corp. Nonetheless, Allie attended the meeting and wanted to revoke the proxy and vote the shares.

May Allie revoke this proxy?

A. No, because the proxy stated that it was irrevocable.

B. No, because the proxy stated that it was irrevocable and Buffy, as a shareholder in Regular Corp., has an interest in the shares subject to the proxy.

C. Yes, because the proxy was signed after the record date.

D. Yes, because the proxy was signed fewer than ten days before the meeting.

E. Yes, because Buffy has no interest in the shares subject to the proxy.

Question 3-9: Desert Corporation has the following balance sheet:

Assets		***Liabilities***	
Cash	$ 70,000	Note	$ 30,000
Equipment	$ 50,000	Line of Credit	$ 40,000
Real Estate	$ 250,000		
Total	$ 370,000	Total	$ 70,000
		Shareholder's Equity	
		Paid-in Capital	$ 50,000
		Capital Surplus	$ 150,000
		Earned Surplus	$ 100,000
		Total	$ 300,000

What is the maximum amount of distribution that the board may lawfully declare under the MBCA and pay to the common stockholders? You may assume that Desert Corporation will be able to pay its debts as they become due in the usual course of business after the distribution and that it has no preferred stock.

A. $100,000
B. $250,000
C. $300,000
D. $370,000

Question 3-10: Same facts as Question 3-9, except that Desert Corporation also has 10,000 shares of preferred stock outstanding, each of which has a $5 per-share liquidation preference.

What is the maximum amount of distribution that the board may lawfully declare under the MBCA and pay to the common stockholders? You may assume that Desert Corporation will be able to pay its debts as they become due in the usual course of business after the distribution.

A. $100,000
B. $250,000
C. $300,000
D. $370,000

Question 3-11: The board of directors of Pink Corp. consists of nine directors, all of whom are elected annually by the shareholders. Pink has 1,000 authorized shares and 300 outstanding shares of common stock. Pink Corp.'s articles of incorporation provide for cumulative voting.

How many shares of Pink Corp. common stock would a shareholder need to own to ensure that she is able to elect at least two directors if all shares are voted?

A. 31 shares
B. 61 shares
C. 101 shares
D. 202 shares

Question 3-12: Same facts as Question 3-11, except that Pink Corp.'s board of directors consists of ten directors.

How many shares of Pink Corp. common stock would a shareholder need to own to ensure that she is able to elect at least two directors if all shares are voted?

A. 60 shares
B. 40 shares
C. 28 shares
D. 55 shares

Question 3-13: The board of directors of Grey Corp. consists of five directors, all of whom are elected annually. On April 1, the only outstanding shares of Grey Corp. stock were 1,000 shares of common stock. On that date, Mr. Black owned 501 of these shares and Mr. White owned the other 499 shares. However, on April 3, Mr. Black sold one share of Grey Corp. common stock to Mr. White. Grey Corp.'s articles of incorporation provide that shareholders elect directors by a plurality vote. Both Mr. Black and Mr. White attended Grey Corp.'s annual shareholders' meeting to vote for their choices for election to the board of directors. The record date for the meeting was April 2. The meeting was held on May 3.

Assuming that both shareholders vote all of the shares that they can vote for the election of director candidates, which of the following is correct?

A. Mr. Black will be able to elect his choices to all five open director positions.
B. Mr. Black will be able to elect his choices to only four of the five open director positions.
C. Mr. Black will be able to elect his choices to only three of the five open director positions
D. Each of Mr. Black and Mr. White will elect two directors and they must agree upon the fifth director because they each own the same number of shares.

Question 3-14: The only outstanding stock of Stereo Corp. ("Stereo") is 100,000 shares of common stock. In April, Stereo's board of directors approved resolutions calling a special meeting of shareholders to be held on May 28, and setting May 7 as the record date for the meeting. On May 10, Stereo's corporate secretary mailed a notice to all of the persons who were Stereo shareholders on May 7. The notice stated the date, time, and place of the meeting, and also described the purposes of the meeting, which were to consider and vote on (1) selling a factory that Stereo owned in China and (2) amending Stereo's articles of incorporation to require that at least 66.67% of the outstanding shares of Stereo stock must vote in favor of a merger in order for any merger to occur. Shareholders that owned a total of 67,000 shares attended the meeting in person or by valid proxies. At the meeting, Proposal 1 (Sale of Factory) received 8,000 "yes" votes, 3,000 "no" votes, and 56,000 abstentions. Proposal 2 (Articles Amendment) received 51,000 "yes" votes, 11,000 "no" votes, and 5,000 abstentions.

Did Stereo's shareholders properly approve Proposal 1 (Sale of Factory)?

A. Yes.

B. No. Proposal 1 failed because Stereo's shareholders did not receive proper notice of the meeting; therefore, the meeting was invalid.

C. No. Proposal 1 failed because there were only 8,000 yes votes, which is less than a majority of the 100,000 outstanding shares.

D. No. Proposal 1 failed because there were only 8,000 yes votes, which is less than a majority of the 67,000 shares represented at the meeting.

Question 3-15: Same facts as Question 3-14. Regardless of how you answered that question, assume that proper notice of the shareholder meeting was given.

Did Stereo's shareholders properly approve Proposal 2 (Articles Amendment)?

A. Yes. Proposal 2 passed because the 51,000 yes votes were more than the required 66.67% of the 67,000 shares represented at the meeting.

B. Yes. Proposal 2 passed because the 51,000 yes votes were more than the required 66.67% of the 62,000 votes cast on Proposal 2.

C. No. Proposal 2 failed because the yes votes fell short of the required 66.67% of the 100,000 outstanding shares.

D. Yes. Proposal 2 passed because the 51,000 yes votes were a majority of the 100,000 outstanding shares.

Question 3-16: Mexican Restaurant Corp. ("MRC") owns and operates a chain of seventeen restaurants that serve Mexican food. MRC's articles of incorporation contain only the items that are required by MBCA § 2.02(a). Janice is a majority shareholder of MRC but is not a director or officer of MRC. Janice was horrified when she learned that MRC's board of directors approved a resolution to stop serving Mexican food at each of the restaurants and to serve Norwegian food instead. Janice thinks this a terrible decision that will be disastrous for the company and has come to you for advice on the best course of action to have the board's decision be changed as quickly as possible.

Which of the following would be the best advice for Janice? You may assume that Janice has the power to call a special meeting of MRC's shareholders.

A. Janice should call a special meeting of shareholders for the purpose of overturning the board's decision.

B. Janice should sue for an injunction because the shareholders did not approve this fundamental change in MRC's business.

C. Janice should call a special meeting of shareholders for the purpose of removing the current directors and replacing them with different directors.

D. Janice should force the corporation to repurchase her stock because she did not approve this fundamental change in MRC's business.

Question 3-17: In August, Hassan and Pete were discussing their idea to form a corporation to run a coffee shop, but had not taken any steps to start the business. On September 1, Hassan saw that an ideal location for the coffee shop was for rent. Unbeknownst to Pete, Hassan then signed a two-year lease with the landlord, but insisted that the following clause be included in the lease: "Landlord understands and agrees that this lease will be adopted by Two Friends Coffee, Inc. upon formation of that corporation and that Two Friends Coffee, Inc. will thereafter be liable for rental payments under this lease." Two Friends Coffee, Inc. was incorporated on September 18. Hassan and Pete, who became the sole shareholders and the sole directors of the corporation, then unanimously passed a board resolution that provided that the corporation agreed to adopt the lease. Unfortunately, Two Friends Coffee, Inc. went bankrupt six months later. The landlord has sued both Hassan and Pete for money damages under the lease.

What is the likely outcome of this lawsuit?

A. Neither Hassan nor Pete will be liable unless the landlord can convince the court to "pierce the corporate veil."

B. Neither Hassan nor Pete will be liable because the terms of the lease contemplate that only Two Friends Coffee, Inc. will be liable.

C. Hassan will likely be liable but Pete will not be.

D. Both Hassan and Pete will be liable because they were partners at the time that the lease was signed.

Question 3-18: Your client was a subcontractor on a construction project and is owed $10,000 by General Contractor Corp. ("GCC"). However, GCC is insolvent and unable to pay its bills. Smith, a local businessman, is the sole shareholder and director of GCC.

Which of the following facts, if true, would help your client to convince a court to pierce the corporate veil of GCC and hold Mr. Smith liable for this debt?

I. Smith owns several other businesses, including a restaurant, a movie theatre, and a concrete manufacturing business.

II. Smith showed your client a balance sheet for GSS that misrepresented its financial condition by inaccurately indicating it had $270,000 in assets.

III. GSS has several other unpaid creditors.

IV. Smith is a multimillionaire.

V. Smith used GSS funds to pay the mortgage payments on his house.

A. All of the above.

B. I, II, and V only.

C. II and V only.

D. II, III, IV and V only.

E. II, III, and V only.

Question 3-19: Your client, Rich Spoiled, just inherited 25% of the outstanding shares of Scion Corp. from his father Anthony, who died last week. Anthony was one of the founders of Scion Corp., served as one of its four directors, and was the president, earning a salary of $250,000 per year. Rich has come to you for advice concerning his rights as a 25% shareholder of Scion Corp.

Assuming no other facts, which of the following is correct advice for Rich?

I. If Scion Corp. issues new shares of stock in the future, it must offer Rich the opportunity to purchase at least 25% of the new shares.

II. Because he owns 25% of the stock, Rich will be entitled to select one of the four directors at the next annual shareholder meeting.

III. Before Rich may sell any of his shares of Scion Corp. stock, he must offer the other shareholders a right of first refusal to purchase the shares.

IV. Rich may require Scion Corp. to repurchase his shares if he no longer wants them.

A. None of the above.
B. I, II, and III only.
C. I, II, and IV only.
D. II only.
E. III only.

Question 3-20: Alpha Corp. produces automobile parts. Alpha Corp. has two shareholders: Mr. Alpha owns 99% of the outstanding common stock (for which he paid $990 when the corporation was formed ten years ago), and Mr. Beta owns the remaining 1% (for which he paid $10). When the corporation was formed, the two shareholders elected Mr. Alpha as the sole director of the corporation. Mr. Alpha, in his capacity as a director, then appointed himself as the President, Secretary and Treasurer of the corporation and approved his salary, which is $300,000 per year. No director or shareholder meetings have been held since that time. Mr. Beta does not work for Alpha Corp. Instead, he has a full-time job with another company. Following payment of its expenses (including Mr. Alpha's salary), Alpha Corp.'s annual after-tax profits average about $1,000. One year ago, Mr. Alpha borrowed $8,000 from Alpha Corp. As a result, Alpha Corp. has only approximately $1,000 in cash on hand. Supplier Corp., one of Alpha Corp.'s suppliers, claimed that Alpha Corp. owes it approximately $250,000 in unpaid bills and that Mr. Alpha promised that he would "stand behind" these bills. Mr. Alpha informed Supplier Corp. that Alpha Corp. does not have enough assets to repay this debt. Supplier Corp. then sued Mr. Alpha and Mr. Beta, claiming that they should be personally liable for this debt.

Which of the following is the most likely result in this lawsuit?

A. Mr. Alpha will be personally liable for this debt because the court will "pierce the corporate veil," but Mr. Beta will not likely be personally liable for this debt.

B. Neither Mr. Alpha nor Mr. Beta will be personally liable for this debt because shareholders are not liable for the corporation's debts.

C. Both Mr. Alpha and Mr. Beta will be personally liable for this debt because Alpha Corp. is a closely held corporation.

D. Neither Mr. Alpha nor Mr. Beta will be personally liable for this debt because Alpha Corp. is a closely held corporation.

Question 3-21: Fish Corp. ("Fish") has 3,000 outstanding shares of common stock. Twelve people own these 3,000 shares, including Ms. Bass (who owns 300 shares), Mr. Perch (who owns 300 shares), and Mr. Trout (who owns 301 shares). Twelve years ago, Ms. Bass, Mr. Perch, and Mr. Trout signed a shareholder voting agreement that provides that they will always vote their shares of Fish stock so that the three of them are always directors of Fish. Including Ms. Bass, Mr. Perch, and Mr. Trout, there are nine persons on the Fish board of directors, and the corporation's articles of incorporation provide that directors are elected by cumulative voting. The annual meeting of Fish shareholders is scheduled for tomorrow. However, earlier today Ms. Bass had a bitter argument with Mr. Perch and Mr. Trout. As a result, Mr. Perch and Mr. Trout are refusing to comply with the shareholder voting agreement.

Which of the following is correct?

A. The shareholder voting agreement is no longer valid, because it was signed more than ten years ago.

B. The shareholder voting agreement is not valid because only three out of the twelve shareholders signed it.

C. Even if the agreement is no longer valid and no other shareholders vote for her, Ms. Bass has enough shares to elect herself to the board under cumulative voting.

D. None of the above is correct.

Question 3-22: X Corp. will be holding its annual shareholder meeting next month and the board has sent out a notice of the meeting to its shareholders and also set a record date. As of the record date set by the board, Frank was shown on the corporation's stock ledger book as the owner of 10,000 shares of the corporation's common stock. However, after the record date but shortly before the meeting, he sold his shares to Ralph. Thinking that he might be unable to personally attend the meeting, Frank gave a proxy to vote his shares to his brother, Arthur, who was also an X Corp. shareholder and who told Frank that he would be personally attending the meeting. Frank has now changed his mind and has appeared at the meeting demanding the right to vote the shares. Also at the meeting are Ralph and Arthur, who are likewise demanding the right to vote the same shares.

Which of the following statements is most correct?

A. The corporation should permit Frank to vote.
B. The corporation should permit Ralph to vote.
C. The corporation should permit Arthur to vote.
D. The corporation must adjourn the meeting until the issue can be resolved.

Question 3-23: Forty-eight percent of the stock of Widget Corp. ("WC") is owned in equal amounts by four individuals, with the remaining 52% of the stock owned by Y Corporation. The four WC shareholders are also the officers and directors of WC, as well as being directors of Y Corporation. WC was incorporated originally to engage in the purchase and sale of widgets and was adequately capitalized. Although it was initially profitable, when widgets lost favor in the eyes of the public, the board changed its direction and the corporation began to engage in the purchase and sale of wassits. Unfortunately, wassits sold poorly and WC is virtually bankrupt. A number of suits have now been started by creditors, one of whom is asking the court to "pierce the corporate veil" and to impose liability personally on the WC's shareholders.

Which one of the following factors would the court consider to be most significant in ruling on the plaintiff's request to pierce the corporate veil?

A. That WC is currently insolvent.
B. That the shareholders of WC have consistently comingled the corporation's assets with their own.
C. That the shareholders of WC are also directors of Y Corporation, thus dominating WC's affairs.
D. That a majority of WC's stock is owned by another corporation.

Question 3-24: A corporation's registered agent has the authority to:

A. Accept service of process on behalf of the corporation.
B. Bind the corporation to loan agreements with major banks.
C. Hire and fire employees of the incorporation.
D. All of the above.

Question 3-25: Which of the following is correct?

A. An individual can be an officer or director of a corporation, but not both.
B. Each director must own at least one share of stock in the corporation.
C. Directors usually cannot be removed from the board except for "cause."
D. None of the above is correct.

Question 3-26: The officers of a corporation:

A. Are appointed by the board of directors.
B. May have actual, express and actual, implied authority, but cannot have apparent authority to act on behalf of the corporation.
C. Can be dismissed by the shareholders at an annual or special meeting.
D. None of the above is correct.

Question 3-27: Melina was one of several persons interested in organizing a book publishing company to be incorporated as Interesting Books Corp. Melina entered into an employment contract for the editorial services of Marcus. It was mutually understood that Marcus would perform certain duties and that these might be performed on behalf of a corporation yet to be formed. Melina, purporting to act on behalf of Interesting Books Corp., also entered into an agreement with Anton Printing Company for printing services to be rendered by it at a future date. Interesting Books Corp. was later properly incorporated under the MBCA, after execution of these contracts. Marcus then performed services for the corporation in accordance with his agreement with Melina.

If Marcus seeks to recover the compensation agreed upon in his agreement with Melina:

A. The corporation is liable to Marcus for the salary under the agreement if it adopted the agreement.

B. The corporation is automatically bound by the pre-incorporation agreement of Melina as its agent.

C. Absent express adoption of the agreement by the corporation's board of directors, Marcus may recover for his services only from Melina.

D. Any personal obligation Melina undertook under the agreement is terminated if Marcus assumes a position with the corporation at the salary specified in the agreement.

Question 3-28: Assume that Melina did not disclose the fact that Interesting Books Corp. had not yet been incorporated to Anton Printing Company when the two parties executed the contract for printing services.

Melina will not have any liability on the contract:

A. because she made it in the name of Interesting Books Corp.

B. if Interesting Books Corp. subsequently adopts the contract.

C. if Interesting Books Corp. and Anton Printing Company enter into a novation regarding the contract.

D. if Interesting Books Corp. is incorporated but its board then rejects the contract.

Question 3-29: The board of directors of Cumulative Corp. ("CC") consists of five directors, all of whom are elected annually by the shareholders. The only outstanding shares of CC stock are 100 shares of common stock, and 100 shares of nonvoting preferred stock.

Under cumulative voting, how many shares of CC common stock would a shareholder need to own to ensure that she will be able to elect at least two members of CC's board? Assume that all outstanding shares entitled to vote will be voted.

A. 17 shares.
B. 34 shares.
C. 34.33 shares.
D. 67 shares.
E. 167 shares.

Question 3-30: A corporation's balance sheet is as follows: (1) total assets of $200,000, consisting of $100,000 of cash and $100,000 of various other assets; (2) total liabilities of $120,000; and (3) shareholders' equity of $80,000. The only outstanding stock of the corporation is 50,000 shares of common stock.

What is the maximum amount of dividends that this corporation could legally pay?

A. $120,000, but only if after paying the dividend it would still be able to pay its debts as they become due in the usual course of business.

B. $100,000, but only if after paying the dividend it would still be able to pay its debts as they become due in the usual course of business.

C. $80,000, but only if after paying the dividend it would still be able to pay its debts as they become due in the usual course of business.

D. Any amount it wants, as long as after paying the dividend it would still be able to pay its debts as they become due in the usual course of business.

Question 3-31: On February 1, Joe Hicks signed a ten-year lease with Cheers Properties Inc. ("Cheers"). Joe signed the lease: "Joe Hicks, for Joe's Bar and Grill, Inc., a corporation to be formed." Joe incorporated Joe's Bar and Grill, Inc. ("JBGI") on February 15. JBGI's articles of incorporation named Joe as the sole initial director. On February 16, Joe, acting in his capacity as the sole director of JBGI, approved a resolution adopting the lease and caused JBGI to issue him 100 shares of common stock in exchange for $100. JBGI made the required lease payments for the next nine months but then defaulted, eventually filing for bankruptcy. Unable to collect from JBGI, Cheers sued Joe personally.

Which one of the following statements is correct?

A. Joe is not liable on the lease as a promoter because JBGI adopted the lease and made lease payments. However, Cheers could try to sue Joe on a veil-piercing theory.

B. Joe is liable on the lease as a promoter because JBGI adopted the lease and made lease payments.

C. Joe is liable on the lease as a promoter because there was no novation that released him from liability.

D. Joe is not liable on the lease as a promoter because he disclosed to Cheers that he was acting for a corporation that had not yet been formed. However, Cheers could try to sue Joe on a veil-piercing theory.

Question 3-32: A corporation gave notice of a special board meeting. The notice was delivered to each of the ten directors six days before the meeting. The notice stated the date, time, and place of the meeting, but did not state the purpose of the meeting. Seven directors attended the meeting. After some discussion and debate, the directors voted on a proposal to buy a building (the "Proposal"). Five directors voted in favor of the Proposal and two voted against it.

Was the Proposal properly approved by the board?

A. Yes, because notice was proper, a quorum was present, and the Proposal received enough votes to pass.
B. No, because the notice was given too late.
C. No, because the notice failed to state the purpose of the meeting.
D. No, because a quorum was not present at the meeting.
E. No, because a majority of the ten directors did not vote in favor of the Proposal.

Question 3-33: A corporation gave notice of an annual shareholder meeting. The notice was mailed 15 days before the meeting and stated the date, time, and place of the meeting, as well as the purposes of the meeting. There are 600,000 shares of common stock outstanding. At the meeting, 400,000 shares were present. At the meeting, the shareholders voted on electing directors, and also voted on a proposal other than electing directors (the "Proposal"). 200,000 shares were voted in favor of the Proposal; 150,000 shares were voted against the Proposal; and 50,000 shares abstained.

Was the Proposal properly approved by the shareholders?

A. Yes, because notice was proper, a quorum was present, and the Proposal received enough votes to pass.

B. No, because the notice was mailed too late.

C. No, because a quorum was not present at the meeting.

D. No, because a majority of the shares that were present at the meeting did not vote in favor of the Proposal.

Question 3-34: In order to form a corporation under the MBCA:

A. The articles of incorporation must state the specific purpose for which the corporation was formed.
B. The purpose clause in the articles of incorporation must be more specific than simply "to engage in any lawful business."
C. The articles need not set forth a par value for the authorized shares.
D. All of the above.

Question 3-35: Alex and Sara were discussing forming a corporation. Before filing the articles, Alex and Sara lined up employees, clients, and found office space. They also obtained a letter of credit for the corporation with First National Bank. Alex later signed the articles of incorporation for the corporation, and filed the articles with the appropriate state official.

Which of the following is correct?

A. Alex was the incorporator of the corporation.
B. Alex was a promoter of the corporation.
C. Sara was a promoter of the corporation.
D. All of the above are correct.

Question 3-36: Same facts as the prior question. In addition, the name of the corporation is X Corporation and it was incorporated in the State of Red (which has adopted the MBCA). However, its headquarters and all of its employees are located in the State of Blue (which has also adopted the MBCA).

Which of the following is correct?

A. X Corporation must obtain a certificate of authority from the State of Blue.

B. If a customer sues X Corporation for products liability, the law of the State of Red will apply to the case.

C. If an employee sues X Corporation for employment discrimination, the law of the State of Red will apply to the case.

D. Both A and C are correct.

Question 3-37: Same facts as the prior two questions. After Alex filed the articles of incorporation, X Corporation issued 500 shares of common stock to Alex and 500 of common stock shares to Sara. The board authorized the issuance at $1.00 per share.

Which of the following may the corporation accept in payment for the shares?

A. Alex's promissory note to pay the corporation $800 at the end of the year.
B. Sara's promise to perform $800 worth of services for the corporation over the next year.
C. Alex's and Sara's services as promoters which the corporation values at more than $2,000.
D. All of the above.

Question 3-38: Same facts as the prior three questions. Some time later, X Corporation wished to issue 300 shares of common stock to Bob, a (potential) new shareholder.

Must Alex and Sara, as shareholders, approve this stock issuance?

A. No, because stock issuances are solely within the discretion of the board of directors.
B. No, because Alex's and Sara's ownership will not be diluted.
C. Yes, but only if Bob pays for the shares with cash or cash equivalents.
D. Yes, but only if Bob pays for the shares with something other than cash or cash equivalents.

Question 3-39: Same facts as the prior four questions, except that no shares were issued to Bob, with Alex and Sara remaining the only two shareholders. To avoid tie votes, the articles of X Corporation require the election of three directors. Alex and Sara want to elect their friend Gary, a former English professor, to the board. The university recently denied Gary's application for tenure, and he would now like a job as an officer of X Corporation.

Which of the following is correct?

A. Gary can be paid a salary as an officer, but cannot be paid for his services as a director.

B. If Gary is elected to the board, his term of office will be for three years if the corporation does not have a staggered board.

C. If Gary becomes a director, he may be removed with or without cause.

D. None of the above is correct.

Question 3-40: Same facts as the prior four questions, except that X Corporation eventually issued a total of 7,000 shares to Alex and 3,000 shares to Sara. There were no other shareholders. The articles of incorporation for X Corporation provided for cumulative voting. Assume that Alex wants to elect himself, Gary, and Hope (Alex's wife), to the board.

If there are three openings on the board of directors, can Sara be assured of winning a seat?

A. No, since Alex can cast 7,000 votes to elect a member for each of the three openings, while Sara has only 3,000 votes to cast each of the three times she votes.

B. No, because cumulative voting is not allowed under the MBCA.

C. Yes, since Sara can cast 9,000 votes for herself and if Alex casts 9,001 votes for himself and 9,001 votes for Gary, he will have only 2,998 votes left to cast for Hope, i.e., Alex can choose the top two "vote getters," but not the top three.

D. No, because Alex can also use the cumulative voting and cast 21,000 votes for each of three candidates while Sara can only cast 9,000 votes for each of three candidates.

Question 3-41: ABC Corp. is a publicly held corporation. Buddy owns .0001% of its outstanding common stock.

As a shareholder, Buddy:

A. is the owner of one or more debt securities.
B. normally does not owe a fiduciary duty, such as a duty of loyalty, to the corporation.
C. cannot generally own stock in a competing corporation.
D. may not vote to elect directors

Question 3-42: Sally is general counsel for ABC Corp. Part of her job is to make sure that there is a quorum at the annual shareholders meeting. Sally asks for your help.

You should advise Sally that a quorum at a shareholders meeting

A. is defined by the number of shareholders.
B. consists of two-thirds of the outstanding shares unless the articles of incorporation provide otherwise.
C. consists of a simple majority of the outstanding shares unless the articles of incorporation provide otherwise.
D. consists of a simple majority of the shareholders unless the articles of incorporation provide otherwise.

Question 3-43: A group of shareholders representing a majority of voting shares in ABC Corp. have transferred their shares to Laura to hold for them as trustee. The term of this voting trust is 15 years and it states that it is irrevocable. ABC is incorporated under the MBCA.

This agreement:

A. is invalid because a voting trust cannot be irrevocable for longer than ten years under the MBCA.
B. can be revoked since it is in actuality only a proxy
C. is valid and irrevocable for the time specified in the trust.
D. None of the above is correct.

Question 3-44: Jonathan owns one share of stock in Hart Book Corp. Jonathan requested an opportunity to inspect the corporation's books, including its bylaws, shareholder meeting minutes, board meeting minutes, and financial records. The corporation allowed inspection of the bylaws and shareholder meeting minutes, but did not permit Jonathan to examine the other materials.

Under the circumstances, a court will require the corporation to allow Jonathan to inspect the other materials if:

A. Jonathan's demand is made in good faith and for a proper purpose.

B. Jonathan describes with reasonable particularity his purpose and the records he desires to inspect.

C. The' records are directly connected with Jonathan's purpose.

D. All of the above must be satisfied for a court to allow Jonathan to inspect the other materials.

Question 3-45: A, B, C, D, and E incorporated X Corporation. The articles of incorporation authorized 1,000 shares of common stock. A, B, C, D, and E were selected as the initial board of directors. They thereafter authorized issuing 850 shares for $50 per share. A and B bought 200 shares each and C, D, and E acquired 150 shares each. A few years later, C, D, and E decided that the corporation needed some additional capital and, as directors, authorized the sale to themselves of an additional 100 shares each at the original $50 per share price. A and B voted against the sale and are upset about this action.

Assuming no other facts, which of the following is most correct?

A. The sale was improper because A and B were entitled to preemptive rights.

B. The sale was improper without an amendment to the articles of incorporation.

C. The sale was improper because directors cannot issue shares to themselves.

D. The sale would be improper only if C, D, and E had paid less than the original $50 per share.

Question 3-46: Corporation's bylaws provide for a seven-person board of directors. The president of the corporation, who is one of the directors, tells you that the corporation must hold an emergency meeting of the board to complete a major loan transaction, including mortgaging all of the corporation's major assets, within 24 hours to meet a financial emergency. The president plans to sign the loan documents at that time. The attorney for the lender wants to be certain that the documents signed by the president will be binding on Corporation. Assume that two of Corporation's directors are hiking in the mountains and can't be reached; one is in the hospital recovering from surgery; one is in Tokyo and can be reached by telephone and the three others, including the president, are in town and available.

Which of the following statements is correct?

A. If the three directors who are available have a telephone conference call with the director who is in Tokyo and approve the transaction, Corporation will be bound if the other three directors later sign a written waiver of notice of the meeting.
B. If the three directors who are available and the director in the hospital sign a written consent to the loan transaction, Corporation will be bound.
C. Corporation will be bound by the president signing the loan documents under his apparent authority as president of the corporation.
D. Corporation will not be bound, absent prior express approval of the board of directors, which cannot be obtained because notice of the special meeting, as required by the MBCA, cannot be given to the two directors in the mountains.

Question 3-47: Which of the following rights do shareholders <u>not</u> possess?

A. The right to approve all major business transactions.
B. The right to approve an amendment to the articles of incorporation.
C. The right to approve a sale of substantially all of the corporation's assets not in the regular course of business.
D. The right to an annual meeting.

Question 3-48: Corporation has a six-member board of directors. There are 1,000 voting shares issued and outstanding. The directors are elected by cumulative voting and all shares are voted. Mike owns 190 shares of Corporation's voting shares

How many directors will Mike able to elect?

A. Zero directors.
B. One director.
C. Two directors.
D. Three directors.

Question 3-49: Same facts as the prior question, except that the size of Corporation's board of directors was just increased from six to eight members and was staggered (classified) into two classes with four directors being elected each year for respective two-year terms.

Which of the following statements is correct?

A. This classification will have no impact on Mike's ability to elect persons to the board.
B. This classification will eliminate Mike's ability to elect persons to the board.
C. This classification will decrease the number of directors Mike may elect, but not to zero.
D. This classification will increase the number of directors Mike may elect.

Question 3-50: The board of directors of Big Top Corp. ("Big Top") consists of seven persons, all of whom are elected annually. Big Top's articles of incorporation provide that directors are elected by cumulative voting. The only outstanding shares of Big Top voting stock are 1,000 shares of common stock. Mrs. Hingling owns 315 shares of Big Top common stock, Mrs. Raley owns 315 shares, and Mr. South owns the remaining 370 shares. Mrs. Hingling and Mrs. Raley have entered into a written voting agreement whereby they agreed to vote their shares of stock at each annual meeting of Big Top shareholders so that the following five persons will be elected to Big Top's board of directors: (1) two persons selected by Mrs. Hingling, (2) two persons selected by Mrs. Raley, and (3) one person that they both select. Mr. South is not a party to this agreement. The voting agreement provided that it would last for 20 years unless both Mrs. Hingling and Mrs. Raley agreed to terminate it earlier than that.

Which of the following is correct?

A. This voting agreement is invalid because Mr. South is not a party to it.
B. This voting agreement is invalid because it concerns the election of directors.
C. The voting agreement is invalid because it has a term of more than 10 years.
D. This voting agreement is valid and specifically enforceable if either party breaches it.

Question 3-51: The board of directors of Coach Corp. ("Coach") consists of four directors: Mr. Harbaugh, Mr. Meyer, Mr. Dantonio, and Mr. Ferentz. Mr. Meyer is also the Chief Executive Officer (CEO) of Coach. The bylaws provide that any director has the power to call a special meeting of the directors.

On November 6, Mr. Harbaugh hand-delivered the following notice to each director:

> Notice of Special Meeting of Directors of Coach Corp.
> to be held November 20, [year]
>
> Dear director: Please join us for a special meeting of the board of directors of Coach Corp. to be held at the company's headquarters, 111 North Avenue, Toledo, Ohio 43601, at 2:00 p.m. Refreshments will be served.

Mr. Harbaugh and Mr. Meyer attended the meeting on November 20 in person. Due to a broken leg that he had suffered a week earlier, Mr. Dantonio did not attend the meeting in person; however, he participated in the meeting through a telephone conference call. Mr. Ferentz did not attend the meeting in any manner.

At the meeting, Mr. Harbaugh announced that the purpose of the meeting was to vote on removing Mr. Meyer from his position as the CEO of Coach. Upon hearing this, Mr. Meyer became enraged and shouted: "What? You can't do this to me without giving me advance notice! I object to this meeting!" Mr. Meyer then left the meeting and did not return.

After Mr. Meyer left the meeting, the remaining directors discussed the proposal. Mr. Harbaugh then made a motion to remove Mr. Meyer from his position as CEO of Coach. Mr. Harbaugh and Mr. Dantonio voted yes on this motion.

Has Mr. Meyer been properly removed from his position as the CEO of Coach?

A. Yes.
B. No, because the notice of the directors' meeting did not state that the purpose of the meeting was to vote on removing Mr. Smith from his position as CEO.
C. No, because the notice of the directors' meeting was not delivered at least 10 days before the meeting.
D. No, because a quorum of directors was not present when the vote was taken.
E. No, because only the shareholders may remove the CEO from office.

Question 3-52: Which of the following is <u>not</u> correct with respect to an incorporator?

A. The incorporator must also be a shareholder of the corporation.
B. The incorporator may be an attorney.
C. The incorporator must sign the articles of incorporation.
D. The incorporator must appoint initial directors, unless the initial directors are named in the articles of incorporation.

Question 3-53: The articles of incorporation of Software, Inc. provide that the corporation is expressly forbidden from making donations for the public welfare or for charitable, scientific or educational purposes. Smith, a major shareholder, convinced the board of directors to announce a proposed contribution of $1 million to State University Law School for the establishment of the Smith Center for the Study of Technology Law. Prior to payment of the contribution, a group of shareholders brought an action to enjoin the proposed contribution.

What is the <u>likely</u> result of the shareholders' suit?

A. The court will enjoin the proposed contribution because the act is *ultra vires*.

B. The court will not enjoin the proposed contribution because a shareholder does not have standing to challenge a corporate action as being *ultra vires*.

C. The court will not enjoin the proposed contribution because a corporation has the right to make charitable contributions regardless of any restriction in the articles of incorporation.

D. The court will enjoin the proposed contribution because the charitable contribution was not intended to maximize the corporation's profit.

Question 3-54: The board of directors of Corporation consisted of five members: Adams, Boston, Carlton, Douglas, and Emdin. Adams served as the chairperson of the board. On Monday, August 1, Adams sent a written notice to each director of a special meeting to be held at noon on Thursday, August 4, at the corporate offices. The notice did not state the purpose of the meeting.

Adams, Boston, Carlton, and Douglas attended the meeting on August 4. Adams presided and announced the purpose of the meeting was to consider the sale of Corporation's factory. Adams, Boston, Carlton, and Douglas discussed the matter at length. When it was apparent that the other directors would vote in favor of the sale, Douglas stormed out of the meeting. Thereafter, Adams, Boston, and Carlton voted in favor of the sale.

Was the board vote on the sale of the factory valid?

A. The board action was not valid because the notice to the directors was invalid.

B. The board action was not valid because a quorum of the directors was not present at the time the vote was taken.

C. The board action was valid because a majority of a quorum of the directors voted in favor of the sale.

D. The board action was valid because Emdin is considered to have voted in favor of the sale by failing to attend the meeting.

Question 3-55: Same facts as the prior question. For purposes of this question, assume that Corporation sought to purchase a replacement factory in Denver. Instead of having a formal meeting, the directors all orally agreed to go through with the purchase of the Denver factory.

Did the board properly approve the purchase of the Denver factory?

A. Yes, because directors may act without a meeting, if approval of the directors is unanimous.
B. Yes, because the directors ratified the action by implication.
C. No, because directors may not act without a formal meeting.
D. No, because the directors did not follow the proper procedure in approving the transaction.

Question 3-56: X Corporation has 35,400 shares of common stock issued and outstanding and seven directors, all of whom are elected annually. It also has cumulative voting. Smith and Jones together own a total of 17,911 of the outstanding shares.

What is the minimum number of directors of X Corporation Smith and Jones should be able to elect at the next annual meeting? Assume that all shares eligible to vote are voted.

A. One.
B. Two.
C. Three.
D. Four.

Question 3-57: Which one of the following will <u>not</u> affect the validity of a voting trust?

A. The trustee did not give the corporation a list of the beneficial owners whose shares are in the trust.
B. The trustee is a not director of the corporation.
C. The trust agreement is not in writing.
D. Fewer than a majority of the corporation's outstanding shares were deposited into the trust.
E. Both B and D.

Question 3-58: Smith, Jones, and Brown decided to form a corporation to manufacture widgets. They felt that they did not need to hire an attorney and Smith, who had had some prior business experience, filled out the form of articles of incorporation. Thereafter, Smith, Jones, and Brown all signed the articles as incorporators. In their haste to begin business operations, Smith forgot to mail the articles to the Secretary of State, and although Smith knew it, Jones and Brown were unaware of this. Shortly thereafter, an employee of the business negligently injured a pedestrian.

Which of the following statements is <u>most</u> correct?

A. Smith, Jones, and Brown will each be personally liable for any judgment obtained by the by the injured pedestrian.
B. Only Smith will be personally liable for any judgment obtained by the injured pedestrian.
C. The "corporation" will be held to be a de facto corporation and Smith, Jones, and Brown will not be personally liable for the judgment.
D. The "corporation" will be held to be a corporation by estoppel and Smith, Jones, and Brown will not be personally liable to the injured pedestrian.

Question 3-59: President of Corporation signed a contract on behalf of Corporation obligating it to sell its headquarters to Buyer. Prior to the contract, Buyer's attorney demanded and received a copy of what was certified by Corporation's secretary and general counsel to be a resolution adopted by Corporation's board of directors authorizing the sale. It turns out, however, that the board never had authorized the sale.

Which of the following statements is most correct?

A. Corporation is bound on the contract because its President would be deemed to have had actual implied authority.

B. Corporation is bound on the contract because its President would be deemed to have had apparent authority.

C. Corporation is bound on the contract because its secretary and general counsel will be deemed to have had apparent authority to certify the board resolution.

D. Corporation is not bound unless the president had actual authority to bind Corporation.

Question 3-60: Which of the following statements concerning corporate law is correct?

A. When directors vote on a resolution that is outside the ordinary course of business, the resolution must receive unanimous approval.

B. Directors may give proxies to other directors to vote for them at board meetings.

C. Directors are agents of the corporation.

D. The corporation's articles of incorporation may only be amended upon the unanimous consent of the shareholders.

E. None of the above is correct.

Question 3-61: The bylaws of Corporation ("Corporation") state that meetings of the board of directors shall take place on the first Tuesday of every month. Soon after the shareholders elected Smith to Corporation's five-person board, he missed a Tuesday meeting. At the meeting, the board approved, by 3-1 vote, the acquisition of substantially all of the assets of Target, Inc. Smith contends that the resolution approving the Target acquisition was invalid because he failed to receive written notice of the meeting.

Which of the following statements is most likely correct?

A. The resolution is invalid because Smith did not receive written notice of the meeting.
B. The resolution is invalid, provided the board failed to inform Smith that meetings take place on the first Tuesday of each month.
C. The resolution is valid because it would have passed even if Smith had received proper notice.
D. The resolution is valid because the board properly held a meeting.

Question 3-62: Corporation has the following balance sheet:

Assets		**Liabilities**	
Cash	$100,000	Note	$40,000
Equipment	$100,000	Line of credit	$10,000
Real Estate	$200,000		
		Shareholder's Equity	
		Capital Surplus	$170,000
		Earned Surplus	$180,000
	$400,000		**$400,000**

Corporation only has shares of common stock outstanding.

What is the maximum amount of distribution that the board may lawfully declare? In answering this question, you may assume that Corporation will be able to pay its debts as they become due in the usual course of business after the distribution.

A. $100,000.
B. $170,000.
C. $180,000.
D. $350,000.
E. $400,000.

PART 4

THE DUTY OF CARE, THE DUTY OF LOYALTY, AND DERIVATIVE LAWSUITS

Question 4-1: Which of the following statements concerning a director's duty of care is correct?

A. Directors have a duty to act in the best interests of the corporation.

B. The person suing the directors for a breach of the duty of care and seeking money damages on behalf of the corporation has the burden of proving causation and damages.

C. Under Delaware law, directors need not implement a "monitoring system" over the corporation's legal compliance unless and until they know, or should know, that the company's employees are engaged in illegal activities.

D. When discharging their duty of care, directors may rely on the opinions and reports of other people, as long as those other people are professionals (such as lawyers or accountants).

Question 4-2: Which of the following statements concerning a director's duty of care is correct?

A. A finding of negligence is ordinarily sufficient to prove that the directors breached their duty of care.

B. Directors are never liable for harm resulting from the illegal actions of employees, unless the directors knew about the illegal actions before they occurred.

C. Directors may successfully defend any duty-of-care lawsuit by proving that a majority of them were disinterested in the challenged transaction.

D. None of the above is correct.

Question 4-3: Tripleday Books Corp. ("TBC") is a book-publishing company that has a very successful history of publishing self-help books, including several by famous celebrities. In March, TBC's board of directors unanimously approved a contract for a new book: "How to Be a Good Husband" by Bob Jennings, a famous baseball player. At the time of the contract, TBC's board was aware that Mr. Jennings had admitted to several extra-marital affairs. However, TBC's directors believed that Mr. Jennings's book was well-written and would be successful because he is a major celebrity.

The book was a disaster, selling fewer than 100 copies. A shareholder has properly brought a derivative lawsuit against TBC's board of directors alleging that the directors breached their duty of care and seeking to recover from the directors the $5 million advance payment that TBC made to Mr. Jennings.

Which of the following statements is correct?

A. The board of directors will lose the case because the contract with Mr. Jennings was a terrible decision and thus was not in the best interests of the corporation.

B. To win the case, the board of directors will have the burden of proving that the contract with Mr. Jennings was fair to TBC.

C. The board of directors will have the business judgment rule as a defense in the case, provided that the directors first prove that they were sufficiently informed of all material information reasonably available to them before they approved the contract and that they acted in good faith.

D. None of the above is correct.

Question 4-4: Shelia was asked by Helicopter Corp., a corporation which does not have any "special" provisions in its articles of incorporation, to serve as a director.

If Shelia accepts this position, which of the following cannot result in her being personally liable for damages?

A. Diverting corporate opportunities to herself.

B. Gross negligence in the performance of her duties as a director.

C. Honest errors of judgment that are made with due diligence.

D. All of the above could result in personal liability for Shelia.

Question 4-5: Several employees of BSI Inc. ("BSI"), none of whom were directors of BSI, pleaded guilty to criminal charges that they engaged in illegal bribery of various governmental officials. In connection with these pleas, BSI agreed to pay a $50 million fine to the federal government and to terminate the employment of the employees involved in the bribery. Despite having a corporate monitoring system in place, the members of BSI's board of directors did not know about the bribery until the Federal Bureau of Investigation (FBI) began an investigation several months after the bribery had taken place. A group of BSI shareholders has approached you about the possibility of filing a derivative action against BSI's directors for breach of their duty of care. The shareholders want BSI to recover from the directors the fine that the company paid to the federal government.

Which of the following would be correct advice to these shareholders?

A. The case will be very difficult to win if BSI's articles of incorporation contain a provision limiting director liability in accordance with MBCA § 2.02(b)(4).

B. Although the BSI directors will have the business judgment rule available as a defense in the case, it will be easy to overcome the business judgment rule because the directors will be defendants in the lawsuit and thus have a conflict of interest.

C. Although the BSI directors will have the business judgment rule available as a defense in the case, it will be easy to overcome the business judgment rule by showing that the directors were grossly negligent in not reasonably informing themselves about the bribery at a board meeting.

D. The case will be difficult to win because the plaintiffs must prove that the directors made a decision that was not in good faith.

Question 4-6: Assume that a director is grossly negligent in performing her oversight duties as a director and the corporation thereafter become insolvent and files for bankruptcy protection.

If the bankruptcy trustee sues the director on behalf of the corporation, which of the following would be correct?

A. The plaintiff will have the burden of proving that the director breached her duty of loyalty to the corporation.
B. The director will be liable for breaching the business judgment rule.
C. The director will not be liable unless the plaintiff proves that the director's gross negligence caused damage to the corporation.
D. None of the above.

Question 4-7: Smothers was the CEO and a director of Sunnybrook Corporation ("Sunnybrook"). Sunnybrook was formed to manufacture parts for various airplanes as well as NASA spacecraft. In January, Smothers asked his good friend Jensen to serve on Sunnybrook's board of directors. Jensen agreed and was elected as one of Sunnybrook's twelve directors at the annual shareholders' meeting on March 15. At that time, Sunnybrook owned a factory to produce the parts, but had not yet actually produced any. It had also hired several executives and managers to run the business, each of whom received a substantial salary. Jensen served as a director of Sunnybrook until his resignation on September 1 of the same year. Jensen attended only one of the three board meetings held during his time as a director. Jensen learned much of what he knew about Sunnybrook's business from informal conversations with Smothers. A few months later, the corporation filed bankruptcy. A shareholder then filed a derivative action on behalf of Sunnybrook against Jensen, alleging that he breached his fiduciary duties to Sunnybrook.

What is the likely outcome of this lawsuit?

A. Jensen will prevail, because the business judgment rule will shield him from liability.
B. Jensen will prevail, provided his inaction was not a proximate cause of harm to Sunnybrook.
C. The plaintiff will prevail, because Jensen breached his duty of care to Sunnybrook.
D. The plaintiff will prevail because Jensen had a duty to monitor the business and make sure that the parts were being produced.

QUESTIONS 4-8 TO 4-11 ARE BASED ON THE FOLLOWING FACT PATTERN

Big Oil Corp. ("BOC") is in the oil drilling business. In 2015, BOC's board of directors approved the construction of an offshore well in the Gulf of Mexico called the Really Deep Well. Because this well was 6,000 feet below the ocean surface, the board held four lengthy meetings to discuss safety issues before approving the well. Two different designs for the well were discussed at these meetings. The first design was presented by Eureka, Inc. ("Eureka"). The second, more expensive, design was presented by Drilling Safety, Inc. ("DSI"). Eureka's design featured two shut-off valves near the top of the drilling platform above the ocean surface. DSI's design was similar, but also included two emergency shut-off valves near the ocean floor. At these meetings, the board listened to several oil industry experts discuss the two well designs. Some of the experts believed that Eureka's well design was not sufficiently safe. However, several other experts believed that Eureka's design was safe, because it had two shut-off valves on the drilling platform. In the end, the choice between the two different designs boiled down to cost: Eureka's design was cheaper. Thus, BOC's board chose the Eureka design and authorized the construction of the Really Deep Well using that design. The director who argued most strenuously in favor of the Eureka design was Dave Drum. Mr. Drum did not inform the other BOC directors that his daughter, Bertha Barrel, is the majority shareholder of Eureka.

In April 2016, there was an explosion at the Really Deep Well. Eleven BOC employees were killed, and several million barrels of oil leaked from the well near the ocean floor for more than three months. Eventually, the leak was stopped, but not before billions of dollars of damage had been done. Several state and local governments spent billions of dollars cleaning up oil. BOC agreed that it was liable for these costs, and set aside $20 billion to be used to pay these claims. In addition, the federal government fined BOC several million dollars for safety violations.

A group of shareholders wants to bring a derivative suit on behalf of BOC's board. In addition to Mr. Drum, there are nine other people on BOC's board, including Camilla Crude and Dave Drill. Ms. Crude was absent from the series of meetings because she was on a four-week vacation. Dave Drill, who is the grandson of the founder of BOC and owns 5% of its stock, flunked out of high school. He is also known to attend board meetings while intoxicated.

Question 4-8: If Mr. Drum is sued for breaching his fiduciary duties to BOC, what is the likely outcome of the lawsuit?

A. Mr. Drum will likely win the case—he will be entitled to the protection of the business judgment rule because the board as a whole was well-informed before it chose the Eureka well design.
B. Mr. Drum will likely lose the case unless he can show that the transaction was entirely fair to BOC.
C. Mr. Drum will likely lose the case because BOC was fined by the government, which means it engaged in illegal activities.
D. Mr. Drum will likely win the case because he acted in good faith.

Question 4-9: If Ms. Crude is sued for breaching her fiduciary duties to BOC, what is the likely outcome of the lawsuit?

A. Ms. Crude will likely win the case because she did not vote in favor of the Eureka well design.
B. Ms. Crude will likely lose the case because she did not attend the board meeting at which the Eureka well design was approved.
C. Ms. Crude will likely win the case because she will be entitled the protection of the business judgment rule.
D. Ms. Crude will likely lose the case if the plaintiffs can show causation and damages.

Question 4-10: If Mr. Drill is sued for breaching his fiduciary duties to BOC, what is the likely outcome of the lawsuit?

A. Mr. Drill will likely win the case because he did not violate his duty of loyalty.
B. Mr. Drill will likely win the case by proving that he has below-average intelligence and is often intoxicated.
C. Mr. Drill will likely lose the case because two experts told the board that the Eureka well design was not safe.
D. Mr. Drill will likely win the case—he will be entitled to the protection of the business judgment rule because the board as a whole was well-informed before it decided to choose the Eureka well design.
E. Mr. Drill will likely lose the case because BOC was fined by the government, which means it engaged in illegal activities.

Question 4-11: If the directors other than Mr. Drum, Ms. Crude, and Mr. Drill are sued for breaching their fiduciary duties to BOC, what is the likely outcome of the lawsuit?

A. The directors will likely win the case—they will be entitled to the protection of the business judgment rule because the board was well-informed before it decided to choose the Eureka well design.
B. The directors will likely lose the case because two experts told the board that the Eureka well design was not safe.
C. The directors will likely win the case because they chose the cheapest well design and therefore reasonably believed they were acting in the best interests of BOC.
D. The directors will likely win the case because the only way the plaintiffs could win the case is if they showed that the directors intentionally tried to harm the corporation or approved illegal dividends, none of which happened here.
E. The directors will likely lose the case because BOC was fined by the government, which means it engaged in illegal activities.

Question 4-12: If a corporation purchases property owned by one of its directors, which of the following statements is correct?

A. The purchase contract is automatically voidable because of the director's conflict of interest.
B. The contract will be upheld, as long as the director does not participate in the board meeting when the board approves the purchase.
C. The contract will be upheld if it is established to be fair to the corporation.
D. None of the above is correct.

Question 4-13: Duane is a director of Machine Corp. ("MC") and owns 45% of the outstanding MC stock. Because MC needed a machine that Duane owned, Duane caused MC to buy the machine from him, signing on behalf of MC as its president. He then called a special meeting of shareholders to vote on approving this purchase. At the meeting, after having disclosed all of the material facts about the transaction to the other shareholders, Duane voted all of his shares in favor of the transaction. However, all of the other shareholders present (who collectively owned 30% of outstanding stock of MC) voted against the transaction.

Which of the following is correct?

A. The transaction may not be challenged due to Duane's interest because a majority of the shares present at the meeting approved it.

B. Because this is a director's conflicting interest transaction, all of the disinterested shares present at the meeting would have to approve the transaction to protect it against challenges based on Duane's interest in the transaction.

C. Because this is a director's conflicting interest transaction, Duane's shares may be counted for purposes of establishing a quorum, but they may not be voted.

D. None of the above.

Question 4-14: There are 10 million shares of Vaccine Corporation ("VC") common stock outstanding. There are five people on VC's board of directors, none of whom are related: Mr. Flu, Ms. Smallpox, Ms. Polio, Mr. Hepatitis, and Ms. Cold. Each director owns 1 million shares of VC common stock. VC wanted to buy a piece of property that is jointly owned by Ms. Polio, Mr. Hepatitis, and Ms. Cold (the "Sellers"). The fair market value of the property, as determined by a recent expert appraisal, is $25,000. However, after negotiations with Ms. Smallpox (who was acting on behalf of VC), the Sellers agreed to sell the property to VC for $20,000. Ms. Smallpox and Mr. Flu then unanimously approved VC's purchase of the property at a board meeting which none of the Sellers attended. The shareholders of VC also voted on the transaction at a shareholder meeting by the following margins: 3 million shares were voted in favor of the transaction; 2 million shares were voted against the transaction; and 5 million shares (which were the 5 million shares owned by VC's directors) abstained from voting. You may assume that full disclosure of the material terms of the transaction was made to the directors and the shareholders of VC.

If a shareholder of VC challenges this transaction as a breach of the duty of loyalty of the Sellers, what is the most likely result?

A. The Sellers will lose, unless they prove that the transaction was "fair" to VC.

B. The Sellers will win, unless the shareholder proves that the transaction was not "fair" to VC.

C. The Sellers will win, because the transaction was properly approved by the disinterested directors of VC.

D. The Sellers will win, because the transaction was properly approved by the disinterested shareholders of VC.

E. Both C and D are correct.

Question 4-15: The directors of Metal Corp. unanimously approved a resolution that provided that the corporation would pay them each $50,000 per year for serving as directors.

Which of the following is correct?

A. Director compensation amounts may only be determined by the shareholders.
B. Although directors can establish their own compensation amounts, the amounts must later be approved by the disinterested shareholders.
C. Directors are not permitted to receive compensation for their services as directors other than stock options.
D. None of the above.

Question 4-16: The board of directors of Zoo Corp. ("Zoo") consists of five persons: Mr. Gorilla, Mr. Monkey, Mr. Elephant, Mr. Tiger, and Mr. Lion. There are 800,000 shares of Zoo common stock outstanding. Oddly enough, each of the five directors of Zoo owns exactly 50,000 shares of Zoo common stock and each of the spouses of the five directors owns exactly 10,000 shares of Zoo common stock. Four of the five directors (Mr. Gorilla, Mr. Monkey, Mr. Elephant, and Mr. Tiger) wish to purchase a valuable piece of real estate from Zoo. Realizing that this transaction would be a "directors' conflicting interest transaction" (also known as an "interested director transaction"), they have asked you for legal advice about how to "sanitize" this transaction against a claim that it would violate their duty of loyalty to Zoo.

Which of the following would be the best advice you could give them? Assume the transaction would not constitute "waste."

A. They should have Mr. Lion approve the transaction because he is the only "disinterested" director (also known as a "qualified" director) with respect to this transaction.

B. They should submit the transaction for approval by Zoo's shareholders; as long as at least a majority of the 600,000 shares of Zoo common stock not owned by the four interested directors are voted in favor of the transaction after full disclosure, they will have "sanitized" the transaction.

C. They should submit the transaction for approval by Zoo's shareholders; as long as a majority of the 560,000 qualified shares of Zoo common stock that are cast are voted in favor of the transaction after full disclosure, they will have "sanitized" the transaction.

D. They should submit the transaction for approval by Zoo's shareholders; as long as at least 400,001 shares of Zoo common stock (regardless of who owns those shares) are voted in favor of the transaction after full disclosure, they will have "sanitized" the transaction.

Question 4-17: Sam Phillips is a director of Conglomo Records Corp. ("CRC"). Several years ago, long before he was in any way associated with CRC, Sam bought the rights ("Rights") to all of the recordings of Steelbelly Perkins, an obscure blues singer, for $25,000. Due to a recent, highly popular, documentary about blues music, interest in Steelbelly Perkins has increased. CRC would like to release all of Steelbelly's old records, and Sam is willing to sell the Rights to the recordings to CRC for $300,000, which is the estimated fair market value of the Rights.

If Sam sells the Rights to CRC after full disclosure, which of the following would be correct?

A. If the sale was approved by a majority of the disinterested directors, the sale would be proper and Sam would not have to show his $275,000 profit was fair.

B. If Sam sells the Rights to CRC for more than he paid for them, he would be breaching his duty of loyalty to CRC.

C. Sam could sell the Rights to CRC for $300,000 even without full disclosure of the circumstances of the sale because he is acting in good faith.

D. Sam could not sell the Rights to CRC without the unanimous approval of all of the disinterested directors.

E. None of the above is correct.

Question 4-18: Dave is a director, but not an officer, of Bomb Corp., a manufacturer of bombs and other military items. One day, Dave was playing golf with his former college roommate, Jeff, when Jeff told Dave that he had discovered a way to convert lead into gold. Although Dave did not believe Jeff's claim at first, he eventually came to believe that Jeff was telling the truth, especially when he examined the results of Jeff's laboratory experiments. Dave then asked Jeff why he had told him about this discovery. Jeff said: "Well, to make any money off of this discovery, I need either a ton of money or I need to partner with a company that has some heavy-duty manufacturing or industrial operations. I thought that, with your manufacturing experience with Bomb Corp., maybe you would know what companies might be interested in this idea." Dave replied: "I know that Bomb Corp. is short on cash right now and that its factory is obsolete. But I know several wealthy people who would be interested in investing in this idea. We can form a new company in which you and I will be the controlling shareholders, have those people invest a bunch of money, and then use the money to develop your lead-into-gold process."

Later, Dave and Jeff formed Gold Corp. and became the majority shareholders in it. Gold Corp. subsequently began turning lead into gold, earning enormous profits. Bomb Corp. later sued Dave, claiming that the opportunity to develop the lead-into-gold process was a "corporate opportunity" that belonged to Bomb Corp.

Which of the following facts would be helpful to Dave to argue that the opportunity to develop the lead-into-gold process was <u>not</u> a "corporate opportunity" under the American Law Institute (ALI)* Principles of Corporate Governance*?

I. Dave and Jeff had been friends in college.

II. Turning lead into gold is not the same "line of business" as manufacturing military items.

III. Bomb Corp. was not financially able to take advantage of this opportunity.

IV. Dave did not use any of Bomb Corp.'s information or resources to learn of the opportunity.

A. All of the above.
B. I and IV only.
C. I, II, and IV only.
D. III and IV only.

Question 4-19: Same facts as the previous question.

Which of the following facts would be helpful to Dave to argue that the opportunity to develop the lead-into-gold process was not a "corporate opportunity" under the common-law (Delaware)* Guth *test?

I. Dave and Jeff had been friends in college.

II. Turning lead into gold is not the same "line of business" as manufacturing military items.

III. Bomb Corp. was not financially able to take advantage of this opportunity.

IV. Dave did not use any of Bomb Corp.'s information or resources to learn of the opportunity.

A. All of the above.
B. I and IV only.
C. I, II, and IV only.
D. III and IV only.

Question 4-20: Sixty percent of the stock of H&M Corp. ("H&M") is owned by the Hatfield family and the other forty percent is owned by the McCoy family. H&M's board of directors consists of seven people; four of the directors are members of the Hatfield family and the other three directors are members of the McCoy family. Because the company needed funds and was unable to obtain a bank loan, the four Hatfield directors loaned $50,000 to H&M at the prime interest rate. The three McCoy directors voted against the loan.

If the McCoy shareholders sue the Hatfield directors for breaching their duty of loyalty to H&M as a result of this loan, what is the likely result?

A. The Hatfields will win because the loan appears to have been fair to the corporation.

B. The McCoys will win because a majority of disinterested directors did not approve the loan.

C. The McCoys will win because a majority of disinterested shares were not voted in favor of the loan.

D. The Hatfields will win because they did not engage in self-dealing.

Question 4-21: Joe and Steve formed an advertising agency called Madison Ave. Corp. ("MAC") and both of them became directors of MAC. Soon after MAC was formed, MAC approached Fashionista Corp. about becoming an advertising client of MAC. Meanwhile, however, Steve formed another advertising agency with Henrietta called S&H Advertising Inc. ("S&H"). Steve then obtained the advertising contract with Fashionista Corp. for S&H. Joe was not aware of Steve's actions until Fashionista Corp. has already contracted with S&H.

MAC may have a cause of action against Steve for:

A. A director's conflicting interest transaction.
B. Breach of the duty of care.
C. Taking a corporate opportunity.
D. None of the above.

Question 4-22: Land Corp. has five directors: A, B, C, D, and E. Directors A and B wish to sell a piece of real estate that they own to Land Corp., and the company wishes to buy it. Directors A and B fully disclose their conflict of interest to the other three directors and abstain from voting on the transaction. Directors C, D, and E, after several weeks of negotiations with a lawyer representing Directors A and B, approve the transaction. Some shareholders of Land Corp., who are upset that the company paid what they think is too high a price for the land, have brought suit against all five directors.

What is the most likely result in this lawsuit? Assume that the plaintiffs would be able to show causation and damages.

A. All five directors will win the case because (1) Directors A and B properly "sanitized" the transaction and (2) the Directors C, D, and E will be protected by the business judgment rule.

B. Directors A and B will win the case because they properly "sanitized" the transaction, but Directors C, D, and E will lose the case because they will not be protected by the business judgment rule.

C. Directors A and B will lose the case because they did not properly "sanitize" the transaction, but Directors C, D, and E will win the case because they will be protected by the business judgment rule.

D. All five directors will lose the case because (1) Directors A and B did not properly "sanitize" the transaction and (2) Directors C, D, and E will not be protected by the business judgment rule.

E. None of the above is correct.

Question 4-23: Vince is a director of Minnesota Mining, Inc. ("MMI"), a corporation that owns several rock quarries, but that is considering selling all of its assets and dissolving. One day, Vince received a telephone call from his high school friend, Julius. Julius told Vince that he would like to buy one of MMI's rock quarries. However, Vince convinced Julius that it would be a better idea for Julius to buy a parcel of land that Vince's wife owned. This land does not have a rock quarry on it, but it is near one of MMI's rock quarries and Vince told Julius that he thought that it would be perfect for rock mining. Julius eventually agreed, and purchased the land from Vince's wife.

If MMI sues Vince, what is the likely result?

A. Vince will win because this was not a director's conflicting interest transaction.

B. Vince will lose because this was a director's conflicting interest transaction and he did not have it approved by the disinterested directors or shareholders.

C. Vince will win, because the land belonged to his wife, not Vince himself.

D. Vince will lose, because he was required to tell MMI's board about Julius's interest in purchasing one of its rock quarries and did not.

Question 4-24: Under Delaware law, which of the following statements concerning interested director transactions is correct? Assume in each answer that approval of the interested director transaction was made after full disclosure.

A. Disinterested shareholder approval of an interested director transaction means that the transaction may not be successfully challenged unless the plaintiff shows the transaction was wasteful.

B. Disinterested shareholder approval of an interested director transaction means that the transaction may not be successfully challenged unless the defendant fails to show that the transaction was not wasteful.

C. Disinterested director approval of an interested director transaction means that the transaction may not be successfully challenged unless the plaintiff shows the transaction was unfair.

D. Disinterested director approval of an interested director transaction means that the transaction may not be successfully challenged unless the defendant fails to show that the transaction was fair.

E. None of the above is correct.

Question 4-25: The board of directors of Plastics Corp. ("PC") consisted of eleven directors, one of whom, Jon, was an "inside director" (i.e., he worked for PC as its President) and ten of whom were "outside directors" (i.e., their only relationship to PC was serving as directors). In the fall of one year, PC's board of directors held a meeting to discuss Jon's compensation for the following year. Jon did not attend this meeting. At the meeting, the directors heard a presentation by Executive Metrics, Inc., a well-known consulting firm that the board had previously hired to make a recommendation as to Jon's compensation. Executive Metrics recommended that Jon be paid a base salary of $1.2 million, and granted options to purchase 20,000 shares of PC common stock at the current market price. The board then unanimously approved this compensation package. However, PC lost more than $20 million during the following year and the price of its stock declined by more than 50%.

If a shareholder validly sues the outside directors, alleging that Jon's compensation package violates the board's fiduciary duties, which of the following is most likely correct?

A. The shareholder will win if he proves that Jon's compensation was not "fair" to PC.

B. The outside directors will win, but only if they can prove that Jon's compensation was "fair" to PC.

C. The outside directors will win if the shareholder cannot overcome the business judgment rule.

D. The outside directors will win, but only if the disinterested shareholders of PC had approved Jon's compensation package.

QUESTIONS 4-26 TO 4-29 ARE BASED ON THE FOLLOWING FACTS

Engine Parts Corp. ("Engine Parts") manufactures engine parts and sells the parts to automobile manufacturers such as General Motors, Toyota, and Big Car Corp. ("BCC"). In October 2015, Engine Parts shipped a large quantity of engine parts to BCC, which BCC installed in the automobiles that it was manufacturing at that time. Later, it became apparent that these engine parts were defective. As a result, BCC had to recall the automobiles that it had sold that contained the defective engine parts and repair the problems. BCC lost $25 million in 2015 as a result of this recall. However, BCC has not yet sued Engine Parts to recover this loss. Frank Fender is a shareholder of BCC and is upset that BCC's board of directors hasn't sued Engine Parts. Frank owns 100 shares of BCC stock, which he purchased through his stockbroker on April 13, 2016. (BCC is publicly traded and has more than 10 million shares of stock outstanding.)

Question 4-26: Which of the following statements is correct?

A. Frank does not have proper standing to file this derivative lawsuit on behalf of BCC.

B. Frank may have proper standing to file this derivative lawsuit on behalf of BCC if the court finds that he would be a fair and adequate representative of BCC's interests in the action.

C. Frank may have proper standing to file this derivative lawsuit on behalf of BCC unless the court finds that he would *not* be a fair and adequate representative of BCC's interests in the action.

D. Frank will have proper standing to file this derivative lawsuit on behalf of BCC unless another shareholder, who owns more than the 100 shares that Frank owns, wishes to file the derivative lawsuit.

Question 4-27: Regardless of how you answered the previous question, assume for purposes of this question that Frank has proper standing to be a proper shareholder-plaintiff.

Is Frank required to make a demand before filing this lawsuit?

A. Yes, regardless of whether BCC is incorporated under the MBCA, in Delaware, or in New York.

B. Yes, if BCC is incorporated under the MBCA; but no if BCC is incorporated in Delaware or in New York.

C. Yes, if BCC is incorporated in Delaware or in New York; but no if BCC is incorporated under the MBCA.

D. Yes, if BCC is incorporated under the MBCA or in Delaware; but no if BCC is incorporated in New York.

E. No, regardless of whether BCC is incorporated under the MBCA, in Delaware or New York.

Question 4-28: Regardless of how you answered the previous question, assume for purposes of this question that Frank was required to make a demand. Therefore, on May 1, 2016, Frank sent a letter to BCC's board of directors, demanding that they sue Engine Parts. On June 1, 2016, the Chairperson of the board of directors of BCC sent the following letter to Frank:

> Dear Mr. Fender: We received your letter to the board of directors demanding that we sue Engine Parts Corp. We carefully considered your request at a lengthy board meeting, but we feel that it would be inappropriate to sue Engine Parts, which has been a long-time supplier of our company. We have discussed the matter with Engine Parts, which has assured us that this problem will never occur again and has offered to sell us engine parts at reduced prices in the future. Thank you for your interest, but we will not be suing Engine Parts.

After he read this letter, Frank decided to file a derivative lawsuit to recover $25 million from Engine Parts for the benefit of BCC.

Which of the following statements is correct? Assume for purposes of this question that BCC is incorporated under the MBCA.

A. Frank must wait until 90 days after May 1, 2016 to file this derivative lawsuit.

B. Frank is now free to file the lawsuit.

C. Frank is now free to file the lawsuit, but will bear all of the expenses in the lawsuit because the board rejected his demand.

D. Based on the facts, it is unlikely that Frank may file the lawsuit.

Question 4-29: Regardless of how you answered the previous three questions, assume for purposes of this question that Frank had the required standing to be a proper shareholder-plaintiff and that he properly filed the derivative lawsuit. In October 2016, while the lawsuit was still pending, the board of directors of BCC formed a committee which it named the "Special Litigation Committee," and appointed Mr. Jones and Ms. Smith, two directors of BCC, to the committee. After several lengthy meetings during which they interviewed potential witnesses in the litigation and consulted a lawyer that the committee hired to assist it, the two members of the Special Litigation Committee determined that BCC should move to dismiss the derivative lawsuit because it is not in the best interests of the corporation.

If BCC is incorporated under the MBCA, how will the court likely rule on this motion to dismiss?

A. The motion will be denied because the corporation has no right to dismiss a derivative lawsuit after it has been properly filed by a shareholder.

B. The motion will be denied because Mr. Jones and Ms. Smith, as directors of BCC, are not independent (qualified).

C. The court will grant the motion only if it finds, using its own business judgment, that dismissing the derivative lawsuit is in the best interests of the corporation.

D. The court will grant the motion if it finds that the Special Litigation Committee determined in good faith, after conducting a reasonable inquiry, that maintaining the derivative lawsuit is not in the best interests of the corporation.

Question 4-30: Which of the following must be brought as derivative lawsuit, and which may be brought as direct lawsuits?

I. A shareholder wishes to sue because she wasn't allowed to inspect the corporation's bylaws.

II. A shareholder wishes to sue the board for selling some of the corporation's assets for a price that was too low.

III. A shareholder wishes to sue the board for approving an excessive salary for the corporation's CEO.

IV. A shareholder wishes to sue the former directors for approving a merger in which the shareholders were paid an inadequate price for their shares.

A. All of the above must be brought as derivative lawsuits.

B. All of the above may be brought as direct lawsuits.

C. I, II, and IV may be brought as direct lawsuits; III must be brought as a derivative lawsuit.

D. I and IV may be brought as direct lawsuits; II and III must be brought as derivative lawsuits.

E. I may be brought as a direct lawsuit; II, III, and IV must be brought as derivative lawsuits.

QUESTIONS 4-31 TO 4-33 ARE BASED ON THE FOLLOWING FACTS

Bob Benson is the President of Big Bank, Inc. and is also one of the six members of its board of directors. Bob is the only member of the board who is an employee of Big Bank. In January, Big Bank sent Bob and several other employees to a seminar about banking regulation that was held in Las Vegas, Nevada. While in Nevada, Bob and two other employees took a trip to the "Bunny Ranch" (a legal prostitution brothel) and used a company credit card to pay for the services of several prostitutes, which was in violation of company policies (obviously). Also while in Nevada, Bob was arrested for drunk and disorderly conduct. A day later, the *Wall Street Journal* printed a story about Bob's arrest. (The story did not mention the use of the company credit card for prostitutes.)

Shep Sullivan, a long-time shareholder of Big Bank, read the story in the *Wall Street Journal* and now wishes to bring a derivative action on behalf of Big Bank against Bob, seeking to recover money damages for harm to Big Bank's reputation.

Question 4-31: Which of the following is a correct statement as to whether Shep must make a demand on Big Bank's board of directors before commencing this lawsuit? Choose the best answer.

A. If Big Bank is incorporated under Delaware law, Shep will be excused from making a demand on Big Bank's board because he can show that Bob's actions were not the product of a valid exercise of business judgment.

B. If Big Bank is incorporated under New York law, Shep will be excused from making a demand on Big Bank's board because he can show that Big Bank's board was not fully informed about Bob's actions to the extent reasonably appropriate in the circumstances.

C. If Big Bank is incorporated under New York law, Shep will be excused from making a demand on Big Bank's board because he can show that Bob's actions were so egregious on their face that they could not have been the product of sound business judgment.

D. All of the above are correct.

E. Under either New York or Delaware law, Shep will be required to make a demand.

Question 4-32: Assume that Shep made a demand on Big Bank's board. The board then held a three-hour meeting to discuss Shep's demand. At the meeting, Bob told the other directors about his unauthorized use of the company credit card and agreed to pay back the amounts that he had charged on it. The directors other than Bob unanimously voted to reject Shep's demand. (Bob abstained from voting.) The Chairperson of the board then sent Shep a letter that stated that the board had considered his demand but had decided to reject it because "filing the lawsuit against Bob Benson could result in the public disclosure of information that would harm Big Bank's reputation."

Which of the following is a correct statement as to Shep's ability to file the derivative lawsuit after the rejection of his demand? Assume for purposes of this question that Big Bank is incorporated under the MBCA.

A. Shep most likely will be unable to file the derivative lawsuit because the directors that rejected his demand were independent (qualified), made a reasonable inquiry, and had a good faith basis for rejecting his demand.
B. Shep will be able to file the lawsuit because Bob was not independent (qualified) or disinterested.
C. Shep will be able to file the lawsuit because the board does not have a good faith basis for rejecting his demand.
D. Shep will be able to file the lawsuit if the court, using its own business judgment, decides that the lawsuit should be brought.

Question 4-33: Regardless of how you answered the previous two questions, assume that Shep properly filed the derivative action. Two months later, Big Bank's board of directors appointed two of the directors (Mr. Jones and Ms. Smith) as a "Special Litigation Committee" to determine whether Big Bank should move to dismiss the lawsuit.

If the special litigation committee moves to dismiss the lawsuit, which of the following is correct? Assume for purposes of this question that Big Bank is incorporated under the MBCA.

A. If Mr. Jones and Ms. Smith were independent (qualified), made a reasonable inquiry, and had a good faith basis for moving to dismiss the lawsuit, the court will dismiss the case.
B. If Mr. Jones and Ms. Smith were independent (qualified), made a reasonable inquiry, and had a good faith basis for moving to dismiss the lawsuit, the court probably will dismiss the case.
C. If Mr. Jones and Ms. Smith were independent (qualified), make a reasonable inquiry, and had a good faith basis for moving to dismiss the lawsuit, the court will dismiss the case if the court, using its own business judgment, decides that the lawsuit should be dismissed.
D. The court will not grant the motion to dismiss because Mr. Jones and Ms. Smith were on Big Bank's board of directors at the time of Bob's wrongdoing.

Question 4-34: Gator Corp. is in the business of manufacturing athletic uniforms. The board of directors of Gator Corp. consists of eight directors. Five of the directors, Mr. A, Mr. B, Ms. C, Ms. D, and Mr. E, were joint owners of a parcel of worthless land in a swamp in Florida. At a regular meeting of the board of directors held on April 13, the board of Gator Corp., after five minutes of discussion, approved a transaction in which Gator Corp. purchased this land for $3.5 million. No notice of the meeting was given and no agenda for the meeting was sent to the directors before the meeting. Mr. X, a shareholder of Gator Corp. for more than eight years, found out about this transaction and was extremely upset. Mr. X seeks to bring a derivative action against the board of directors for violating their fiduciary duties to the corporation. He would be able to allege all of the facts set forth above "with particularity" in a complaint. Gator Corp. is incorporated in New York.

Must Mr. X first make a demand on the board of directors before commencing his derivative lawsuit?

A. No, because a majority of the directors of Gator Corp. were interested in the transaction.
B. No, if the court agrees that the directors did not sufficiently inform themselves about the transaction before they approved it.
C. No, if the court agrees that the transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.
D. All of the above are correct.
E. Mr. X must make a demand on the board before filing a derivative lawsuit.

Question 4-35: Same facts as in the previous question, except that Gator Corp. is incorporated under the MBCA.

Must Mr. X first make a demand on the board of directors before commencing his derivative lawsuit?

A No, because a majority of the directors of Gator Corp. were interested in the transaction.
B. No, if the court agrees that the directors did not sufficiently inform themselves about the transaction before they approved it.
C. No, if the court agrees that the transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors.
D. All of the above are correct.
E. Mr. X must make a demand on the board before filing a derivative lawsuit.

Question 4-36: Under Delaware law, if a shareholder wishes to bring a derivative lawsuit to challenge the corporation's purchase of property from one of its directors, the shareholder would have to make a demand for relief on the board of directors, unless she could plead facts that:

A. Create a reasonable doubt that the directors were disinterested and independent.

B. Show it would be inconvenient to make the demand.

C. Create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.

D. Either A or C.

Question 4-37: Assume that the derivative lawsuit referred to in Question 4-36 is properly commenced because the plaintiff was able to show reasonable doubt that the directors were disinterested and independent. Shortly thereafter, two of the directors resign from the board and two new, independent persons are chosen to fill the vacancies. The board then creates a special litigation committee composed of the two new directors. The committee finds that derivative suit will be extremely costly to the corporation, both in terms of legal fees and potential lost earnings. The committee decides that these costs substantially outweigh any potential benefit to the corporation from maintaining the suit and the committee then files a motion on behalf of the corporation seeking dismissal of the derivative suit.

Which of the following statements is most correct? Keep in mind that this is a Delaware corporation.

A. If the court is satisfied that the two new directors were, in fact, independent, acted in good faith and upon a reasonable investigation, the court *may* apply its own business judgment to determine whether the lawsuit should continue.

B. If the court is satisfied that the two new directors were independent, acted in good faith and upon a reasonable investigation, the court *must* dismiss the lawsuit.

C. If the court is satisfied that the two new directors were, in fact, independent, acted in good faith and upon a reasonable investigation, the court *must* apply its own business judgment to determine whether the lawsuit should continue.

D. None of the above.

QUESTIONS 4-38 TO 4-40 ARE BASED ON THE FOLLOWING FACTS

Parker and Shawn incorporated a corporation under the MBCA called Surf Boards, Inc. The corporation was a great success and eventually became a publicly traded company. Thereafter, it was discovered that Parker and Shawn had used corporation assets for what appeared to have been their own personal pursuits, such as extravagant vacations. Parker and Shawn argued that these vacations were legitimate business trips designed to "scout" for new products. At no time before the vacations did Parker or Shawn disclose the vacations or obtain permission from the board of directors. (Neither Parker nor Shawn currently serves on the board of directors.) Since the discovery, the board of directors has taken no action on the issue. Hector, a shareholder who owns 0.05% of the outstanding stock of Surf Boards, Inc., filed a derivative lawsuit on behalf of the corporation seeking damages from Parker and Shawn. Parker, Shawn, and the corporation have moved to dismiss the lawsuit on grounds that Hector failed to make a demand on the board of directors. Hector argues that demand is excused.

Question 4-38: Which of the following is correct?

A. Hector will lose because a demand is required.
B. Hector will win if he can show that irreparable injury to the corporation would result by waiting for the board to respond to a demand.
C. Hector will win if he can show that a majority of the directors are interested in the challenged transaction.
D. Hector will win if he can show that all of the directors are interested in the challenged transaction.

Question 4-39: Assume that the demand is excused in the Question 4-38. The board of directors then appoints a "special litigation committee" consisting of two outside directors, Pamela and Greta. Neither Pamela nor Greta were directors at the time of Parker and Shawn's vacation. After investigating the charges, Pamela and Greta recommend dismissing Hector's lawsuit. Although Pamela and Greta noted that the lawsuit might be successful, they felt it was in the corporation's best interests to put the matter to rest and avoid all of the bad publicity that the lawsuit is generating. The corporation subsequently moves to dismiss Hector's lawsuit. There are a total of nine directors on the board.

For Hector to successfully oppose the motion he must convince the court that:

A. Pamela and Greta acted in bad faith.
B. Pamela and Greta did not conduct a reasonable inquiry.
C. Pamela and Greta are not disinterested (qualified) directors.
D. Any of the above.

Question 4-40: If Hector is successful in the derivative lawsuit referred to in the preceding two questions, Parker and Shawn will have to pay damages to:

A. the corporation.
B. Hector.
C. All of the shareholders.
D. None of the above.

Question 4-41: Dazzle Corporation ("Dazzle") owns and operates movie theaters. Dazzle plans to build a 15-theater complex. Dazzle's eight-member board met to discuss the purchase of land. Dazzle's board was considering making an offer on a parcel of land owned by Real Estate LLC ("Seller"). Seller is owned by Jim Paxon, a member of Dazzle's board. After approval by its board, Dazzle made an offer on the parcel, and Seller accepted the offer. At the time, none of Dazzle's directors (other than Jim, of course) knew that Jim owned Seller.

If a Dazzle shareholder brings a derivative lawsuit against Jim to challenge the transaction on the ground that it was a breach of Jim's duty of loyalty, the shareholder will lose the case if:

A. The shareholder fails to show that the Dazzle board acted in bad faith.

B. Jim establishes that the transaction was entirely fair to Dazzle at the time.

C. A majority of the Dazzle board approved of the transaction after a thorough investigation, regardless of whether Jim disclosed his conflict of interest.

D. Any of the above.

Question 4-42: Adam, Bob, Carlie, and Dave are the only shareholders of Corporation. Adam owns 400 shares, Bob owns 200 shares, Carlie owns 200 shares, and Dave owns 200 shares. Adam is a director and the President of Corporation. Earl and Francine are the other two directors. Earl is Bob's father, although they rarely see each other outside of Corporation business since they live on opposite sides of town. Because Corporation has a great deal of extra money, Adam suggests that Corporation purchase some land owned by Earl and Francine. Knowing that they have a conflict of interest in this transaction, Earl and Francine request that the shareholders approve the transaction so that it will be "sanitized."

With respect to qualified shareholder approval under MBCA § 8.63, which of the following is correct? Assume that Earl and Francine will make the "required disclosure" (i.e., full disclosure) under MBCA § 8.63.

A. At a properly called meeting with a quorum of at least 501 qualified shares present, more qualified shares must be voted to approve the transaction than against the transaction.

B. At a properly called meeting with a quorum of at least 401 qualified shares present, more qualified shares must be voted to approve the transaction than against the transaction.

C. At a properly called meeting with a quorum of at least 401 qualified shares present, a majority of the qualified shares present must be vote to approve the transaction.

D. At a properly called meeting, at least 401 qualified shares must vote to approve the transaction.

Question 4-43: Phil is a director and the President of Florida Land Ventures, Inc. ("FLVI"), which is incorporated in a state that follows the American Law Institute *Principles of Corporate Governance.* FLVI'S primary business is developing residential subdivisions, but it also owns several retail shopping malls. Currently, FLVI is experiencing a "cash crunch" because many of the houses in its newest subdivision remain unsold. However, Phil is confident that FLVI will eventually sell the houses and be "back in the black."

Yesterday, Tom, an old college friend of Phil's, called Phil at FLVI's office to ask whether FLVI would be interested in investing in a property near Disney World that Tom and his business associates want to acquire and then develop into a golf course. It is possible that the property could also be developed to include a few "high end" (i.e., expensive) mansions. Tom needs one more investor in the project, who will invest \$200,000. Phil wants to invest his own money in Tom's deal, but is worried that he will not be able to do so if FLVI does.

Which one of the following statements is most likely correct?

A. Phil has no duty to offer the Tom deal to FLVI because its primary line of business is the development of residential housing projects, not golf courses.

B. Phil has no duty to offer the Tom deal to FLVI because it is not financially able to invest in the Tom deal due to its current shortage of cash.

C. Phil has no duty to offer the Tom deal to FLVI because he and Tom are good friends from college, which means that the chance to invest came to Phil in his "personal capacity."

D. Before he may invest in the Tom deal, Phil must offer the Tom deal to FLVI.

Question 4-44: Which of the following lawsuits would be a direct lawsuit, rather than a derivative lawsuit?

A. A suit by a shareholder seeking to enjoin a proposed issuance by the corporation of shares of its stock to a new shareholder, because the stock issuance would violate the shareholders' preemptive rights in the corporation's articles of incorporation.

B. A suit against a director to require him to account for profits resulting from a business opportunity taken by the director from the corporation.

C. A suit against the directors seeking damages resulting from the board's approval of a new product that turned out to be very unpopular with consumers and did not sell well.

D. All of the above are direct suits.

Question 4-45: In April, the board of directors of ABC Internet Sales Corp. ("ABC") hired Web Consultants, Inc. ("WCI") to redesign ABC's website. The new website debuted in June. Unfortunately, the website was a disaster and kept crashing, causing ABC to lose millions of dollars of business. The following shareholders have learned that WCI is owned by the brother of one of ABC's directors and that ABC's board hired WCI without doing much research about it beforehand. Each of these shareholders wants to bring a derivative lawsuit on behalf of ABC against ABC's directors:

- Dave is a successful lawyer who works at a big law firm in Manhattan. Dave owns 5% of the outstanding shares of ABC stock, which he purchased in September.

- Julie is a successful doctor who lives in Chicago and has owned 1% of the shares of ABC stock for many years. Julie is a cousin to one of ABC's directors.

- Chad is a carpenter. Chad owns 10 shares of ABC stock (0.01% of the total shares outstanding), which he inherited as a result of his grandmother's death in June.

Assuming no other facts, which of the foregoing shareholders would most likely have standing to bring a derivative lawsuit on behalf of ABC?

A. Dave.
B. Julie.
C. Chad.
D. Either Dave or Chad.

Question 4-46: Joe Rich, a billionaire, is a director of Speed's Car Rental, Inc., a company that rents automobiles on a short-term basis. Joe's daughter Vanessa was engaged to be married. The wedding was scheduled for July. A few weeks before the wedding, Joe decided to buy a car as a wedding present. He thus bought a car for $20,000 in his own name, planning to transfer title to it to Vanessa after the wedding. Unfortunately, the wedding never took place because Vanessa was killed while skydiving in California. After a long period of grieving, Joe realized that he now had a car that he did not need. A fellow director of Speed's Car Rental, Inc., Mr. Herrig, suggested to Joe that he sell the car to the company. Because the car reminded Joe of his terrible misfortune, he decided to sell the car for $500. At the regularly scheduled meeting of the board of directors of Speed's Car Rental, Inc., Joe told the other directors everything that he knew about the car and then left the room where the meeting was being held. After Joe left the room, the five other directors unanimously voted to approve the purchase of the car from Joe for $500.

Shareholder is a shareholder of Speed's Car Rental, Inc. who believes that Joe violated his duty of loyalty to the corporation by selling the car to the corporation. As such, she wants to bring a derivative action to compel the corporation and Joe to rescind (unwind) the transaction because of this conflict of interest.

As to whether Shareholder will be successful on the merits in her derivative suit to rescind the transaction, which of the following is correct?

A. Joe will prevail because this transaction was not a directors' conflicting interest transaction.

B. Joe will prevail because the transaction was approved by the qualified directors.

C. Shareholder will prevail because the transaction was not approved by the shareholders of Speed's Car Rental, Inc.

D. Joe will prevail only if he can show that the transaction was entirely fair to Speed's Car Rental, Inc.

Question 4-47: The board of directors of Corporation consisted of fifteen directors, twelve of whom were outside directors and three of whom were insider directors (i.e., they worked as officers of Corporation). On January 10, the board voted unanimously to adopt a stock option plan for the outside directors. The plan entitled each outside director to purchase 10,000 shares at $12 per share. At the time the board adopted the plan, the shares of Corporation were trading at $24 per share on the New York Stock Exchange. After adopting the plan, the board sought ratification from Corporation's shareholders. In the notice of shareholders' meeting, the board disclosed all of the material terms and conditions of the stock option plan. On February 15, the shareholders ratified the stock option plan at their meeting by a majority vote of the disinterested shares.

Shareholder purchased 100 shares of Corporation on January 6 (an investment of $1,200). Additionally, Shareholder purchased another 100,000 shares of Corporation (an investment of $1.2 million) on February 22. When Shareholder learned of the stock option plan, he filed a derivative suit against all fifteen directors of Corporation, claiming that the directors violated their duty of loyalty to Corporation by approving the stock option plan.

Does Shareholder have standing to bring a derivative suit?

A. No, because Shareholder did not own a significant number of shares at the time the <u>board</u> adopted the stock option plan.
B. No, because Shareholder did not own a significant number of shares at the time the <u>shareholders</u> ratified the stock option plan.
C. Yes, provided Shareholder fairly and adequately represents the interests of Corporation.
D. Yes, because any shareholder has the right to bring a derivative suit under the MBCA.

Question 4-48: Same facts as the prior question. For purposes of this question, assume that <u>Delaware</u> law is controlling. Also assume that Shareholder had proper standing and filed the derivative suit without first making a demand on Corporation and its board of directors.

Is Shareholder's failure to make a demand excused?

A. No, because a derivative suit plaintiff must make a pre-suit demand in all cases under Delaware law and wait 90 days before filing suit.
B. No, because Shareholder cannot show that a demand would be futile.
C. Yes, because Shareholder can allege particularized facts creating a reasonable doubt that a majority of the directors were disinterested and independent.
D. Yes, because a pre-suit demand under Delaware law is no longer required.

Question 4-49: Same facts as the prior two questions. For purposes of this question only, assume that a demand was excused. After Shareholder filed the derivative suit, the board (including the directors named as defendants in the suit) voted to appoint a special litigation committee to evaluate the derivative suit. The special litigation committee consisted of two new directors who joined the board after the stock option plan was approved. The two new directors did not have any rights under the stock option plan.

The special litigation committee hired nationally renowned lawyers and management consultants (none of whom had worked for Corporation in the past) to advise it on the matter. The special litigation committee met four times with its lawyers and consultants before concluding that the litigation fees in the suit would be considerably high in comparison to any potential recovery. As such, the special litigation committee recommended that the board dismiss the derivative suit as not being in Corporation's best interests. The special litigation committee submitted a 100-page report explaining and justifying their decision. The board followed the special litigation committee's recommendation and moved to dismiss the derivative suit.

Assuming Delaware law controls, how will the court rule on the motion to dismiss?

A. The court will not grant the motion, because a special litigation committee has no power to recommend the dismissal of a derivative suit in a demand-excused case under Delaware law.

B. The court will not grant the motion, because the special litigation committee lost its independence when the defendant directors appointed its members.

C. The court will grant the motion, because the business judgment rule applies and will protect the special litigation committee's decision from judicial scrutiny.

D. The court will grant the motion, unless the court applies its own independent business judgment and concludes that the derivative suit would be in Corporation's best interests.

Question 4-50: Same facts as the prior three questions. For purposes of this question only, assume that the derivative suit goes forward and is decided on the merits. Again assume that Delaware law applies.

With respect to Shareholder's claim that the directors violated their duty of loyalty, which of the following is correct?

A. The defendant directors will prevail, because the disinterested shareholders approved the stock option plan after full disclosure, which forecloses any further inquiry.

B. The defendant directors will prevail, unless Shareholder can meet his burden of proof to show that the stock option plan was wasteful.

C. The defendant directors will prevail, provided that the directors satisfy their burden of proof to show that the stock option plan was fair to the corporation.

D. Shareholder will prevail, because the directors engaged in self-dealing.

Question 4-51: The directors of Corporation, at a meeting following their election, approved a resolution whereby they were to receive compensation of $20,000 per year for their service as directors.

Which of the following statements is most correct?

A. Directors' compensation can be established only by vote of the shareholders.

B. Although directors may establish their own compensation, the amounts must be approved by a majority vote of a quorum of disinterested shares.

C. Directors are not permitted to receive compensation as directors but may receive compensation as officers.

D. None of the above is correct.

Question 4-52: Superior Corporation has entered into a number of contracts with X Corporation, whose sole shareholder is Jones. Jones is also a director and the President of Superior Corporation. However, his stock ownership in X Corporation has been deliberately concealed by him. Assume that the contracts between Superior and X Corporation constituted a breach of Mr. Jones' duty of loyalty to Superior.

Which of the following statements is <u>most</u> correct?

A. Superior could not sue Jones personally for damages because the harm caused by the agreements was to the Superior shareholders and not to Superior itself.

B. Superior could sue Jones personally or seek rescission of the agreements.

C. Superior could not sue Jones unless Jones was guilty of an affirmative material misrepresentation.

D. Superior could not successfully sue Jones because he would be protected by the business judgment rule.

Question 4-53: Same facts as the prior question.

If a derivative lawsuit was brought on behalf of Superior against Jones, based on the agreements, which of the following statements is most correct?

A. The plaintiff would have to be a shareholder at the time of the alleged wrongdoing.

B. The plaintiff would not have to be a shareholder at the time of the alleged wrongdoing because Jones deliberately concealed his ownership of his X Corporation.

C. Plaintiff would not have to make a demand on the directors because Jones had breached his duty of loyalty to Superior.

D. None of the above.

Question 4-54: Candy Bar Corp. ("CBC") makes candy bars. CBC's board of directors consists of seven people. In 2016, after several months of market research, CBC's board of directors unanimously decided to discontinue its popular Jupiter Bar and replace it with a new candy bar called the Saturn Bar. The Saturn Bar did well in consumer testing while it was being developed, and CBC's board was convinced that the Saturn Bar would be very popular. In part, this was because CBC's board believed the opinion of Sally Johnson, an independent consultant who had been employed by many other food companies. Sally thought the Saturn Bar would be a big "hit." However, the Saturn Bar sold poorly, thus reducing CBC's profits by tens of millions of dollars.

A shareholder of CBC wishes to file a derivative action on behalf of CBC against CBC's directors, to allege that the directors breached their duty of care to CBC by approving the Saturn Bar. The shareholder made a demand and the board unanimously rejected the demand.

May the shareholder file this derivative action?

A. Yes. None of the directors are qualified directors because, if they are found to have breached their duty of care to CBC, they could be personally liable for millions of dollars in damages.
B. Yes, both only if the board did not act in good faith after a reasonable inquiry when it rejected the demand. The shareholder will have the burden of proof on these issues.
C. Yes, both only if the board did not act in good faith after a reasonable inquiry when it rejected the demand. The board will have the burden of proof on these issues.
D. No, because if the board rejects the demand, the court will only allow the derivative lawsuit to be filed if it finds that the board acted irrationally.

Question 4-55: Same facts as the prior question, except that the derivative suit goes forward and is decided on the merits.

With respect to the shareholder-plaintiff's claim that the directors violated their duty of care, which of the following is most likely correct?

A. The defendant directors will likely prevail.
B. The defendant directors will prevail, provided that they show that their approval of the Saturn Bar did not cause any harm to CBC.
C. The defendant directors will prevail, provided that they show that their approval of the Saturn Bar was fair to the corporation.
D. The shareholder will prevail because CBC's shareholders did not approve the Saturn Bar.

PART 5

CLOSELY HELD CORPORATIONS AND CONTROLLING SHAREHOLDERS

Question 5-1: Ted and Michael wish to incorporate a company called Green Garden, Inc. to make vegetarian food products. Ted plans to invest approximately $600,000 in the business and wants Michael to invest $400,000. Ted has also proposed that: (1) Green Garden, Inc. will have 1,000 shares of common stock authorized in its articles of incorporation and that Ted will own 600 shares and Michael will own 400 shares; (2) the board of directors will consist of Ted, Ted's wife, and Michael; and (3) Ted will be President and earn a salary of $60,000 per year and Michael will be Vice President, Secretary and Treasurer and earn a salary of $40,000 per year. Michael is worried that tensions will develop between him and Ted and that Ted will use his majority ownership position to, as Michael put it, "beat up on me."

Which of the following would help address Michael's concern that Ted may use his majority ownership position to exclude Michael from participating in the business?

I. An employment agreement between Michael (as employee) and the corporation (as employer), terminable only for "cause."
II. A classified board of directors.
III. Cumulative voting for directors.
IV. An agreement under MBCA § 7.32 that would require the directors to annually appoint Michael as the Vice President, Secretary, and Treasurer.

A. All of the above.
B. I, III and IV only.
C. I, II and III only.
D. I, II and IV only.
E. I and IV only.

Question 5-2: Same facts as the prior question. Assume that Michael completely ignores your legal advice and instead invests (i.e., becomes a shareholder) in Green Garden, Inc. on the terms proposed by Ted. Assume that you are in a jurisdiction that follows Massachusetts case law but does not have a statute similar to MBCA § 14.30.

If Ted later causes the board of directors to terminate Michael's employment, which of the following best describes Michael's potential remedies (if any)?

A. Michael will be able to cause the dissolution of the Green Garden, Inc. if he can convince the court that he has been oppressed by majority actions that have defeated the reasonable expectations that he had when he decided to become a shareholder in the corporation.

B. Michael has no potential remedy because mere ownership of stock in a corporation does not entitle a shareholder to employment with the corporation.

C. Michael is entitled to resume his employment with the company because he is a shareholder in a closely held corporation.

D. Michael will not have a remedy if Ted is able to show that there was a legitimate business purpose for terminating Michael's employment and Michael is unable to show that this purpose could be achieved by other means that are less disruptive to Michael's interests.

Question 5-3: All of the following techniques can be used to protect a minority shareholder from abuse by majority shareholders, except:

A. Preemptive rights.
B. Higher quorum requirements than are set by statute.
C. No par value or low par value stock.
D. Multiple classes of stock.

Question 5-4: Sammy, Dan, Tammy, and Hank are the four shareholders of Stereo Speakers, Inc. ("SSI"), a Massachusetts corporation. There are 1,000 shares of SSI stock outstanding. Sammy owns 400 shares, Dan owns 200, Tammy owns 200, and Hank owns 200. Each of the four shareholders serves on the board of directors, which consists of only those four persons. Sammy, Dan, and Tammy are siblings and almost never disagree on business decisions. Because SSI currently has a great deal of extra cash on hand and Hank has been complaining for some time about the fact that he is having difficulty selling any of this SSI stock to outside investors, Sammy suggested that SSI buy 100 shares from Hank.

Which of the following is correct?

A. SSI must offer to buy 25 shares from each of the four shareholders, because each shareholder has an equal right to sell his or her shares back to the corporation if the corporation buys shares back from any shareholder.
B. SSI must offer to buy 40 shares from Sammy and 20 shares from each of the other three shareholders, because each shareholder has a right to sell a pro rata (ratable) amount of his or her shares back to the corporation if the corporation buys shares back from any shareholder.
C. This is an interested director's transaction that may only be completed if it is "fair" to the corporation.
D. SSI may buy 100 shares of Hank's stock.
E. None of the above is correct because corporations may not purchase their own stock.

Question 5-5: AB Corporation has two 50% shareholders: Abe and Ben. The bylaws provide that AB Corporation shall have a two-person board of directors. Both Abe and Ben have served as directors for the past three years. Abe and Ben have now decided that they would like to abolish the board of directors and place the power held by the board in themselves as shareholders.

Which of the following statements is not correct?

A. If Abe and Ben approve, a provision to eliminate the board of directors may be placed in the articles of incorporation; it may thereafter be amended only if approved by both Abe and Ben.
B. Abe and Ben may sign and deliver to the corporation an agreement to eliminate the board of directors; it may thereafter be amended only if approved by both Abe and Ben.
C. Failure to note the elimination of the board of directors conspicuously on the front or back of both Abe's and Ben's shares renders the provision or agreement void.
D. If shares of AB Corporation become publicly traded, the provision or agreement ceases to be effective thereafter.

Question 5-6: X Corporation has three equal shareholders: Cassy, Richie, and Sven. When the corporation was formed, there were no articles or bylaw provisions or other agreements restricting the transfer of stock. The articles provided that they could be amended only upon a two-thirds vote of the outstanding shares. Three years after forming the corporation, Cassy and Richie became concerned that Sven might sell his shares to an "undesirable" outsider. Cassy and Richie voted to amend the articles so that no shareholder could sell his or her stock without first giving the corporation an opportunity to buy it at book value, which at all times during these facts was 50% of the market value of the stock. Six months later, Ricardo offered to buy Sven's shares at market value.

Which of the following is most correct?

A. The amendment to the articles is ineffective with respect to Sven because stock transfer restrictions are illegal under the MBCA.

B. The amendment to the articles is ineffective with respect to Sven because Sven did not vote in favor of it.

C. The amendment to the articles is ineffective with respect to Sven because the purchase price is unfair to Sven under these facts.

D. Both B and C are correct.

QUESTIONS 5-7 TO 5-10 ARE BASED ON THE FOLLOWING FACTS

In 2005, Henry, Dave, and Courtney formed Camera Corporation ("Camera"). Henry, Dave, and Courtney each owned one-third of Camera's outstanding stock. Additionally, Henry, Dave, and Courtney served on Camera's three-member board of directors. Shortly after forming Camera, Henry, Dave, and Courtney signed a written shareholders' agreement which provided that Courtney was assured the position of vice president until she resigned, died, or became incapacitated. Furthermore, under the terms of the shareholders' agreement, Courtney was entitled to a $100,000 annual salary. The agreement provided that it would be valid for fifteen years. The parties filed the shareholders' agreement with Camera's corporate minute book. By the middle of 2016, Henry and Dave had a falling out with Courtney. Henry and Dave then called a special meeting of the board of directors. At the special meeting, Henry and Dave voted to remove Courtney as vice president and stop paying her salary. Courtney attended the meeting and voiced her strong objection to the actions of Henry and Dave. Courtney brought suit against Henry and Dave to enforce her rights under the shareholders' agreement.

Question 5-7: What is the most likely result of Courtney's suit against Henry and Dave?

A. Courtney will prevail, because the shareholders' agreement is valid and enforceable.

B. Courtney will prevail, because the board of directors cannot remove an officer without cause.

C. Henry and Dave will prevail, because the shareholders' agreement unreasonably restricted the discretion of the board of directors.

D. Henry and Dave will prevail, because the shareholders' agreement automatically expired after 10 years by statute.

Question 5-8: Same facts as in the previous question. For purposes of this question and the next question only, assume Courtney brought a direct suit against Henry and Dave, individually, for breach of fiduciary duty. At trial, Courtney testified that she worked for Camera full time and depended on her job for her livelihood. Courtney clearly established that she performed her duties well and was instrumental in Camera's success. Furthermore, Courtney proved that Henry and Dave voted to remove her as vice president for personal reasons unrelated to the business. Assume for purposes of this question only that you are in a jurisdiction that follows Massachusetts case law but does not have a statute similar to MBCA § 14.30.

What is the likely result of Courtney's lawsuit against Henry and Dave?

A. Henry and Dave will prevail because they had a legitimate business purpose in removing her as vice president.

B. Henry and Dave will prevail because shareholders of a corporation do not owe a fiduciary duty to each other.

C. Courtney will prevail, because a "without cause" removal of a minority shareholder from her capacity as an officer is a per se breach of fiduciary duty.

D. Courtney will prevail, because Henry and Dave had no legitimate business purpose to remove her as vice president.

Question 5-9: Same facts as in the previous two questions. For purposes of this question, assume Courtney sued Camera, Henry and Dave, claiming that Henry and Dave's actions were oppressive to her. Assume for purposes of this question only that you are in a jurisdiction that has a statute similar to MBCA § 14.30 but that does not follow Massachusetts case law.

What is the likely result of Courtney's lawsuit against Camera, Henry and Dave?

A. Courtney will prevail because her reasonable expectations in investing in Camera were substantially defeated.

B. Courtney will prevail because a "without cause" removal of a minority shareholder from her capacity as an officer is per se oppressive.

C. Henry and Dave will prevail because they cannot be held personally liable for oppressive conduct.

D. Henry and Dave will prevail because Courtney's continued employment is not a protected interest.

Question 5-10: Same facts as in the prior question. For purposes of this question only, assume that Courtney is successful in establishing that Henry and Dave's actions were oppressive.

What is the most likely remedy under the MBCA?

A. The court will order the involuntary dissolution and liquidation of Camera and Camera will be liquidated.

B. The court will set aside the directors' vote and specifically enforce Courtney's right to serve as vice president and receive a $100,000 annual salary.

C. The court will order Henry and Dave to pay damages to Courtney for her lost wages.

D. The court will order involuntary dissolution, unless Henry, Dave or Camera agrees to purchase all of Courtney's shares for fair value.

Question 5-11: For many years Tara has made delicious chocolate chip cookies. One day, while nibbling on cookies, she and her three friends (Scarlet, Ashley, and Meg) decided to form Chocolate Chip Express Corporation under the MBCA. To the extent possible, the four friends want to minimize the amount of administrative requirements needed to operate the corporation. Their plan is that each of them will work for the corporation and have an equal voice in making corporate decisions. Since they will be seeing each other every day, they believe they can address problems and make decisions as they come up, rather than have formal (and often time-consuming) meetings. To eliminate any required meetings, they want to eliminate the board of directors. Tara asks you, her attorney, if they can eliminate the board of directors.

What would be correct advice for Tara?

A. Under the MBCA, a corporation must always have a board of directors.

B. Shareholders, by unanimous agreement, can eliminate the board of directors by executing a written shareholder agreement provided that the shareholders make the agreement known to the corporation.

C. A board of directors is one of the attributes that distinguishes a corporation from a partnership. If the shareholders did eliminate the board, the entity would then be characterized as a partnership, making the shareholders liable for the debts of the corporation.

D. The shareholders could eliminate the board of directors only if they also agreed to eliminate the officers of the corporation.

Question 5-12: Ambient Elevator Music Corp. ("AEMC") is owned by four shareholders: Brian, Harold, Reinhard, and Carlos. Each shareholder owns 1,000 shares and serves on the four-person board of directors. Often, the shareholders disagree with one another, with Brian and Harold falling into one "camp" or "faction" and Reinhard and Carlos falling into another. As a result, the shareholders entered into the following two agreements:

I. Brian and Harold signed a written agreement that they would each use their best efforts to ensure that both of them would be elected to the board of directors. The agreement also provided that Brian and Harold would never vote their shares to approve a merger involving AEMC unless both of them agreed. This agreement was placed in AEMC's corporate minute book.

II. Reinhard and Carlos signed a written agreement that provided that Carlos had a "proxy" to vote in place of Reinhard at any board meeting at which Reinhard was not present. This agreement was also placed in AEMC's corporate minute book.

Which of the following is most likely correct if a shareholder goes to court to obtain specific performance of either of these agreements?

A. Agreement I is enforceable. Agreement II is not enforceable because fewer than all shareholders are parties to it.

B. Agreement II is enforceable. Agreement I is not enforceable because fewer than all shareholders are parties to it.

C. Both agreements are enforceable.

D. Neither agreement is enforceable.

Question 5-13: Abe and Ben are the only shareholders of AB, Inc., each owning 100 common shares. The bylaws provide that AB, Inc. shall have a two-person board of directors. Both Abe and Ben have served as directors of the company for the last three years. Abe and Ben have now decided that they would like to eliminate the board of directors of AB, Inc. and place the former powers of the board in themselves as shareholders.

Which of the following statements is <u>not</u> correct?

A. If Abe and Ben both approve, a provision to eliminate the board of directors may be placed in the articles of incorporation; it will thereafter be subject to amendment only on approval by both Abe and Ben.

B. Abe and Ben may sign and deliver to the corporation an agreement to eliminate the board of directors; it will thereafter be subject to amendment only on approval by both Abe and Ben

C. Failure to note the elimination of the board of directors conspicuously on the front or back of both Abe's and Ben's stock certificates renders the provision or agreement void.

D. If the shares of AB, Inc. become publicly traded, the provision or agreement ceases to be effective thereafter.

Question 5-14: The shareholders of Corporation entered into an agreement that required any shareholder to first offer to sell his or her stock to Corporation before selling the stock to a third party.

Is this agreement enforceable?

A. Yes, if Corporation is a closely held corporation and the restriction is noted on the front or back of the stock certificates.

B. Yes, if the restriction is noted on the front or back of the stock certificates and the restriction is reasonable.

C. Yes, if Corporation is a closely held corporation and the restriction is reasonable.

D. The agreement is not enforceable.

Question 5-15: Before this year, Circle Corp. had four shareholders: Ms. A, Ms. B, Ms. C, and Ms. D. Each shareholder owned 100 shares of Circle Corp. common stock; thus, each shareholder owned 25% of the outstanding shares. In 1999, all of the shareholders signed a written agreement that provided in part: "Each year, we agree to vote so that (1) Ms. A, Ms. B, Ms. C, and Ms. D are elected to the board of directors, (2) Ms. A is appointed President, (3) Ms. B is appointed Chief Executive Officer, (4) Ms. C is appointed Chief Financial Officer, and (5) Ms. D is appointed Vice President of Marketing." Late last year, Ms. E acquired 100 shares of stock from Circle Corp. and became the fifth shareholder. Before Ms. E acquired her shares, she did not know about the 1999 agreement among the other shareholders, and the stock certificate for her 100 shares did not contain any reference to that agreement. Ms. E wants to keep her shares because she thinks Circle Corp. stock is a good investment, but is upset that the other shareholders have agreed to vote for themselves as directors and officers of the corporation.

If Ms. E brings a lawsuit, seeking a declaration that the 1999 agreement is invalid, which of the following is the most likely result?

A. Ms. E will win because the 1999 agreement was not mentioned anywhere on her stock certificate.
B. Ms. E will win because the 1999 agreement was not included in the articles of incorporation or bylaws of Circle Corp.
C. Ms. E will win because directors cannot enter into agreements specifying what officers they will appoint in the future.
D. Ms. E will win because shareholders cannot enter into agreements specifying what directors they will elect in the future.
E. Ms. E will lose her lawsuit, but will be entitled to rescind (undo) the purchase of her 100 shares.

Question 5-16: Same facts as the prior question, except that the articles of incorporation of Circle Corp. stated in part that ‘‘the corporation elects to have preemptive rights."

What effect did this provision have on the facts in the prior question?

A. Circle Corp. was obligated to offer each of Ms. A, Ms. B, Ms. C, and Ms. D an opportunity to purchase 100 shares before it issued 100 shares to Ms. E if she paid cash for the shares.
B. Circle Corp. was obligated to offer each of Ms. A, Ms. B, Ms. C, and Ms. D an opportunity to purchase 25 shares before it issued 100 shares to Ms. E if she paid cash for the shares.
C. Circle Corp. was obligated to offer each of Ms. A, Ms. B, Ms. C, and Ms. D an opportunity to purchase 25 shares before it issued 100 shares to Ms. E if she paid consideration other than cash for the shares.
D. None of the above is correct.

Question 5-17: The articles of incorporation of Closely Held Corp. ("CHC") provide in part that "On all matters submitted for a shareholder vote, other than the election or removal of directors, the proposal shall be approved only upon the affirmative vote of not less than 80% of the outstanding shares of common stock." CHC common stock is owned by Adrian, Brian, and Curt, each of whom owns 100 shares. At the most recent meeting of the shareholders of CHC, Adrian and Brian voted their shares to remove this provision from the articles of incorporation. Curt voted against this resolution.

Did the shareholders properly remove this provision from the articles of incorporation?

A. No, because amendments to the articles of incorporation of a closely held corporation must be unanimously approved.

B. No, because the proposal did not receive enough votes to pass.

C. Yes, because there were more votes cast in favor of the resolution than against it.

D. Yes. However, Curt can sue to have CHC involuntarily dissolved because the other two shareholders are oppressing him.

Question 5-18: Same facts as the prior question, except that (1) CHC's articles provide that CHC has a three-person board of directors, (2) CHC's board currently consists of Adrian, Brian, and Curt, and (3) CHC's articles provide that directors are elected through cumulative voting. Adrian and Brian, who no longer "like" Curt, want to remove him from the board of directors before next year's annual meeting of shareholders.

How can Adrian and Brian go about removing Curt from the board?

A. Adrian and Brian B can simply vote their 200 shares to remove Curt from the board. They will win that vote because Curt only has 100 shares.

B. Same as Answer A, except that Adrian and Brian would also have to show "cause" for removing Curt from the board.

C. They could amend CHC's articles to provide that the board will only consist of two people.

D. None of these ideas will work.

Question 5-19: Same facts as the prior two questions, except that Carl is tired of fighting with Adrian and Brian all the time and wants to quit and start his own business. He paid $10,000 for his 100 shares of CHC stock back when the corporation was formed, but thinks that the company might be worth $1 million today.

Which of the following would be correct advice for Carl?

A. If he wants money for his shares, he will need to find a buyer for them and agree upon a price with that buyer.

B. He can require that CHC repurchase his shares for the $10,000 that he paid for them, plus interest.

C. He can require that CHC repurchase his shares for their appraised value.

D. He can require that CHC repurchase his shares for their appraised value, but only if he agrees to sign a noncompetition agreement.

Question 5-20: Which of the following statements is correct?

A. A corporation's articles, but not its bylaws, may require that all director decisions be approved unanimously.

B. A corporation's articles and/or its bylaws may require that all director decisions be approved unanimously.

C. A corporation's articles may provide that a quorum at a board meeting may consist of all of the directors then in office.

D. Both B and C are correct.

Question 5-21: Gizmo Corp., a Delaware corporation, is in the consumer electronics business. Gizmo Corp. owns 90% of the stock of Omega Corp., a Delaware corporation which is also in the consumer electronics business. The remaining 10% of the stock of Omega Corp. is held by approximately 1,000 shareholders. The board of directors of Omega Corp. consists of ten persons, all of whom are executives of Gizmo Corp. Last year, the inventor of a new hand-held electronic device which combines the features of cell phones, computers, and global positioning systems in a revolutionary way approached Omega to see if Omega was interested in licensing this technology. Omega's board of directors told the inventor that Omega was not interested in this opportunity, but that he should approach Gizmo Corp. Eventually, Gizmo Corp. and the inventor entered into a licensing agreement that earned tens of millions of dollars for each party. A shareholder of Omega Corp. has properly brought a derivative lawsuit against Gizmo Corp. for breach of fiduciary duties.

What will likely happen in this case?

A. The court will apply the business judgment rule.
B. The court will apply the intrinsic fairness test. Gizmo Corp. will have the burden of proof.
C. The court will apply the entire fairness test. The plaintiff will have the burden of proving that both fair dealing and fair price were lacking.
D. The court will apply the entire fairness test. The plaintiff will have the burden of proving either fair dealing or fair price were lacking.
E. The court will dismiss the case because Gizmo Corp. owes no fiduciary duties.

Question 5-22: Same facts as the previous question. In addition, Omega called a special meeting of its shareholders to vote on whether to *reject* the opportunity to license the invention. At the meeting, Gizmo Corp. made full disclosure of all material facts about the invention and its desire to license the invention. Afterwards, a majority of the shares of Omega stock owned by persons other than Gizmo Corp. were voted to reject the opportunity. Nonetheless, a shareholder of Omega Corp. has properly brought a derivative lawsuit against Gizmo Corp. for breach of fiduciary duties.

What will likely happen in this case?

A. The court will apply the business judgment rule.
B. The court will apply the intrinsic fairness test. Gizmo Corp. will have the burden of proof.
C. The court will apply the entire fairness test. The plaintiff will have the burden of proving that both fair dealing and fair price were lacking.
D. The court will apply the entire fairness test. The plaintiff will have the burden of proving either fair dealing or fair price were lacking.
E. The court will dismiss the case because a majority of the shares held by persons other than Gizmo Corp. were voted in favor of rejecting the opportunity.

Question 5-23: Zoo Corp., a Delaware corporation, has two classes of stock: Class A common stock and Class B common stock. Each share is entitled to one vote on all matters on which shareholders vote; however, the holders of Class A common stock are collectively entitled to elect nine members of the board and the holders of Class B common stock are collectively entitled to elect one member of the board. Monkey Corp. owns all of the Class A common stock. The shares of Class B common stock are owned by approximately 100 persons. Last month, the board of directors of Zoo Corp. caused the corporation to pay dividends on the Class A common stock but did not declare dividends on the Class B common stock. The payment of the dividends complied with all applicable statutes. The holders of Class B common stock have sued Monkey Corp. for breach of fiduciary duties.

What will likely happen in this case?

A. The court will apply the business judgment rule.

B. The court will apply the intrinsic fairness test. Monkey Corp. will have the burden of proof.

C. The court will apply the entire fairness test. The plaintiffs will have the burden of proving that both fair dealing and fair price were lacking.

D. The court will apply the entire fairness test. The plaintiffs will have the burden of proving either fair dealing or fair price were lacking.

E. The court will dismiss the case because Monkey Corp. owes no fiduciary duties.

Question 5-24: Mr. Fizz founded Soda Pop Corp. ("SPC"), a Delaware corporation, thirty-three years ago. However, for the past twenty years SPC has been a publicly traded corporation. Currently, there are 10 million shares of SPC common stock outstanding. Mr. Fizz owns 370,000 shares and members of his immediate family own an additional 230,000 shares. The other 9.4 million shares are held by approximately 1,200 persons, none of whom owns more than 40,000 shares. Mr. Fizz retired for the board of directors and as an employee of SPC five years ago. Currently, he lives in Bermuda and has very little contact with SPC's board, other than to periodically send the directors angry letters and e-mails complaining about SPC's business performance and the price of its stock. Mr. Fizz recently appeared on a popular business news program and heavily criticized SPC's management. SPC currently has a great deal of extra cash on hand and the board is considering using it to repurchase Mr. Fizz's shares so that he will "shut up and go away."

If SPC repurchases Mr. Fizz's shares and other SPC shareholders sue Mr. Fizz claiming a breach of fiduciary duties, what will likely happen in this case?

A. The court will apply the business judgment rule.

B. The court will apply the intrinsic fairness test. Mr. Fizz will have the burden of proof.

C. The court will apply the entire fairness test. The plaintiffs will have the burden of proving that both fair dealing and fair price were lacking.

D. The court will apply the entire fairness test. The plaintiffs will have the burden of proving either fair dealing or fair price were lacking.

E. The court will dismiss the case because Mr. Fizz owes no fiduciary duties.

Question 5-25: Parent Corp. owns 70% of the outstanding shares of Sub Corp. The other 30% of Sub Corp.'s shares are owned by approximately 1,000 persons. Sub Corp.'s board of directors consists of ten people, seven of whom are officers of Parent Corp. The other three directors of Sub Corp. are not affiliated with Parent Corp. in any way. Parent Corp. wishes to merge Sub Corp. into Parent Corp., but is concerned that Sub Corp.'s other shareholders will sue it. Parent Corp. wants to know what it can do to either avoid being sued by some of the minority shareholders of Sub Corp. or, if it is sued, have the court apply the business judgment rule, as opposed to a "tougher" standard of review.

What advice would you give Parent Corp.? Choose the best answer.

A. Fully disclose everything about Sub Corp. and the merger to the minority shareholders and have the merger agreement say that the merger won't happen unless a "majority of the minority" votes in favor of it.

B. Have a special committee of the board of Sub. Corp., consisting of the three directors who are not affiliated with Parent Corp. be authorized to hire their own advisers, negotiate the merger for Sub Corp., and have the power to reject the merger if the committee doesn't think the price offered by Parent Corp. is high enough.

C. Either A or B will work.

D. Both A and B are necessary.

PART 6

ASSET SALES, MERGERS, AND OTHER SIGNIFICANT TRANSACTIONS

Question 6-1: Liquid Corp.'s board of directors decided that business was no longer good and passed a resolution to dissolve the corporation. Subsequently, the holders of all of Liquid Corp.'s 10,000 outstanding shares of common stock approved the dissolution. During its winding up process, Liquid Corp. sold all of its assets for $100,000 in cash and distributed this money to its shareholders, but took no steps to pay or bar creditors' claims. A few months after Liquid Corp. dissolved, Gas Corp. sued the former shareholders of Liquid Corp. to recover $200,000 that Liquid Corp. owed Gas Corp. The court found that the claim was valid and that Gas Corp. had not been notified that Liquid Corp. was dissolving. Mr. Solid owned 1,000 shares of Liquid Corp. common stock.

Assuming that there were no other classes of stock in Liquid Corp. outstanding before the dissolution, what amount, if any, must Mr. Solid pay to Gas Corp.?

A $ 1,000.
B. $10,000.
C. $20,000.
D. Nothing, because shareholders are not liable for the corporation's debts.

Question 6-2: Record Corp.'s articles of incorporation provide that:

> "The corporation's authorized capital shall consist of 500,000 shares of common stock and 500,000 shares of preferred stock. Each share of preferred stock shall be entitled to a liquidation preference of $10 upon dissolution of the corporation. Following full payment of this liquidation preference, each share of preferred stock shall be entitled to share in any remaining amounts to be distributed to the shareholders of the corporation, with each share of preferred stock and each share of common stock being treated equally for purposes of this sentence."

Record Corp. was properly dissolved. After the winding-up process was completed by paying off all of its creditors in full and selling its remaining assets, Record Corp. had $1,000,000 in cash left over. At that time, there were 90,000 shares of Record Corp. common stock outstanding, and 10,000 shares of Record Corp. preferred stock outstanding.

How will this $1,000,000 be distributed?

A. Holders of common stock will receive $1 per share, and holders of preferred stock will receive $1 per share.

B. Holders of common stock will receive $10 per share, and holders of preferred stock will receive $10 per share.

C. Holders of common stock will receive $9 per share, and holders of preferred stock will receive $19 per share.

D. Holders of common stock will receive $11 per share, and holders of preferred stock will receive $19 per share.

Question 6-3: The articles of incorporation of Widget Corp. ("Widget") provide that:

> "The corporation's authorized capital consists of 100,000 shares of common stock and 50,000 shares of preferred stock. Each share of preferred stock is entitled to a liquidation preference of $20 upon dissolution of the corporation. Following full payment of this liquidation preference, no share of preferred stock shall be entitled to receive any further amounts upon dissolution of the corporation."

Widget was properly dissolved. Upon dissolution, Widget distributed $1,000,000 to its shareholders. When they caused Widget to distribute this amount to the shareholders, the members of Widget's board of directors were aware that Widget owed $100,000 to a supplier, Raw Materials, Inc., but did not take any steps to pay or otherwise bar this claim. However, none of Widget's shareholders knew about the amount that Widget owed to Raw Materials, Inc. The amount owed to Raw Materials, Inc. was Widget's only debt at the time of dissolution. At the time of dissolution, there were 1,000 shares of Widget common stock outstanding, and 1,000 shares of Widget preferred stock outstanding.

Which of the following statements is incorrect?

A. Raw Materials, Inc. may not recover the $100,000 from the shareholders of Widget because they did not know that Widget owed money to Raw Materials, Inc.

B. Raw Materials, Inc. may recover the $100,000 from the shareholders of Widget even if they did not know that Widget owed money to Raw Materials, Inc.

C. If Widget had paid the $100,000 owing to Raw Materials, Inc. and then distributed $900,000 to its shareholders, then a holder of one share of Widget common stock would have received $880 upon the dissolution of Widget.

D. If Widget had paid the $100,000 owing to Raw Materials, Inc. and then distributed $900,000 to its shareholders, then a holder of one share of Widget preferred stock would have received $20 upon the dissolution of Widget.

Question 6-4: Seller Corp. ("SC") has operated a large bakery for many years. It has three lines of business: its cookie division, its bagel division, and its cake division. The percentages of SC's overall business that these three divisions represented as of the end of the most recently completed fiscal year are as follows:

Division	Percentage of SC's Assets	Percentage of SC's Pre-Tax Income	Percentage of SC's Revenues
Cookie Division	25%	51%	33%
Bagel Division	51%	24%	34%
Cake Division	24%	25%	33%

Buyer Corp. and SC entered into an asset purchase agreement whereby SC will sell the assets of its cookie division and its bagel division to Buyer Corp. for $10 million in cash. SC's President calls you to ask whether SC can complete this transaction without getting the approval of SC's shareholders.

What is your advice?

A. Shareholder approval is not required because this transaction is in the ordinary course of business.
B. Shareholder approval is not required because SC will definitely still have a "significant continuing business activity" after the transaction.
C. Shareholder approval is required because SC will definitely not have a "significant continuing business activity" after the transaction.
D. Shareholder approval might not be required because a court could find that SC will still have a "significant continuing business activity" after the transaction.

Question 6-5: This year, following approval by its board of directors, Corporation entered into an Asset Sale Agreement to sell the assets of its widget division (the "Division") to Buyer for $300 million. As of the end of last year, the assets of the Division represented 28% of EAC's total assets. Last year, the Division generated 37% of Corporation's income before taxes, and 80% of its revenues.

Is the approval of Corporation's shareholders required before Corporation may sell the assets of the Division to Buyer?

A. Definitely no.
B. No, unless the court finds that the Division is a "significant continuing business activity."
C. Definitely yes.
D. Yes, assuming that Corporation can prove that its remaining assets are a "significant continuing business activity."

Question 6-6: Snow Corp. ("Snow") seeks to acquire Sleet, Inc. ("Sleet"), a wholly owned subsidiary of Precipitation Corp. ("Precipitation"). Sleet manufactures all of Precipitation's green widgets. Precipitation's other wholly owned subsidiary, Rain Corp., manufactures blue widgets. Snow will pay $200 million to Precipitation for all of Sleet's stock. Sleet constitutes 70% of Precipitation's total assets, and last year generated 80% of Precipitation's pre-tax income and 75% of its revenues. After the sale of Sleet's stock, Precipitation will continue to manufacture blue widgets through Rain Corp.

Is shareholder approval of Precipitation required to effectuate the sale?

A. Yes, because Precipitation's sale of Sleet is quantitatively and qualitatively substantial.

B. Yes, because Precipitation will be left without a significant continuing business activity after the sale.

C. No, because shareholder vote is never required where the board decides to sell the corporation's assets.

D. No, because the sale fits within the "safe harbor" rule of the MBCA.

Question 6-7: The board of Guitar Corp. ("Guitar"), a public corporation whose stock is traded on the New York Stock Exchange, approved and recommended the acquisition of Drum, Inc. ("Drum"), a closely held corporation, by merger. Guitar had 70 million shares of common stock outstanding. In connection with the proposed merger, Guitar would issue 20 million new shares of common stock to Drum's shareholders. At a validly called meeting of the shareholders of Guitar, the holders of 35,100,000 shares attended the meeting or were represented by proxy. Once the vote was taken, 17,125,000 shares were voted in favor of the merger, 17,100,000 shares were voted against the merger, and the remaining 875,000 shares abstained.

Did the merger receive shareholder approval?

A. Yes, because the number of shares voted in favor of the merger exceeded the number of shares that voted against it.

B. It doesn't matter, because the approval of Guitar's shareholders wasn't necessary because the merger would be a "small scale" merger.

C. No, because a majority of the outstanding shares were not voted in favor of the merger.

D. No, because quorum was not satisfied and the vote was invalid.

Question 6-8: The board of Mellow Corp. ("Mellow"), a public corporation whose stock is traded on the New York Stock Exchange, approved and recommended the acquisition of Stressed, Inc. ("Stressed"), a closely held corporation, by merger. Mellow had 70 million shares of common stock outstanding. In connection with the proposed merger, Mellow would issue 20 million new shares of common stock to Stressed's shareholders. The boards and shareholders of both Mellow and Stressed properly approved the merger to the extent that such approvals were required. Mark, a shareholder of Stressed, abstained from voting his shares on the merger proposal. Before the meeting of Stressed's shareholders, Mark provided written notice to Stressed's board of directors of his intent to exercise dissenters' rights (also known as appraisal rights).

Is Mark entitled to dissenters' rights with respect to this transaction?

A. Yes, because Mark is entitled to dissenters' rights and he followed the proper procedure in preserving his right to appraisal.
B. Yes, because Mark is automatically entitled to dissenters' rights, as he was a shareholder of the target corporation.
C. No, because Mark would be receiving publicly traded shares in the merger.
D. No, because Mark's abstention from voting on the merger proposal disqualifies him from demanding appraisal rights.

Question 6-9: Same facts as the previous question. Assume for purposes of this question that Mark is entitled to dissenters' rights.

What will he be paid for his shares?

A. The greater of the liquidation value or the pro-rata value based on a sale of the entire business as a going concern.
B. The fair value of his shares as determined by the public stock markets.
C. The fair value of his shares as determined by a court.
D. The fair value of his shares as determined by the price that would be paid by a willing buyer to a willing seller in an arm's length transaction.

Question 6-10: Under the MBCA, a merger:

A. Always requires the vote of the shareholders of both constituent corporations.
B. May never be used to "cash out" or eliminate minority shareholders.
C. Is an action from which a shareholder of the target corporation may dissent and receive payment for the value of their shares if the target corporation's stock is not publicly traded.
D. All of the above are correct.

Question 6-11: Under the MBCA, if a corporation has only one class of stock (common stock) outstanding:

A. All amendments to the corporation's articles of incorporation must be approved by a majority of the outstanding shares of common stock.
B. All amendments to the corporation's articles of incorporation must be approved by the holders of common stock on a "more yes votes than no votes" basis.
C. The board of directors may amend the articles, provided that the shareholders do not thereafter object to the amendment.
D. Only the board of directors may amend the bylaws.
E. None of the above is correct.

Question 6-12: Under the MBCA, which of the following statements concerning asset sales is correct?

A. The shareholders of the selling corporation must always approve the sale if it is outside the usual and regular course of business.
B. The shareholders of the selling corporation are not required to approve the sale if it is in the usual and regular course of business.
C. The shareholders of the buying corporation must always approve the purchase if it is outside the usual and regular course of business.
D. The shareholders of the buying corporation must approve the purchase if the buying corporation will issue any shares of its stock to the selling corporation.

Question 6-13: Basket Corp. has 10 million shares of common stock outstanding. Trash Corp. has 1 million shares of common stock outstanding. The boards of directors of Basket and Trash have adopted a plan of merger that provides that Trash will merge into Basket, and that Basket will survive the merger. In the merger, each share of Trash common stock will be converted into the right to receive $500 in cash, for a total of $500 million. Basket will need to borrow approximately $400 million in order to pay this amount to the Trash shareholders. The merger will not result in any change to the currently outstanding shares of Basket common stock or the articles of incorporation of Basket.

As to whether the shareholders of these corporations must approve the merger, which of the following is correct?

A. The merger requires the approval of the Basket shareholders only.
B. The merger requires the approval of the Trash shareholders only.
C. The merger requires the approval of both corporations' shareholders.
D. The merger requires the approval of neither corporation's shareholders.

Question 6-14: Various Sports Corp. ("VSC") has three lines of business: its football division, its soccer division, and its baseball division. The percentages of VSC's overall business that these three divisions represented as of the end of the most recently completed fiscal year are as follows:

Division	**Percentage of VSC's Assets**	**Percentage of VSC's Pre-Tax Income**	**Percentage of VSC's Revenues**
Football Division	24%	19%	10%
Soccer Division	25%	30%	10%
Baseball Division	51%	51%	80%

Buyer Corp. and VSC entered into an asset purchase agreement whereby VSC will sell the assets of its baseball division to Buyer Corp. for 1 million shares of Buyer Corp. common stock. There currently are 10 million shares of Buyer Corp. common stock outstanding.

Which of the following statements concerning this transaction is correct?

A. The approval of VSC's shareholders is not required, but the approval of Buyer Corp.'s shareholders is required.

B. The approval of VSC's shareholders is required, but the approval of Buyer Corp.'s shareholders is not required.

C. Neither the approval of VSC's shareholders nor the approval of Buyer Corp.'s shareholders is required.

D. Both the approval of VSC's shareholders and approval of Buyer Corp.'s shareholders is required.

Question 6-15: Buyer wishes to purchase the assets of another corporation and continue manufacturing the same products that the selling corporation currently manufactures. Buyer wishes to avoid "successor liability."

What would be the best advice you could give Buyer?

A. Buyer should pay for the assets with shares of its own stock.
B. Buyer should pay for the assets with cash.
C. The Buyer should pay for the assets with a combination of cash and shares of its own stock.
D. Buyer need not be concerned about successor liability if it pays for the assets with shares of its stock so long as it does not use the same physical location that the selling corporation used.

QUESTIONS 6-16 AND 6-17 ARE BASED ON THE FOLLOWING FACTS

The common stock of Glass Corporation ("Glass") is listed on the Nasdaq Stock Market. There are 30 million shares of Glass common stock outstanding, which are held by approximately 5,000 shareholders. The common stock of Beverage Corporation ("Beverage") is held by approximately 200 shareholders, but is not listed on either Nasdaq or the New York Stock Exchange. There are 100,000 shares of Beverage common stock outstanding.

The boards of directors of Glass and Beverage have adopted a merger agreement that provides that Beverage will be merged into Glass. Glass will be the surviving corporation in the merger. In the merger, each share of Beverage common stock will be converted into the right to receive 100 shares of Glass common stock. The merger agreement does not contain any provisions that would amend the articles of incorporation of Glass or that would change or affect the Glass common stock that is outstanding immediately before the merger.

Question 6-16: Which of the following statements concerning shareholder approval of this merger is correct?

A. The merger requires the approval of the shareholders of both corporations.
B. The merger requires the approval of the shareholders of Beverage. The approval of the shareholders of Glass is not required.
C. The approval of the shareholders of Beverage is not required because they will receive publicly traded stock in the merger.
D. The approval of the shareholders of Glass is not required because Glass will survive the merger and the shares of Glass common stock that are outstanding prior to the merger will not be changed in any way.

Question 6-17: Which of the following statements concerning dissenters' rights (also known as appraisal rights) is correct?

A. The shareholders of Beverage have dissenters' rights with respect to this merger.
B. The shareholders of Glass do not have dissenters' rights with respect to this merger because Glass common stock is listed on the Nasdaq Stock Market.
C. The shareholders of Beverage do not have dissenters' rights with respect to this merger because they will receive publicly traded stock in the merger.
D. The shareholders of Glass do not have dissenters' rights with respect to this merger because their stock will remain outstanding following the merger.
E. Both A and D are correct.

QUESTIONS 6-18 AND 6-19 ARE BASED ON THE FOLLOWING FACTS

The common stock of Kite Corporation ("Kite") is owned by ten people. However, Kite is a very large corporation, with more than $1 billion in annual revenues. There are 10 million shares of Kite common stock outstanding. The common stock of String Corporation ("String") is held by approximately 500 shareholders, and is listed on the Nasdaq Stock Market. There are 1 million shares of String common stock outstanding.

The boards of directors of Kite and String have adopted a merger agreement that provides that String will be merged into Kite. Kite will be the surviving corporation in the merger. In the merger, each share of String common stock will be converted into the right to receive one share of Kite common stock. The merger agreement does not contain any provisions that would amend the articles of incorporation of Kite or that would change or affect the Kite common stock that is outstanding immediately before the merger. Kite has no plans to have its common stock listed on any stock exchange following the merger.

Question 6-18: Which of the following statements concerning shareholder approval of this merger is correct?

A. The merger requires the approval of the shareholders of both Kite and String.

B. The merger requires the approval of the shareholders of String. The approval of the shareholders of Kite is not required.

C. The approval of the shareholders of String is not required because they own publicly traded stock.

D. The approval of the shareholders of String is not required because the surviving company will have more than 200 shareholders following the merger.

Question 6-19: Which of the following statements concerning dissenters' rights (also known as appraisal rights) is correct?

A. The shareholders of String have dissenters' rights with respect to this merger, but the shareholders of Kite do not have dissenters' rights.

B. The shareholders of String do not have dissenters' rights with respect to this merger, but the shareholders of Kite have dissenters' rights.

C. The shareholders of both String and Kite have dissenters' rights with respect to this merger.

D. The shareholders of neither String nor Kite have dissenters' rights with respect to this merger.

Question 6-20: The board and shareholders of Asbestos & Lead, Inc., a corporation that was headquartered in Chicago, Illinois, properly approved its dissolution on April 1, 2016. Three days later, the company published the following notice in *The Chicago News*, a local newspaper. The notice was published on only one day.

> **Notice of Dissolution of Asbestos & Lead, Inc.**
>
> Please be advised that Asbestos & Lead, Inc. (the Company) has dissolved. Any persons who have claims against the Company are hereby advised to submit such claims to the Company's Secretary, no later than April 4, 2019, at the following address: Asbestos & Lead, Inc., 111 Main Street, Chicago, IL 60643, Attn: Corporate Secretary. Each claim shall describe the claim in reasonable detail, including the name of the creditor and the reason for the alleged claim. A claim against the Company will be barred unless a proceeding to enforce the claim is commenced no later than April 4, 2019.

Will this notice be sufficient to bar a claim against Asbestos & Lead, Inc. if the holder of the claim does not sue Asbestos & Lead, Inc. before April 4, 2019?

A. No, because the notice must give claimants at least five years following dissolution to sue Asbestos & Lead, Inc.

B. No, because the notice was published only one time.

C. No, because the notice was published in a local newspaper rather than a newspaper that has a national circulation, such as *The New York Times.*

D. Yes.

Question 6-21: Which of the following statements concerning mergers is correct?

A. From the acquirer's perspective, a triangular merger is generally superior to an asset purchase to minimize future liabilities.

B. From the acquirer's perspective, a triangular merger is generally superior to a two-party merger to minimize future liabilities.

C. In a forward triangular merger, the subsidiary of the acquiring corporation merges into the target corporation.

D. If a parent corporation owns at least 90% of the voting shares of a subsidiary, it may merge the subsidiary into itself without needing the approval of the subsidiary's other shareholders; however, the approval of the subsidiary's board of directors is required.

Question 6-22: Bucket Corp. has 3 million shares of common stock outstanding, which are traded on the New York Stock Exchange. Drop Corp. has 10,000 shares of common stock outstanding, which are held by three shareholders and are not admitted for trading on any stock exchange or other market. The boards of directors of Bucket and Drop have adopted a plan of merger that provides that Drop will merge into Bucket, and that Bucket will survive the merger. In the merger, each share of Drop common stock will be converted into the right to receive 100 shares of Bucket common stock. The merger will not result in any change to the currently outstanding shares of Bucket common stock or Bucket's articles of incorporation.

As to whether the shareholders of these corporations have dissenters' rights (also known as appraisal rights) with respect to the merger, which of the following is correct?

A. Only the Bucket shareholders have dissenters' rights.

B. Only the Drop shareholders have dissenters' rights.

C. Both corporations' shareholders have dissenters' rights.

D. Neither corporation's shareholders have dissenters' rights.

Question 6-23: Sports Corp. ("SC") is the parent corporation of two wholly owned subsidiaries: (1) The Middlevillle Rats, Inc. (the "Rats"), which operates a minor league baseball team, and (2) The New Town Polar Bears, Inc., which operates a minor league hockey team. SC is considering selling all of the stock of the Rats to Billy Hughes, who thinks that he can do a better job managing the Rats. At of the end of last year, the value of the Rats stock owned by SC was 42% of SC's total consolidated assets. Last year, the Rats generated 60% of SC's consolidated revenues and 48% of its consolidated pre-tax income.

Does SC need the approval of its shareholders to sell all of the stock of the Rats to Billy Hughes?

A. Yes, because SC will not have a "significant continuing business activity" after the sale.

B. No, but only if a court were to find that SC will still have a "significant continuing business activity" after the sale.

C. No, because SC will still have a "significant continuing business activity" after the sale.

D. No, because SC is selling stock, not assets.

Question 6-24: Nuts Corp. ("Nuts") has 50 million shares of common stock outstanding. Nuts stock is listed on The Nasdaq Stock Market. Bolts Corp. ("Bolts") has 20 million shares of common stock outstanding. Bolts stock is also listed on Nasdaq.

The boards of directors of Nuts and Bolts have adopted a plan of merger that provides that Bolts will merge into Nuts, and that Nuts will survive the merger. In the merger, each share of Bolts common stock will be converted into the right to receive 0.3 shares of Nuts common stock. The merger will not result in any change to the currently outstanding shares of Nuts common stock, but the plan of merger does provide that, upon the effective date of the merger, Nuts's articles of incorporation will be amended to increase the number of its authorized shares of common stock from 55 million shares to 60 million shares.

As to whether the shareholders of these corporations must approve the merger, which of the following is correct?

A. The merger requires the approval of the Nuts shareholders only.

B. The merger requires the approval of the Bolts shareholders only.

C. The merger requires the approval of both corporations' shareholders.

D. The merger requires the approval of neither corporation's shareholders.

Question 6-25: Same facts as the prior question.

As to whether the shareholders of these corporations have dissenters' rights (also known as appraisal rights), which of the following is correct?

A. The shareholders of both corporations have dissenters' rights with respect to the merger.

B. The shareholders of neither corporation have dissenters' rights with respect to the merger.

C. Only the shareholders of Bolts have dissenters' rights with respect to the merger.

D. Only the shareholders of Nuts have dissenters' rights with respect to the merger.

Question 6-26: Glove Corp. ("Glove") has 6 million shares of common stock outstanding. Hand Corp. ("Hand") has 3 million shares of common stock outstanding. The boards of directors of Glove and Hand have adopted a plan of merger that provides that Hand will merge into Glove. Glove will survive the merger. Glove's articles of incorporation will not be changed as a result of the merger, nor will there be any change to its currently outstanding shares of common stock. In the merger, each share of Hand common stock will be converted into the right to one share of Glove common stock.

As to whether the shareholders of these corporations must approve the merger, which of the following is correct?

A. The merger requires the approval of both corporations' shareholders.

B. The merger requires the approval of neither corporation's shareholders.

C. The merger requires the approval of Glove's shareholders only.

D. The merger requires the approval of Hand's shareholders only.

Question 6-27: Consider the following mergers. Only one of them will give the Target's shareholders dissenters' rights.

Merger 1: Both Target and Acquirer are privately held. In the merger, Target shareholders will get cash.

Merger 2: Target is publicly traded, but Acquirer is privately held. In the merger, Target shareholders will get cash.

Merger 3: Both Target and Acquirer are publicly traded. In the merger, Target shareholders will get shares of Acquirer stock.

Merger 4: Both Target and Acquirer are publicly traded. In the merger, Target shareholders will get cash.

Which merger will give the Target's shareholders dissenters' rights?

A. Merger 1.
B. Merger 2.
C. Merger 3.
D. Merger 4.

Question 6-28: Buyer, Inc. wishes to acquire all of the assets of Seller, Inc. ("Seller"). Seller, which manufactures shotguns, is a wholly owned subsidiary of Parent, Inc. ("Parent"), which is engaged in several lines of business. Seller represents 25% of the total consolidated assets of Parent, 70% of the revenues of Parent, and 95% of the income before taxes of Parent.

Does the proposed sale of the assets of Seller require the approval of Parent's shareholders?

A. No, because following the sale Parent is conclusively deemed to have retained a significant continuing business activity.

B. No, provided that Parent can show that it has retained a significant continuing business activity.

C. No, because Seller is a wholly owned subsidiary of Parent.

D. Yes, because following the sale Parent is conclusively deemed not to have retained a significant continuing business activity.

Question 6-29: Regardless of how you answered the previous question, assume that Parent decides to submit the proposed sale to Parent's shareholders for their approval at a shareholders meeting (even if shareholder approval isn't or might not be required).

If Parent Corp. has only 3,000 shares of common stock outstanding:

(1) what is the minimum number of shares that constitutes a quorum at a shareholder meeting called for the purpose of approving the proposed sale, and

(2) assuming that only the bare minimum number of shares necessary to constitute a quorum are voted at the meeting and that there are no abstentions, what is the minimum number of shares that must be voted in favor of the proposed sale in order for it to be approved?

A. The answer to (1) is 1,500 and the answer to (2) is 1,500.

B. The answer to (1) is 1,501 and the answer to (2) is 1,501.

C. The answer to (1) is 1,500 and the answer to (2) is 751.

D. The answer to (1) is 1,501 and the answer to (2) is 751.

Question 6-30: A shareholder vote is typically required:

A. If the corporation is to be the surviving corporation in a "short form" merger.

B. If the corporation purchases all or substantially all of the assets of another corporation.

C. If the corporation purchases all or substantially all of the stock of another corporation.

D. If the corporation proposes to amend its articles of incorporation to increase its authorized shares.

Question 6-31: Your client, T-Bone Perkins, who is the President and sole shareholder of Messy Oil Corp., has informed you that Messy Oil Corp. plans to conduct a tender offer for 51% of the outstanding shares of common stock of Neat Oil Corp. (Neat Oil Corp. common stock is listed on the New York Stock Exchange.)

Which of the following would be <u>in</u>correct advice to Mr. Perkins?

A. While Messy Oil Corp. normally would be required to hold its tender offer open to all shareholders of Neat Oil Corp. for at least 20 business days, if 51% of the shares were tendered by the second day of the tender offer, Messy Oil Corp. could terminate the tender offer and purchase the shares that have been tendered so far.

B. Neat Oil Corp. shareholders may have the right to withdraw their shares from the tender offer while it is still open.

C. Neat Oil Corp. may not pay any shareholder in the tender offer more than it pays any other shareholder in the tender offer.

D. If 100% of the shares of Neat Oil Corp. common stock are tendered, Messy Oil Corp. would not have to purchase all of those shares.

Question 6-32: Solar Corp. common stock is listed on the Nasdaq Stock Market. There are 10 million shares of Solar Corp. common stock outstanding, which currently have a market price of $20 per share. Coal Corp. wishes to acquire Solar Corp. but has not yet publicly announced this plan. Coal Corp. recently gave its President, Mr. Lump, $2 million. Mr. Lump used this money to purchase 100,000 shares of Solar Corp. Mr. Lump has agreed to transfer these shares to Coal Corp. whenever he is asked to do so. In addition, Coal Corp. purchased 300,000 shares of Solar Corp. stock.

Which of the following is a correct statement concerning the requirement to file a Schedule 13D with the Securities and Exchange Commission?

A. Coal Corp. and Mr. Lump must file a Schedule 13D within ten days after either of them acquires an additional 100,000 shares of Solar Corp. stock.

B. Coal Corp. and Mr. Lump must file a Schedule 13D within ten days after either of them acquires an additional 100,001 shares of Solar Corp. stock.

C. Coal Corp. must file a Schedule 13D within ten days after it acquires an additional 200,000 shares of Solar Corp. stock, but would not need to do so if it acquired only 100,001 shares.

D. Coal Corp. must file a Schedule 13D within ten days after it acquires an additional 200,001 shares of Solar Corp. stock, but would not need to do so if it acquired only 100,001 shares.

Question 6-33: On Monday, October 2, The Gecko Corp. ("TGC") began a tender offer for shares of Rusty Airplane Corp. ("RAC") common stock. There are 20 million shares of RAC common stock outstanding, which are listed on the Nasdaq Stock Market. In its tender offer, TGC is offering $20 per share, subject to receiving a minimum of 10,000,001 shares. As of Thursday, October 19, only 8 million shares had been tendered. However, the next day, The Lizard Fund Inc. began a tender offer seeking "any and all" shares of RAC stock and offering $23 per share. TGC is considering how to respond to this development. To that end it is considering the following actions:

I. Immediately terminate the tender offer and purchase all shares that had been tendered at that time.

II. Amend the tender offer so that (1) the offering price for all shares is $24 per share and (2) the tender offer will terminate on Wednesday, November 8.

III. Amend the tender offer so that (1) the offering price is $24 per share for all shares tendered on or after Monday, October 23, and (2) the tender offer will terminate on Wednesday, November 8.

Which, if any, of these actions would be legal for TGC to take?

A. I only.
B. II only.
C. III only.
D. II and III only.
E. None of the above would be legal actions to take.

Question 6-34: Consider the following transactions:

I. Book Corp., a publicly traded corporation with no shareholders that own more than 1% of its stock, wishes to acquire Page Corp. through a merger in which Page Corp. shareholders will receive cash.

II. Book Corp., a publicly traded corporation with no shareholders that own more than 1% of its stock, wishes to acquire Page Corp. through a merger in which Page Corp. shareholders will receive shares of Book Corp. stock.

III. Book Corp., a publicly traded corporation, wishes to acquire Page Corp. through a merger in which Page Corp. shareholders will receive shares of Book Corp. stock. Currently, Mr. Ink owns a majority of the outstanding shares of Book Corp. stock and it is expected that he will remain a majority shareholder of Book Corp. following the merger.

In which, if any, of these potential transactions would <u>Page</u> Corp.'s directors have "Revlon" duties under Delaware law?

A. All of them.
B. None of them.
C. I only.
D. II and III only.
E. I and III only.

Question 6-35: On Monday, August 1, The Ikan Fund Corp. ("IFC") began a tender offer for shares of Widget Corp. ("WC") common stock. There are 10 million shares of WC common stock outstanding, which are listed on the New York Stock Exchange. Of these shares, 750,000 are owned by Ms. Widget, who is a director of WC.

In its tender offer, IFC is offering $20 per share, subject to receiving a minimum of 5,000,001 shares in the tender offer. As of Friday, August 12, a total of 4 million shares had been tendered. However, the next day, in an interview with CNN, Ms. Widget stated that this tender offer is a "terrible deal" for WC's shareholders and that IFC "will put our employees out of a job." IFC is now considering what to do in response.

Which, if any, of the following actions may IFC legally undertake?

I. Amend the tender offer so that it ends on Monday, August 22.

II. Exclude Ms. Widget's shares from the tender offer.

III. Amend the tender offer so that once IFC receives 5,000,001 shares it will immediately end the tender offer and purchase the shares that have been tendered.

A. I only.
B. II only.
C. III only.
D. I and III only.
E. None of the above would be legal actions to take.

PART 7

SECURITIES OFFERINGS, INSIDER TRADING, AND SECTION 16(b)

Question 7-1: Tonya owns a large parcel of undeveloped real estate in Michigan. Tonya plans to sub-divide the parcel into ten plots and sell the plots to ten persons. However, instead of selling the plots solely for cash, Tonya will require that each purchaser agree to farm the land for 15 years, growing the kinds of vegetables specified by Tonya. At harvest time each year, the vegetables will be loaded onto a truck and sold at a local farmers' market. The proceeds from the sale will be divided, with Tonya receiving 80%, and the other persons dividing the other 20% equally, regardless of the kind or quality of the vegetables that they grew. At the end of 15 years, Tonya will transfer full title to the plots to these ten persons, for a $20 cash payment. Tonya does not expect to do any work other than driving the truck.

As to whether this idea would be considered a "security" under federal securities laws, which of the following is correct? Choose the best answer.

A. It is not a security, because land is not a security.
B. It is not a security, because the ten purchasers will be required to perform a great deal of work farming the land.
C. It is not a security, because these transactions will take place solely in one state.
D. It is not a security, because it is likely to be considered a limited partnership.
E. It is a security.

Question 7-2**:** Rule 506 allows a company to raise an unlimited amount of money, whereas Rule 504 is limited to $10 million in a 12-month period.

Why might an issuer choose Rule 504 instead of Rule 506 offering when it wishes to sell securities in an exempt offering?

A. The issuer can sell securities to more non-accredited investors under Rule 504 than it can under Rule 506.
B. Rule 504 does not require that non-accredited investors (either alone or with their purchaser representatives) be "sophisticated," but Rule 506 does.
C. Rule 504 does not require that any specific information be disclosed to non-accredited investors, but Rule 506 does.
D. All of the above are correct.

Question 7-3: You represent SuperLarge Corp., a telecommunications company whose common stock is registered under Section 12(g) of the Securities Exchange Act (i.e., it is a publicly traded company). SuperLarge is considering an offering of common stock to raise additional capital for its operations, which are located in five different states. SuperLarge plans to offer the stock to the residents of those five states. SuperLarge has not made any securities offerings in the last 12 months.

Which of the following statements is correct with respect to this proposed stock offering?

A. SuperLarge could raise an unlimited amount of money under Rule 147.

B. SuperLarge could raise $10 million in a Rule 504 offering.

C. SuperLarge could raise $20 million in a Rule 506 offering.

D. None of the above is correct.

Question 7-4**:** Bob Broker, a stockbroker, maintains discretionary trading accounts for several clients. (A discretionary trading account allows Bob to buy and sell securities for the client's account in his discretion, without any pre-approval by the client.) Each of these accounts is operated independently of Bob's other accounts; thus, Bob may decide to buy securities for one of the accounts but not any of the other accounts, and the profitability of an account does not depend on how well the other accounts fare. However, the amount of Bob's commissions depends on how profitable the account is (i.e., how well the investments in the account perform).

In deciding whether the <u>account itself</u> (rather than the securities in it) is a "security" for purposes of the Securities Act, which of the following statements is most likely correct?

A. If the court applies the horizontal formulation of the "common enterprise" part of the *Howey* test, it will find that the account is a "security."

B. If the court applies the vertical formulation of the "common enterprise" part of the *Howey* test, it will find that the account is a "security."

C. To determine whether the account is a "security" the court should apply the "family resemblance" test.

D. None of the above is correct.

Question 7-5**: According to* **SEC v. Ralston Purina, for purposes of determining whether an offering is exempt from registration pursuant to Section 4(a)(2) of the Securities Act, which of the following is the most important issue?*

A. The number of persons who purchase the securities in the offering.
B. The number of persons to whom the securities are <u>offered</u>.
C. The characteristics of the offerees, e.g., their "sophistication."
D. How well-established and financially strong the issuer is.
E. The total dollar value of securities that are offered.

Question 7-6: Cheese Corp. ("<u>Cheese</u>") is a corporation incorporated under Wisconsin law. As you might guess from its name, Cheese manufactures cheese and sells it to various grocery stores throughout Wisconsin. All of Cheese's assets and operations are located in Wisconsin. However, Cheese common stock is listed on the New York Stock Exchange and is owned by approximately 800 record shareholders who reside throughout the United States. Cheese wishes to raise approximately $5 million to expand its manufacturing facility in Wisconsin by selling additional shares of its common stock in an offering that is exempt from registration under the Securities Act. It believes that it can sell the entire $5 million of stock to wealthy and "sophisticated" persons who reside in Wisconsin.

Which of the following would be correct advice?

A. Cheese may not use the intrastate exemption of Section 3(a)(11) and/or Rule 147 for this offering because its current shareholders reside throughout the United States.

B. Cheese may not use the intrastate exemption of Section 3(a)(11) and/or Rule 147 for this offering because it seeks to sell more than $1 million worth of stock.

C. Cheese may use Rule 506 for this offering, provided that all of the non-accredited investors are "sophisticated" (able to understand the merits and risks of the investment).

D. Cheese may not use Rule 506 for this offering because it is a publicly traded company.

Question 7-7: Same facts as the previous question. Assume that Cheese decides to conduct its stock offering under Section 4(a)(2) of the Securities Act and Rule 506, i.e., Cheese wants its offering to comply with both Section 4(a)(2) and Rule 506. Cheese has identified several potential investors that it wishes to approach to see whether they would be interested in purchasing Cheese stock, including Mr. Lucky. Mr. Lucky, who never completed high school and can barely read and write, inherited $1.5 million when his wealthy parents died two weeks ago. Mr. Lucky, who does not have a job and is not married, usually spends his days playing videogames. Cheese hopes that Mr. Lucky will purchase $600,000 worth of Cheese stock in this offering.

Which of the following would be good advice to Cheese? Assume that it is not possible to have a "purchaser representative" represent Mr. Lucky.

A. Mr. Lucky would not be a permissible offeree/purchaser for purposes of Section 4(a)(2), but would be a permissible offeree/purchaser for purposes of Rule 506.
B. Mr. Lucky would not be a permissible offeree/purchaser for purposes of Rule 506, but would be a permissible offeree/purchaser for purposes of Section 4(a)(2).
C. Cheese should not offer or sell any stock to Mr. Lucky because he would not be a permissible offeree/purchaser under either Section 4(a)(2) or Rule 506.
D. Mr. Lucky would be a permissible offeree/purchaser under both Section 4(a)(2) and Rule 506.

Question 7-8: Corporation is a closely held manufacturing company, with all of its assets and operations in Michigan. It is incorporated under Michigan law. Corporation's President has informed you that Corporation wishes to raise $10 million in a stock offering so that it can expand its manufacturing plant in Michigan. The President also said that she believes that a few of her wealthy and financially sophisticated friends would buy enough stock to meet the $10 million offering amount.

Assuming that Corporation restricts the stock offering only to offerees and purchasers who are Michigan residents and also strictly complies with whatever other advice you give it, which of the following provisions could be relied upon to exempt this stock offering from registration under the Securities Act of 1933?

I. Section 4(a)(2) of the Securities Act of 1933
II. Section 3(a)(11) of the Securities Act of 1933
III. Rule 504 under the Securities Act of 1933
IV. Rule 506 under the Securities Act of 1933

A. All of the above.
B. II, III, and IV only.
C. I, II, and III only.
D. I, II, and IV only.

Question 7-9: Same facts as in the previous question, except that Corporation wishes to raise $12 million in the stock offering.

Assuming that Corporation restricts the offering only to offerees and purchasers who are Michigan residents and also strictly complies with whatever other advice you give it, which of the following provisions could be relied upon to exempt this stock offering from registration under the Securities Act of 1933?

I. Section 3(a)(11) of the Securities Act of 1933
II. Rule 504 under the Securities Act of 1933
III. Rule 506 under the Securities Act of 1933

A. All of the above.
B. I only.
C. I and II only.
D. I and III only.

Question 7-10: Cloning Corp. ("Cloning") is a new biotechnology corporation. It has all of its assets and operations in California, and is incorporated in California. Cloning intends to go into the business of offering rich pet owners in Beverly Hills, California, the opportunity to clone dead pets such as cats and dogs, for the low, low price of $70,000. Unfortunately, Cloning needs a lot of money to develop its cloning technology and is unable to persuade a bank to loan it any money. Cloning's President, Dr. Frankenstein, has informed you that Cloning wishes to raise $35 million in a stock offering so that it can develop its cloning technology. Dr. Frankenstein also said that he believes that it will be possible to sell the entire $35 million worth of stock to wealthy businesspeople in Los Angeles, California.

Assuming that Cloning Corp. strictly complies with whatever advice you give it, which of the following provisions could be relied upon to exempt this stock offering from registration under the Securities Act of 1933?

I. Section 3(a)(11) of the Securities Act of 1933
II. Section 4(a)(2) of the Securities Act of 1933
III. Rule 504 under the Securities Act of 1933
IV. Rule 506 under the Securities Act of 1933

A. I and II only.
B. I, II, and III only.
C. I, II, and IV only.
D. All of the above.

Question 7-11: Corporation sold some of its shares to 100 different shareholders without registration, relying on the intrastate exemption of Section 3(a)(11) of the Securities Act.

Which of the following factors will not destroy the exemption?

A. An immediate resale of some of the shares by the original purchasers to out-of-state residents.

B. An immediate resale of some of the shares by the original purchasers to in-state residents.

C. A resale of some of the shares by the original purchasers to out-of-state residents that occurs more than one year later.

D. Both B and C are correct.

E. None of the above factors would destroy the exemption.

Question 7-12: In order for a corporation to qualify for the non-public offering exemption of Section 4(a)(2) of the Securities Act:

A. Only the actual purchasers of the shares must be able to fend for themselves.

B. There can be no more than 25 actual purchasers of the shares.

C. All of the offerees of the shares must be able to fend for themselves in that they have access to the same kind of information that a registration statement would provide them.

D. It cannot sell more than $20 million of securities in a Section 4(a)(2) offering.

Question 7-13: Technology, Inc. ("Technology") is a Delaware corporation engaged in the manufacture of high-tech machines. The company wished to raise new funds for research and expansion. In order to do this, Cosmo Gearhead, the company's Chief Executive Officer, and George Poindexter, the company's Chief Financial Officer, sent personal letters to 1,000 people in California, Colorado, Wyoming, and New Hampshire asking if they were interested in purchasing stock in Technology. Cosmo and George later followed up with the people who expressed interest in the proposal. Ultimately, 100 people purchased $1.5 million worth of Technology stock, but only after the company had disclosed all the information these people had asked for regarding the company's management and experience, its financial statements, and other information. None of these shareholders were insiders or employees of Technology or were wealthy or sophisticated investors. Most were elderly, retired school teachers with modest pensions.

Under these circumstances:

A. The offering was probably exempt from registration under the Securities Act because the investors received all the information they asked for from the company.

B. The offering was probably exempt from registration under Section 4(a)(2) of the under the Securities Act.

C. The offering was probably exempt from registration as a Rule 506 offering.

D. None of the above is correct.

Question 7-14: Grocery Corp. is a wholesale supplier to approximately 750 independent grocery stores throughout the United States. Grocery Corp. decided that it needed to raise money to build a new warehouse. Instead of taking out a loan from a bank, Grocery Corp. offered promissory notes ("Notes") to all 750 of its grocery store customers. These Notes paid 4% interest annually and had a term of 36 months. In other words, Grocery Corp. agreed to pay interest on the Notes for 36 months and then to pay each Note holder the principal balance of the Note at the end of 36 months. Grocery Corp. sold Notes to several grocery store customers and raised $8 million to build its new warehouse. However, Grocery Corp. soon ran into financial difficulties and is unable to repay the Notes. Grocery Corp. argues that the Notes are not "securities" under Section 2 of the Securities Act for the following reasons:

I. The Notes are not securities because they have a term of more than 9 months.

II. The Notes are not securities because Grocery Corp. used the proceeds ($8 million) to build a new warehouse.

III. The Notes are not securities because the Note purchasers had a pre-existing relationship with Grocery Corp. (i.e., the Note purchasers are customers).

Which of the above arguments is (are) likely to be successful in convincing a court that the Notes are not "securities" under Section 2 of the Securities Act?

A. I only.
B. II only.
C. I and II only.
D. III only.
E. None of the above.

Question 7-15: Restaurant, Inc. is a closely held Michigan corporation that operates restaurants in Michigan and Florida. Its revenues, profits, and operations are roughly evenly split between those two states. Restaurant wants to raise capital through a stock offering. To avoid registration requirements, Restaurant plans to limit its sale of stock to Florida residents.

Which one of the following statements is correct concerning Rule 147?

A. Restaurant can avoid registration so long as its prospectus prominently states: "Purchase Limited to Florida Residents."

B. Restaurant can avoid registration as long as it does not expand into a third state.

C. Restaurant does not qualify for Rule 147 because that rule would not allow sales to Florida residents on these facts.

D. Restaurant can avoid registration if it limits sales of the shares to wealthy and "sophisticated" individuals.

Question 7-16: Specific Electric Inc. ("SEI") has a policy that permits any of its 50,000 worldwide employees to purchase SEI stock under its Employee Stock Purchase Program (the "Program"). Members of the general public may not purchase SEI stock pursuant to the Program. While SEI's high-level executives have purchased the greatest number of shares, at least 500 "rank-and-file" employees, including administrative assistants, assembly line workers, and staff engineers, purchased a collective total of $16 million of SEI stock under the Program last year. SEI did not file a registration statement with the Securities and Exchange Commission with respect to the Program. The SEC brought suit against SEI, contending that SEI has illegally made a public offering of securities without registration.

What is the likely result of this suit?

A. SEI will prevail, because SEI did not offer to sell stock to the general public.

B. SEI will prevail, because the offering is exempt under Regulation D.

C. SEI will lose, because the Program is a public offering.

D. SEI will lose, because its stock is an "investment contract."

Question 7-17: Tony Baritone is the sole shareholder of Jersey Fashion Corp., which manufactures and sells track suits. Baritone wants to expand his business, but he does not want to borrow from a lender at high interest rates. Instead, he would like to raise $9.9 million of additional capital by having the corporation sell stock to fund its expansion. Baritone has four friends who are multi-millionaires who would like to invest $2 million each. Additionally, Baritone knows nine other individual investors who would like to invest $200,000 each. None of these nine investors earn more than $150,000 per year (alone or with his or her respective spouse) or has a net worth greater than $900,000 (alone or with his or her respective spouse). Furthermore, none of these nine investors has significant experience in business or financial matters and will not be represented by someone who does. Because filing a registration statement would be too expensive, Baritone wants to raise the money without one.

Which of the following statutes or SEC rules would allow Baritone to conduct the stock offering without registration with the Securities and Exchange Commission?

A. Rule 504.
B. Rule 506.
C. Section 4(a)(2).
D. All of above would work.

Question 7-18: Elvis was the CEO of Drugs 'n' Stuff, Inc., a biotechnology company whose stock was traded on the New York Stock Exchange. In June, Drugs 'n' Stuff publicly announced that it was working on developing a drug that would cure colon cancer. By July, the press publicly touted this drug as the next "wonder drug." From June to December, the price of Drugs 'n' Stuff stock increased from $30 per share to $60 per share, based primarily on the promising news about this drug. In August, Drugs 'n' Stuff submitted the drug for approval with the U.S. Food and Drug Administration ("FDA"). On December 1, the FDA informed Elvis that it would not approve the drug because it had many adverse side effects. The FDA made its public announcement of their non-approval of the drug at 9:00 a.m. on December 2. By 11:00 a.m., several TV news networks broadcast reports of the FDA's non-approval of the drug. By 11:45 a.m., the price of Drugs 'n' Stuff stock fell from $60 per share to $50 share. At 12:15 p.m. on December 2, Elvis sold 10,000 shares of Drugs 'n' Stuff stock for $45 per share. Elvis had previously purchased his 10,000 shares of Drugs 'n' Stuff stock for $33 per share on July 15.

Based on the foregoing, which of the following statements is correct concerning Section 16(b) of the Securities Exchange Act and Rule 10b-5 under the Securities Exchange Act?

A. Elvis has violated Rule 10b-5 and Section 16(b).
B. Elvis has violated Rule 10b-5, but he has not violated Section 16(b).
C. Elvis has violated Section 16(b), but he has not violated Rule 10b-5.
D. Elvis has violated neither Rule 10b-5 nor Section 16(b).

QUESTIONS 7-19 TO 7-21 ARE BASED ON THE FOLLOWING FACTS

Bill Beancounter worked in the accounting department of Large Corp., a publicly traded corporation whose common stock was listed on the New York Stock Exchange. On a Friday afternoon in March, while working on the audit of Large Corp.'s financial statements for the previous year, Bill discovered that financial statements that Large Corp. had included in previous filings with the Securities and Exchange Commission (the SEC) grossly overstated the amounts of Large Corp.'s revenues. For example, in its quarterly report to the SEC for the quarter ended September 30 of the previous year, Large Corp. had stated that its revenues were $100 million. In fact, Bill discovered that the correct number was closer to $80 million.

Depressed, Bill went to a St. Patrick's Day party with his friend Andy that evening and consumed several bottles of beer. The alcohol deepened his depression. When Andy asked Bill what was wrong, Bill, now very intoxicated, told Andy what he had discovered. Another guest at the party, Tom, overheard this conversation, but neither Bill nor Andy knew that Tom heard what Bill said to Andy. Tom owned 500 shares of Large Corp. common stock, but had no other relationship to Large Corp.

On the following Monday morning, while Large Corp. common stock was trading at $10 per share, Tom sold all of his shares of Large Corp. stock through his stockbroker.

That same day, Bill remembered that his friend Angie (whom Bill had been trying unsuccessfully to date) owned shares of Large Corp. common stock. Bill telephoned Angie and had the following conversation:

BILL: "Hi Angie, it's Bill."

ANGIE: "Hi Bill. How are things at Large Corp.?"

BILL: "Well, not so good. Say, do you still own Large Corp. stock?"

ANGIE: "Yes I do."

BILL: "Well, you probably should sell it pretty soon."

ANGIE: "Why?"

BILL: "Well, I can't really tell you, but let's just say that a little birdie told me that there's going to be some bad news about the company coming out soon."

ANGIE: "Thanks for the advice."

BILL: "No problem. Maybe we can go on a date some time."

ANGIE: "It's a deal. Meet me at the Black Rose Pub on Friday after work. Bye."

Angie, who had no relationship to Large Corp. other than as a shareholder, then called her stockbroker and arranged to sell all of her shares of Large Corp. stock. Three weeks later, Large Corp. filed corrected versions of its financial statements with the SEC. After these financial statements were filed, the trading price of Large Corp. stock plummeted to $4 per share.

Question 7-19: Which of the following is a correct statement as to whether Bill has violated any provision of or rule under the Securities Exchange Act of 1934? Please choose the best answer.

A. Bill violated Rule 10b-5 by "tipping" both Tom and Angie about material nonpublic information.
B. Bill violated Rule 10b-5 by "tipping" Angie about material nonpublic information.
C. Bill did not violate Rule 10b-5, but he did violate Section 16(b).
D. Bill did not violate Rule 10b-5 because he did not purchase or sell any shares of Large Corp. stock on the basis of material nonpublic information.

Question 7-20: Did Angie violate Rule 10b-5? Choose the best answer.

A. Angie violated Rule 10b-5 because she misappropriated material nonpublic information from Bill.
B. Angie violated Rule 10b-5 because she was an insider of the company and traded on the basis of material nonpublic information.
C. Angie did not violate Rule 10b-5 because she owed no duty of trust or confidence to Large Corp.
D. Angie violated Rule 10b-5 because she was a "tippee" who traded on the basis of material nonpublic information.

Question 7-21: Did Tom violate Rule 10b-5? Choose the best answer.

A. Tom violated Rule 10b-5 because he traded on the basis of material nonpublic information that he knew came from a source (Bill) that owned a duty of confidentiality to Large Corp.
B. Tom violated Rule 10b-5 because he misappropriated material nonpublic information from Bill.
C. Tom violated Rule 10b-5 because he should have known that Bill was intoxicated.
D. Tom did not violate Rule 10b-5.

QUESTIONS 7-22 TO 7-25 ARE BASED ON THE FOLLOWING FACTS

Potato Chip Corp. ("PCC") common stock is traded on the Nasdaq Stock Market. In early June, the board of directors of a privately held competitor, Nacho Corp. ("Nacho"), decided to investigate the possibility of making a cash tender offer of $40 per share for 100% of PCC's stock. However, before making a formal tender offer or discussing it with PCC, Nacho purchased 4% of PCC's outstanding stock through several different stockbrokers, without publicly disclosing its identity or intentions, for an average price of $26 per share.

Carrie Cruncher was employed as an accountant by PCC. On Friday, July 11, Paul Potato, who is PCC's President, asked Carrie to prepare a binder of financial statements and other financial information concerning PCC. When Carrie asked why, Paul told her: "Well, I shouldn't tell you this, but I trust you to keep this top secret. We've been negotiating to be acquired by Nacho Corp. It looks like Nacho is going to make a tender offer for PCC stock for $40 per share, but Nacho wants some more information about PCC before it makes a final decision." Carrie then asked: "That's great for our shareholders, but what will happen to employees like me?" Paul replied: "I suppose that Nacho will keep some of our employees, but I suspect that many will be laid off. But I promise to recommend that they keep you."

When she came home from work that day, Carrie was very upset and told her husband, Chuck (who is not employed by PCC), about Nacho's possible tender offer, but reminded him that it was a "top secret" situation and that he couldn't tell anyone about it. Later that night, however, after Carrie had fallen asleep, Chuck called his mother, Grace, and told her: "Go buy some PCC Corp. stock on Monday. Something big is happening—PCC is going to be sold." The following Monday, Grace purchased 1,000 shares of PCC common stock for $26 per share.

Meanwhile, around midnight on Friday, July 11, a janitor, Cletus Clean, was cleaning Carrie's office and happened to see a three-ring binder entitled "Confidential Financial Information for Tender Offer by Nacho Corp. for Potato Chip Corp. Stock." Cletus was not employed by PCC, but instead worked for Cleaning Crew, Inc., a firm that cleans office buildings. Seven years ago, Cletus had signed Cleaning Crew's standard employment contract, which prohibited him from using any client information he might come across while on the job. Nonetheless, the following Monday, Cletus purchased 100 shares of PCC common stock for $26 per share.

In early August, Nacho started its tender offer for PCC stock at $40 per share. Assume for purposes of the following questions that the information about Nacho's proposed tender offer was material nonpublic information before the tender offer started, within the meaning of Rule 10b-5 under the Securities Exchange Act of 1934.

Question 7-22: Did Nacho's secret purchase of 4% of PCC's stock in June violate federal securities laws?

A. Yes, because Nacho was required to disclose these secret purchases to the Securities and Exchange Commission (the "SEC") by filing a Schedule 13D.
B. Yes, because Nacho's secret purchases were a manipulative and deceptive device under Rule 10b-5, which acted as a fraud upon PCC's shareholders.
C. Yes, Nacho violated Rule 14e-3.
D. No, because Nacho had no reporting requirements to the SEC under the above facts.
E. No, because the SEC only regulates stock purchases that constitute insider trading under Rule 10b-5.

Question 7-23: Did Carrie violate Rule 10b-5? Choose the best answer.

A. Yes. Carrie had a *Cady, Roberts* duty to PCC and violated Rule 10b-5 by "tipping" Chuck about material nonpublic information in violation of that duty.
B. Yes. Carrie violated Rule 10b-5 by "misappropriating" material nonpublic information from PCC.
C. Yes. Chuck violated Rule 10b-5; this means that Carrie also violated Rule 10b-5.
D. No, Carrie did not violate Rule 10b-5.

Question 7-24: Did Chuck violate Rule 10b-5? Choose the best answer.

A. Yes. Chuck violated Rule 10b-5 because he was a "tippee" of Carrie and was also a "tipper" of Grace.
B. Yes. Chuck violated Rule 10b-5 because he misappropriated material nonpublic information from Carrie and then "tipped" Grace.
C. Yes. Chuck violated Rule 10b-5 because, as Carrie's husband, he owed a *Cady, Roberts* duty to PCC and thus could not "tip" Grace.
D. No. Chuck did not violate Rule 10b-5 because he owed no duties to PCC.

Question 7-25: Did Cletus violate Rule 10b-5? Choose the best answer.

A. Yes. Cletus violated Rule 10b-5 because he traded on the basis of material nonpublic information when he knew or should have known that Carrie would be violating her *Cady, Roberts* duty to PCC by disclosing the information to him.
B. Yes. Cletus violated Rule 10b-5 because he misappropriated material nonpublic information from Cleaning Crew.
C. No. Cletus did not violate Rule 10b-5 because he owed no duty of trust or confidence to Carrie or PCC.
D. No. Cletus did not violate Rule 10b-5 because Carrie did not receive any personal benefit when Cletus learned of the information.

Question 7-26: X Corporation and Y Corporation recently concluded a merger whereby X was merged into Y. Following the merger, Harold, the Chief Executive Officer of Y, decided that the future looked extremely bright for the newly combined business and purchased 1,000 shares of Y stock (which is traded on the Nasdaq Stock Market) through his stockbroker. Harold's intent at the time was to hold the stock for long-term investment. Five months later, however, because of his wife's serious illness, Harold decided to sell not only his Y stock but all of his other holdings to pay for medical bills. Harold made a $15,000 profit on the sale of the Y stock.

Assuming no other facts, which of the following statements is correct about whether Harold violated Rule 10b-5 under the Securities Exchange Act and/or Section 16(b) of the Securities Exchange Act?

A. Harold violated Section 16(b). Harold did <u>not</u> violate Rule 10b-5 because he did not possess material nonpublic information at the time of his transactions.
B. Harold did <u>not</u> violate Section 16(b) because he did not intend to sell the stock within the short-swing period of six months and had a legitimate purpose to sell the stock. Harold did <u>not</u> violate Rule 10b-5 because he did not possess material nonpublic information at the time of his transactions.
C. Harold did <u>not</u> violate Section 16(b) because he did not intend to sell the stock within the short-swing period of six months and had a legitimate purpose to sell the stock. Harold violated Rule 10b-5 because he owed *Cady, Roberts* duties to Y Corporation.
D. Harold violated Section 16(b). Harold also violated Rule 10b-5 because he owed *Cady, Roberts* duties to Y Corporation.

Question 7-27: Movie Streams Inc. ("<u>MSI</u>") is a publicly traded corporation that operates a video-streaming service. MSI common stock is traded on Nasdaq. On July 15, following the close of trading on Nasdaq at 4 p.m., MSI issued a press release to report its earnings for the quarter ended June 30. This press release stated that MSI had profits of 6 cents per share and that it had added 3.28 million new subscribers. These numbers were far above what Wall Street analysts had predicted, and on July 16 the trading price of MSI stock rose from approximately $98 per share to more than $117 per share. MSI's law firm is Sterling Cooper LLP. Don Dapper, a lawyer and employee of Sterling Cooper, spent most of the day on July 15 assisting MSI with drafting the press release. At around on 3 p.m. on July 14, Don purchased 1,000 shares of MSI stock for $98 per share.

Did Don violate Rule 10b-5 under the Securities Exchange Act of 1934?

A. Yes, under the "classic" theory of insider trading.
B. Yes, under the "misappropriation" theory of insider trading.
C. Both A and B are correct.
D. No, because Don was not an employee of MSI and MSI did not "tip" him.

QUESTIONS 7-28 TO 7-30 ARE BASED ON THE FOLLOWING FACTS

Mr. Yellow is the President of Yellow Corp., whose stock is listed on the New York Stock Exchange. Yellow Corp. is engaged in negotiations to be acquired by Orange Corp. in a merger. Although Yellow's shareholders will be paid handsomely for their shares in this merger (more than 40% above the current market price of Yellow stock), Mr. Yellow will be out of a job afterwards, which has made him depressed. On April 15, Mr. Yellow attended a college basketball game with his wife. When she thought that he looked sad, Mrs. Yellow asked Mr. Yellow what was wrong. Mr. Yellow then told her about the planned merger. Sitting a few rows behind them was Fred Fan, who overheard their conversation. Fred is not an employee of Yellow Corp. and has never met Mr. Yellow. On April 20, Fred bought 200 shares of Yellow Corp. stock. The merger was announced on April 30.

Question 7-28: Did Fred violate Rule 10b-5? Choose the best answer.

A. No, because Fred does not owe any duties to Yellow Corp. or Mr. Yellow.

B. No, because the information was not material.

C. Yes, because Fred misappropriated material nonpublic information from Yellow Corp.

D. Yes, because Fred misappropriated material nonpublic information from Mr. Yellow.

Question 7-29: In addition, Mr. Yellow called his stockbroker and bought 150,000 shares of Yellow Corp. several days before the merger was publicly announced.

Did Mr. Yellow violate <u>state-law</u> prohibitions on insider trading? Choose the best answer.

A. No, because the information was not "material."

B. No, because Mr. Yellow owed no duties to Yellow Corp. or its shareholders in this fact pattern.

C. No, because Mr. Yellow did not purchase Yellow Corp. stock in a face-to-face transaction.

D. Mr. Yellow is liable for insider trading based on state law in this fact pattern.

Question 7-30: In addition, the president of Orange Corp., Mr. Orange, called his stockbroker and bought 10,000 shares of Yellow Corp. several days before the merger was publicly announced.

Did Mr. Orange violate Rule 10b-5? Choose the best answer.

A. No, because Mr. Orange owed no duties to Yellow Corp. or its shareholders in this fact pattern.

B. No, because no one in the fact pattern "tipped" Mr. Orange.

C. Yes, this is an example of "classic" insider trading.

D. Yes, this is an example of misappropriation.

***Question 7-31*:** Paul Quinn is a janitor with Waste Pros, Inc., a firm that cleans office buildings. He signed the firm's standard employment contract, which prohibited him from disclosing any client information he might come across while doing his work. While cleaning the offices of Target, Inc., Quinn found a memo from the CEO of Acquirer Inc. which fell out of a trash can. The memo was marked "confidential" and discussed Acquirer's plans to start a hostile takeover bid for Target. The next day, Quinn purchased 10,000 shares of Target stock for $6 per share. A few days later, Acquirer publicly announced its bid to acquire Target and the market price of Target's shares rose to $9 per share. Quinn still owns his shares of Target stock.

Which one of the following statements is most likely correct?

A. Quinn did not violate Rule 10b-5 because it only applies to officers or directors of a corporation who use material nonpublic information for personal gain.

B. Quinn did not violate Rule 10b-5 because he did not disclose any material nonpublic information to anyone in violation of his employment contract.

C. Quinn violated Rule 10b-5 because he misappropriated material nonpublic information he learned in the course of his employment.

D. Quinn did not violate Rule 10b-5 because he did not owe any duties to Target or its shareholders in this fact pattern.

Question 7-32: Joe O'Kagan was a partner at Doochey & White, a law firm. Although Joe was an estate-planning lawyer, one day he saw some confidential documents on the desk of one of his partners who practiced corporate law. These documents indicated that Acquirer Inc., a client of Doochey & White, was about to start a tender offer for Target Inc. for $60 per share. Later than day, Joe called his stockbroker and purchased 1,000 shares of Target stock for $40 per share, which was the current market price of Target stock. Joe also told his brother Frank about the information. Frank then purchased 500 shares of Target stock for $40 per share. A few days later, Acquirer publicly announced its tender offer, and the market price of Target stock rose to $58 per share.

Did Joe violate Rule 10b-5?

A. Yes. Joe was both a misappropriator and a tipper.

B. Yes. Joe was a misappropriator but not a tipper.

C. Yes. Joe was a tipper but not a misappropriator.

D. No. Joe was neither a misappropriator nor a tipper.

Question 7-33: Steve Chores was the president of Banana Computer, Inc. ("Banana"), whose stock is traded on the NASDAQ Stock Market. There are 1,000,000 shares of Banana stock outstanding. On January 5, Steve sold 10,000 shares of Banana stock for $20 per share. (These were the only shares of Banana stock that he owned.) On January 31, Steve bought 5,000 shares of Banana stock for $18 per share.

Is Steve liable under Section 16(b) of the Securities Exchange Act of 1934?

A. No, because the sale of the stock occurred before the purchase of the stock.

B. No, because Steve was not a 10-percent shareholder on January 5 or January 31.

C. Yes, Steve is liable for $20,000.

D. Yes, Steve is liable for $10,000.

E. Yes, Steve is liable for $5,000.

Question 7-34: Baby Food Corp. common stock is listed on the New York Stock Exchange. On September 1, 2015, Mr. Toddler, who is a director of Baby Food Corp., purchased 10,000 shares of Baby Food Corp. common stock for $20 per share. On November 23, 2015, Mr. Toddler purchased an additional 5,000 shares of Baby Food Corp. common stock for $21 per share. On April 1, 2016, Mr. Toddler sold 15,000 shares of Baby Food Corp. common stock for $22 per share.

What is Mr. Toddler's liability to Baby Food Corp. under Section 16(b) of the Securities Exchange Act of 1934?

A. $5,000.
B. $10,000.
C. $25,000.
D. $30,000.

Question 7-35: Baby Food Corp. common stock is listed on the New York Stock Exchange. There are 1 million shares of Baby Food Corp. common stock outstanding. On June 30, Mr. Crier did not own any Baby Food Corp. common stock. However, on July 1, Mr. Crier purchased 200,000 shares of Baby Food Corp. common stock for $20 per share. On August 17, Mr. Crier purchased an additional 50,000 shares of Baby Food Corp. common stock for $21 per share. On September 30, Mr. Crier sold 60,000 shares of Baby Food Corp. common stock for $22 per share. On October 31, Mr. Crier sold 190,000 shares of Baby Food Corp. common stock for $22 per share, thereby reducing his holdings of Baby Food common stock to zero. At no time during these events was Mr. Crier an officer or director of Baby Food Corp.

What is Mr. Crier's liability to Baby Food Corp. under Section 16(b) of the Securities Exchange Act of 1934?

A. $50,000.
B. $60,000.
C. $120,000.
D. $500,000.

Question 7-36: Cop Corp. common stock is listed on the Nasdaq Stock Market. On January 23, Mr. Robber, who is a director of Cop Corp., purchased 1,000 shares of Cop Corp. common stock for $10 per share. On May 3, Mr. Robber purchased 2,000 shares of Cop Corp. common stock for $11 per share. On August 10, Mr. Robber sold 2,000 shares of Cop Corp. common stock for $14 per share. On December 10, Mr. Robber purchased 1,000 shares of Cop Corp. common stock for $9 per share.

What is Mr. Robber's liability to Cop Corp. under Section 16(b) of the Securities Exchange Act of 1934?

A. $5,000.
B. $6,000.
C. $8,000.
D. $9,000.

Question 7-37: Mondo Corp. common stock is listed on the New York Stock Exchange. Mr. Bondo has been a director of Mondo Corp. for many years, but only shows up to board meetings about once a year (if he's lucky). Mr. Bondo decided to buy some Mondo Corp. stock, because he hadn't yet bought any. Thus, on April 13, Mr. Bondo purchased 3,000 shares of Mondo Corp. stock for $10 per share. On July 7, Mr. Bondo attended a meeting of the board of directors of Mondo Corp. and was surprised to learn that Mondo Corp.'s business was not doing very well. As a result, Mr. Bondo sold all 3,000 of his shares of Mondo stock the next day, for $8 per share. On October 28, Mr. Bondo read in the paper that Mondo Corp.'s business was starting to recover, so he purchased 1,000 shares for $7 per share.

What is Mr. Bondo's liability to Mondo Corp. under Section 16(b) of the Securities Exchange Act of 1934?

A. $1,000.
B. $3,000.
C. $9,000.
D. Nothing, because the first transaction was more than six months before the last transaction.

Question 7-38: Sharp Corp. common stock is listed on the New York Stock Exchange. There are 1 million shares of Sharp Corp. common stock outstanding. On March 13, Mr. Dull, who is neither an officer nor a director of Sharp Corp., owned 99,000 shares of Sharp Corp. common stock. On March 13, Mr. Dull purchased 2,000 shares of Sharp Corp. common stock for $6 per share. On April 13, Mr. Dull purchased an additional 2,000 shares of Sharp Corp. common stock for $7 per share. On August 7, Mr. Dull sold 10,000 shares of Sharp Corp. common stock for $8 per share.

What is Mr. Dull's liability to Sharp Corp. under Section 16(b) of the Securities Exchange Act?

A. $2,000.
B. $4,000.
C. $6,000.
D. Nothing.

Question 7-39: Radio Corp. common stock is listed on the Nasdaq Stock Market. There are 5 million shares of Radio Corp. common stock outstanding. On May 7, Mr. Video, who is a director of Radio Corp., purchased 12,000 shares of Radio Corp. common stock for $17 per share. On October 10, Mr. Video sold 10,000 shares of Radio Corp. common stock for $15 per share. On December 3, Mr. Video sold 2,000 shares of Radio Corp. common stock for $20 per share.

What is Mr. Video's liability to Radio Corp. under Section 16(b) of the Securities Exchange Act?

A. $36,000.
B. $20,000.
C. $6,000.
D. Nothing.

Question 7-40: Mr. Slate was recently fired from his job as President and Chief Executive Officer of Quarry Corporation, a publicly traded corporation. Quarry is now suing Mr. Slate for violating the Securities Exchange Act of 1934 by making short-swing profits in the buying and selling of his Quarry stock. These sales and purchases occurred while Mr. Slate was an officer of the company.

Which of the following could Mr. Slate use as a defense to the lawsuit?

A. Mr. Slate's actions were made in good faith since he anticipated that once he was ousted his stock would lose much of its value.

B. The transactions alleged to be in violation of Section 16(b) of the Securities Exchange Act were purchases made in February and the sales were made in October.

C. Mr. Slate and his immediate family do not own enough stock in Quarry so as to be insiders under Section 16(b) of the Securities Exchange Act.

D. Mr. Slate did not use any material nonpublic information when he bought and sold the Quarry stock.

PART 8

PUBLICLY TRADED COMPANIES

Question 8-1: Which of the following is <u>not</u> an accurate statement about liability for materially false or misleading Exchange Act reports under Section 18 of the Securities Exchange Act?

A. The plaintiff must show that the defendant acted with scienter (e.g., negligence, recklessness, or intent to defraud).
B. A defendant may establish a defense by showing that she acted in good faith and had no knowledge that the Securities Exchange Act filing was false or misleading.
C. The plaintiff must show that she bought or sold securities of the company which filed the false or misleading Exchange Act filing.
D. The plaintiff must show that she relied on the false or misleading Exchange Act filing.

Question 8-2: In early 2016, Rental Car Corp. ("<u>RCC</u>") conducted an IPO of its common stock. Immediately after the IPO, RCC had 287 record holders of its common stock. RCC has $30 million in assets and is engaged in interstate commerce but its stock is not listed on any exchange. Its fiscal year ends December 31 and you may assume that it will have the same number of shareholders at the end of 2016.

Which of the following is correct?

A. Pursuant to Section 15(d) of the Securities Exchange Act, RCC must comply with the periodic reporting requirements of the Securities Exchange Act with respect to 2016 only.
B. Pursuant to Section 15(d) of the Securities Exchange Act, RCC must comply with the periodic reporting requirements of the Securities Exchange Act indefinitely (i.e., for the foreseeable future).
C. RCC must register its common stock under Section 12(g) of the Securities Exchange Act within 120 days after the end of 2016.
D. RCC must register its common stock under Section 12(b) of the Securities Exchange Act.

Question 8-3: The primary purpose of a Form 10-Q filed under the Securities Exchange Act is for a company to report:

A. Its annual financial statements.
B. Its quarterly financial statements.
C. Material events of an unusual, nonrecurring nature.
D. Acquisitions of the stock or assets of other companies.
E. None of the above.

Question 8-4: Which of the following is an accurate statement about the proxy rules under Section 14 of the Securities Exchange Act?

A. A shareholder who has owned at least $1,000 of stock of a publicly traded company for at least six months may require the company to include a shareholder proposal in its proxy statement under Rule 14a-8.

B. There is no private cause of action under Rule 14a-9, which prohibits materially false or misleading proxy statements.

C. A publicly traded company is not required to solicit proxies for an annual meeting of shareholders.

D. Statements of opinion can never violate Rule 14a-9, which prohibits materially false or misleading proxy statements.

Question 8-5: Which of the following is not an accurate statement about stock markets?

A. Both the NYSE and Nasdaq are national securities exchanges; however, OTC Link (formerly known as the Pink Sheets) is not a national securities exchange.

B. National securities exchanges are prohibited from adopting rules that are "tougher" than SEC rules.

C. The SEC has the power to change rules that national exchanges have adopted.

D. More issuers have securities listed on Nasdaq than on the NYSE.

Question 8-6: Which of the following is an accurate statement about Section 12(g) of the Securities Exchange Act?

A. Companies with more than $10 million in assets that had registered a class of securities under Section 12(g) may "deregister" the class once there are fewer than 500 record holders of the class.

B. Companies with more than $10 million in assets that had registered a class of securities under Section 12(g) may "deregister" the class once there are fewer than 300 record holders of the class.

C. Banks, insurance companies, and pharmaceutical companies are exempt from having to register securities under Section 12(g).

D. Registering a class of securities under Section 12(g) requires that the securities are listed on a national securities exchange.

Question 8-7: Which of the following is an accurate statement about the proxy rules under Section 14 of the Securities Exchange Act?

A. Under current SEC rules, public companies must include in their proxy materials the name of a director candidate who has been nominated by any shareholder.

B. Under current SEC rules, public companies must include in their proxy materials the name of a director candidate who has been nominated by a shareholder (or group of shareholders) who owns at least 5% of the company's voting stock.

C. Under current SEC rules, public companies must reimburse a shareholder who solicits proxies in favor of a director candidate who was not nominated by the "incumbent" board but who ends up being elected to the board.

D. Both B and C are correct.

E. None of the above is correct.

Question 8-8: Which of the following is an accurate statement about the Sarbanes-Oxley Act of 2002 (SOX)?

A. SOX requires all corporations that have securities registered under Section 12 of the Securities Exchange Act to have an audit committee that is composed entirely of independent directors.

B. SOX requires that an issuer's Form 10-K must contain a certification by the issuer's CEO and CFO that the report "fully complies" with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act.

C. SOX made it illegal for insiders of a company to buy that company's securities.

D. SOX requires all corporations that have securities registered under Section 12 of the Securities Exchange Act to have a code of ethics that applies to their directors and officers.

E. Both A and B are correct.

Question 8-9: Which of the following are likely consequences of a private company deciding to have its stock listed on a stock exchange and registered under Section 12(b) of the Securities Exchange Act?

I. In the future, if the company decides to do a registered offering of stock under the Securities Act of 1933, it will be somewhat "easier" than if the company were a private company.

II. The company will have better access to information about its competitors that are also publicly traded.

III. The company may be better able to use its stock as "acquisition currency" if it wishes to acquire another company.

IV. The company will profit from purchases and sales of its securities on the stock market.

A. All of the above.
B. I, II, and III only.
C. I and III only.
D. II and III only.
E. I and IV only.

Question 8-10: Which of the following is an accurate statement about recent developments in corporate governance?

A. Many companies have decided to "de-stagger" their boards of directors as a result of shareholder "pressure."

B. Many companies have decided to "de-stagger" their boards of directors as a result of "pressure" from the SEC.

C. Many companies have adopted majority voting systems that prohibit a director candidate who receives more "no" votes than "yes" votes from serving on the board under any circumstances.

D. The new "say on pay" requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act prohibit companies from paying executives more than the amounts approved by shareholders.

Question 8-11: At the end of 2016, Corporation (which is not a bank or bank holding company) had 1,200 record holders of its common stock. Of these record holders, 600 were accredited investors, and 600 were non-accredited investors. Corporation has $50 million in assets and is engaged in interstate commerce but its stock is not listed on any exchange. Its fiscal year ends December 31.

Must Corporation register its common stock under Section 12(g) of the Securities Exchange Act?

A. Yes, because it has more than 500 record shareholders.
B. Yes, because it has more than 1,000 record shareholders.
C. Yes, because it has more than 500 record shareholders who are not accredited.
D. No, because it has fewer than 2,000 record shareholders.

Question 8-12: Corporation's common stock is traded on Nasdaq. In March, Corporation mailed its Schedule 14A proxy statement to its shareholders, soliciting proxies for the upcoming meeting of shareholders to be held on May 1. The only agenda item for the shareholder meeting was the election of Candidate A, Candidate B, and Candidate C to Corporation's board of directors. Joe Shareholder is a "famous" investor who owns 5% of Corporation's shares, but does not serve as an officer or director of Corporation. In April, Joe was interviewed on the Financial News Network, a cable news channel. During the interview, Joe stated: "Well, I think that Candidate A, Candidate B, and Candidate C are terrible choices for election to Corporation's Board and I do not intend to vote my shares for any of them." Joe also serves as guardian for his brother Ted, who owns 5,000 shares of Corporation stock. In April, Joe asked Ted to sign a proxy card authorizing Joe to vote Ted's shares at the upcoming meeting of Corporation's shareholders.

Was Joe engaged in the "solicitation" of proxies within the meaning of Section 14(a) of the Securities Exchange Act?

A. No. Neither the TV interview nor Joe's request that Ted sign a proxy card would be considered a "solicitation" of a proxy.

B. Yes. The TV interview was not a "solicitation" of a proxy. However, Joe's request that Ted sign a proxy card would be considered a "solicitation" of a proxy.

C. Yes. Joe's request that Ted sign a proxy card would not be considered a "solicitation" of a proxy. However, the TV interview was a "solicitation" of a proxy.

D. Yes. Both Joe's request that Ted sign a proxy card and the TV interview were "solicitations" of proxies.

Question 8-13: Corporation, a publicly traded corporation, entered into an agreement to sell a significant amount of its assets to Buyer for $45 million. None of Corporation's directors have any personal or other relationships with Buyer. The price was determined after weeks of negotiations, including Corporation's receipt of an appraisal which found that the assets were worth $50 million. Needing shareholder approval for the sale under state law, Corporation called a special meeting of shareholders and mailed a Schedule 14A proxy statement to its shareholders. The proxy statement contained several factual errors, as well as this statement: "Your board of directors believes that the $45 million that Corporation will receive for the assets is a fair price." Following shareholder approval of the sale, a group of "angry" shareholders sued Corporation, claiming that the proxy statement was false and misleading in violation of Rule 14a-9.

Which of the following statements is most likely correct? Assume that the shareholders did not have dissenters' rights (also known as appraisal rights) with respect to this transaction under state law.

A. The shareholders may have a valid cause of action with respect to the factual errors if they were material, but have no valid cause of action with respect to the directors' statement of opinion.

B. The shareholders may have a valid cause of action with respect to the directors' statement of opinion if the directors did not honestly believe that $50 million was a fair price for the assets.

C. The shareholders do not have a valid cause of action because, even if the factual errors were material, the shareholders were not harmed by them.

D. Because the transaction has already been approved by the shareholders, it is too late to sue. The shareholders should have sued for an injunction beforehand.

Question 8-14: Same facts as the prior question, except that shareholder approval was not required for the sale under state law.

Which of the following statements is most likely correct?

A. The shareholders do not have a valid cause of action because they will not be able to show causation.

B. The shareholders may have a valid cause of action with respect to the directors' statement of opinion if the directors did not honestly believe that $50 million was a fair price for the assets.

C. Although causation was present, noting in the facts shows that the proxy statement was materially false or misleading.

D. The new facts do not change the outcome. Because the transaction has already been approved by the shareholders, it is too late to sue. The shareholders should have sued for an injunction beforehand.

Question 8-15: In early 2012, Corporation conducted an IPO of its common stock. Immediately after the IPO, Corporation had 525 record holders of its common stock. At the end of 2012, it also had 525 record holders of its common stock. By the end of 2013, however, Corporation only had 493 record holders of common stock. It also had 493 record holders at the end of 2014 and the end of 2015, and continues to have 493 record holders today. Corporation's stock is not listed on any exchange.

Which of the following is correct concerning Section 15(d) of the Securities Exchange Act?

A. Corporation could have stopped complying with the periodic reporting requirements of the Securities Exchange Act with respect to 2014 and later years.
B. Corporation could have stopped complying with the periodic reporting requirements of the Securities Exchange Act with respect to 2015 and later years.
C. Because Corporation has had fewer than 500 record shareholders for three consecutive years, it may discontinue complying with the periodic reporting requirements of the Securities Exchange Act.
D. Corporation must continue to comply with the periodic reporting requirements of the Securities Exchange Act indefinitely (i.e., for the foreseeable future) because it still has more than 300 record shareholders.

Question 8-16: Corporation's common stock is traded on Nasdaq. In March, Corporation mailed its Schedule 14A proxy statement to its shareholders, soliciting proxies for the upcoming meeting of shareholders to be held on May 1. The only agenda item for the shareholder meeting was the election of Candidate A, Candidate B, and Candidate C to Corporation's board of directors. Joe Shareholder thought that these candidates were terrible choices and thus solicited proxies for a competing "slate" of candidates consisting of Candidate D, Candidate E, and Candidate F. Joe properly gave a Schedule 14A to all persons from whom he solicited proxies. Candidate D, Candidate E, and Candidate F ended up being elected to the board. Joe incurred more than $500,000 in legal, printing, and mailing expenses in connection with his proxy solicitation.

Which of the following correctly describes Joe's rights in this situation?

A. Joe is not entitled to any reimbursement of his expenses, unless the corporation voluntarily decides to reimburse him.
B. Joe is not entitled to any reimbursement of his expenses, unless a court finds that his efforts resulted in a substantial benefit to the corporation.
C. Because Joe's candidates won election, he is entitled to full reimbursement of his expenses.
D. Because Joe's candidates won election, he is entitled to reimbursement of his reasonable expenses.

Question 8-17: Stuff Mart Corp. ("SMC") is a publicly traded Delaware corporation that operates a chain of general merchandise stores. In 2014, a man purchased a rifle at an SMC store and later shot ten people at an elementary school. A little while later in 2014, Stop the Violence, a nonprofit organization dedicated to the advancement of gun control laws, purchased $3,000 worth of SMC common stock. In 2016, Stop the Violence submitted a shareholder proposal (the "Proposal") for inclusion in SMC's proxy statement for its 2016 annual meeting of shareholders. The Proposal reads as follows: "RESOLVED, the shareholders of Stuff Mart Corp. hereby recommend that the corporation discontinue selling guns and ammunition at all of its stores." SMC wants to exclude the Proposal from its proxy materials for its 2016 annual meeting of shareholders.

Which of the following would be SMC's best argument to exclude the Proposal from its proxy materials?

A. Stop the Violence does not own enough SMC stock to be eligible to submit the Proposal for inclusion in SMC's proxy materials under Rule 14a-8.
B. Stop the Violence has not owned SMC stock for a long enough period of time to be eligible to submit the Proposal for inclusion in SMC's proxy materials under Rule 14a-8.
C. The Proposal is not a proper subject for action by shareholders under Delaware law.
D. The Proposal relates to SMC's ordinary business operations.

Question 8-18: Which of the following correctly describes differences between a "true majority" system of electing directors and a "plurality plus" system?

A. In a "true majority" system, a director must receive more "for" votes than "withhold" votes to be elected to the board. In a "plurality plus" system, a director can be elected to the board if she receives more votes than any other candidate for that board position.

B. In a "true majority" system, a director must receive "for" votes from a majority of the outstanding shares to be elected to the board. In a "plurality plus" system, a director must receive "for" votes from a majority of the shares present at the shareholder meeting to be elected to the board.

C. In a "true majority" system, a director who received more "withhold" votes than "for" votes will not be allowed to serve on the board. In a "plurality plus" system, it is possible that a director who received more "withhold" votes than "for" votes could serve on the board.

D. A "true majority" system may only be approved by the shareholders. A "plurality plus" system could be adopted by the board.

Question 8-19: Holiday Cruise Lines, Inc. ("Holiday"), a publicly traded corporation, owns several cruise ships, including Boaty McBoatface. On February 21, twenty passengers on Boaty McBoatface were taken to a hospital with food poisoning from eating raw fish caught off the coast of the Bahamas and served on the ship. News of this incident would likely be devastating to cruise bookings on Holiday's ships, many of which are made in March. The affected passengers agreed to accept free cruises to Europe in exchange for signing confidentiality agreements. Holiday's board decided to disclose the matter in Holiday's Form 10-Q for the quarter ending March 31, which Holiday will file on or before April 14. However, on February 24, Holiday's board did disclose the incident on a conference call with Wall Street analysts to discuss Holiday's financial results for the prior year.

Which one of the following statements is most likely correct?

A. Holiday will fully comply with SEC reporting requirements by disclosing the incident in its Form 10-Q because the incident happened in the first quarter of the year.

B. Holiday will be required to file a Form 14A with the SEC as soon as possible to disclose the incident. It may not wait until it files its Form 10-Q.

C. Holiday will be required to file a Form 8-K with the SEC as soon as possible to disclose the incident. It may not wait until it files its Form 10-Q.

D. The incident wasn't "material" and therefore need not be reported to the SEC, because the cost of the twenty free cruise tickets is minimal.

Question 8-20: At the end of 2016, Corporation (which is not a bank or bank holding company) had 800 record holders of its common stock. Of these record holders, 325 were accredited investors, and 457 were non-accredited investors. Corporation has $14 million in assets and is engaged in interstate commerce but its stock is not listed on any exchange. Its fiscal year ends December 31.

Must Corporation register its common stock under Section 12(g) of the Securities Exchange Act?

A. No, because its stock is not listed on a national securities exchange.
B. No, because it has fewer than 2,000 record shareholders.
C. Yes, because it has more than 500 record shareholders.
D. Yes, because it has more than 300 record shareholders who are not accredited investors.

Question 8-21: Corporation A has had shares of stock listed on the NYSE for three years. Corporation B has had shares of stock listed on Nasdaq for five years. Both corporations have fiscal years that end on December 31. The market value of Corporation A's outstanding common stock is approximately $1 billion, and the market value of Corporation B's outstanding common stock is approximately $50 million (in each case excluding shares owned by affiliates of the corporations).

What is the deadline for these corporations to file their Forms 10-K with the SEC? Assume no leap years are involved.

A. Corporation A must file its Form 10-K on or before February 14, and Corporation B must file its Form 10-K on or before March 1.

B. Corporation A must file its Form 10-K on or before March 1, and Corporation B must file its Form 10-K on or before March 15.

C. Both corporations must file their Forms 10-K on or before March 15.

D. Corporation A must file its Form 10-K on or before March 1, and Corporation B must file its Form 10-K on or before March 31.

Question 8-22: Which of the following correctly describes the "say on pay" requirements of the Dodd-Frank Act and related SEC rules?

A. Publicly traded companies must allow shareholders to cast an "advisory" vote on executive compensation every year. Executive compensation that was paid but that was not properly approved by shareholders must be repaid under a "clawback" policy.

B. Publicly traded companies must allow shareholders to cast an "advisory" vote on executive compensation every two years. Executive compensation that was paid but that was not properly approved by shareholders must be repaid under a "clawback" policy.

C. Publicly traded companies must allow shareholders to cast an "advisory" vote on executive compensation every three years. Executive compensation that was paid but that was not properly approved by shareholders must be repaid under a "clawback" policy.

D. None of the above is correct.

***Question 8-23**: What, if anything, is wrong with following excerpt from a proxy card?*

Annual Meeting Proxy Card | **1234 5678 9012 345**

▼ IF YOU HAVE NOT VOTED VIA THE INTERNET OR TELEPHONE, FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE ▼

Proposals — You might sign the card on the reverse side for your vote to be counted.

The Board of Directors recommends a vote FOR all the nominees listed.

1. Election of Directors	For	Withhold		For	Withhold
01– Joe Schmo	☐	☐	02 – Ann Schmo	☐	☐
03 – Betty Schmo	☐	☐	04 – Boris Schmo	☐	☐
05 – Donny Schmo	☐	☐	06 – Rachel Schmo	☐	☐
07 – Jill Schmo	☐	☐	08 – Harold Schmo	☐	☐

The Board of Directors recommends a vote FOR Proposals 2 and 3.

	For	Against
2. Advisory vote to approve executive compensation	☐	☐
3. Ratification of the appointment of Arnst & Old as Independent Auditors	☐	☐

A. The proxy card is not permitted to state how the board recommends that shareholders vote.
B. It doesn't have a box where shareholders can vote "against" nominees.
C. It doesn't allow shareholders to abstain from voting on proposals 2 and 3.
D. It looks fine to me.

ANSWER KEYS AND EXPLANATIONS
PART 1

Answer Key to Part 1:

1-1: C
1-2: B
1-3: E
1-4: C
1-5: B
1-6: E
1-7: D
1-8: B
1-9: D
1-10: B
1-11: C
1-12: C
1-13: D
1-14: C
1-15: D
1-16: C
1-17: D
1-18: D
1-19: D
1-20: B
1-21: D
1-22: A
1-23: A
1-24: C
1-25: A
1-26: E
1-27: B
1-28: C
1-29: B
1-30: B
1-31: D
1-32: B
1-33: B
1-34: C
1-35: B
1-36: D
1-37: D
1-38: C
1-39: B

1-40: D
1-41: B
1-42: B
1-43: A
1-44: D
1-45: A
1-46: A
1-47: C
1-48: D
1-49: D
1-50: C
1-51: B
1-52: C
1-53: B
1-54: C
1-55: B
1-56: D
1-57: D
1-58: D
1-59: B
1-60: C
1-61: D
1-62: B
1-63: D
1-64: D
1-65: A
1-66: C
1-67: D
1-68: C
1-69: D
1-70: D
1-71: D
1-72: B
1-73: A
1-74: A
1-75: D

Explanations to Part 1:

Question 1-1: The correct answer is C. Answer A is incorrect because in a limited partnership the general partner has control over the business, whereas the limited partner(s) does (do) not. Thus, the first goal would not be met if they chose to run the business as a limited partnership. In addition, the general partner is personally liable for the limited partnership's debts, thus defeating the second goal. Answer B is incorrect because in a general partnership the partners are personally liable, on a joint and several basis, for the debts and obligations of the partnership. Thus, the second goal would not be met if they chose to run the business as a general partnership. Answer D is incorrect because a "C" corporation is subject to a "double layer" of taxation: the corporation pays taxes on its income and the shareholders pay taxes on any dividends that they receive. Thus, the third goal would not be met if they chose to run the business as a "C" corporation.

Question 1-2: The correct answer is B. In a general partnership the partners are personally liable for the partnership's debts and obligations. By contrast, the shareholders of a corporation and the member of an LLC are generally not personally liable for the debts and obligations of the corporation or LLC. Thus, on these facts, only C and D will be personally liable.

Question 1-3: The correct answer is E. One important fact to keep in mind is that Miriam personally committed a tort. Thus, regardless of how the business is organized, Miriam will be personally liable for her own actions. Any answer that states that Miriam will not be personally liable is therefore incorrect, which eliminates Answers A and B. On the other hand, Chloe (the non-tortfeasor) will only be personally liable if the structure of the business imposes personal liability on owners. Answer C is true because partners in an LLP are not generally not liable for torts committed by other partners. Answer D is also true, because partners are personally liable for all partnership obligations, and here the partnership is liable because the tort occurred in the ordinary course of the partnership's business. See RUPA § 305. This makes Answer E the best answer.

Question 1-4: The correct answer is C. As explained in Chapter 1, an "S" corporation cannot have more than 100 shareholders, which eliminates Answer B. Further, "S" corporations may only have individuals and certain trusts as shareholders, which eliminates Answer A. (Remember, XYZ, Inc. is a corporation that wants to become a shareholder of Corporation. While one corporation can own stock in another corporation, that will not allow the second corporation to qualify as an "S" corporation.) Answer D is wrong for what should be obvious reasons; if the rule were otherwise, nothing would stop "S" corporations from *initially* having proper shareholders but then issuing shares to persons who would not be proper shareholders in an "S" corporation.

Question 1-5: The correct answer is B. In a "flow through" entity such as a partnership, the owners report their proportionate shares of the entity's income on their own tax returns, *regardless of whether they actually received the money in the form of a distribution*. (Otherwise, partnerships would be wonderful "tax shelters" where you only get taxed on amounts that you take out of the entity.) Thus, Partner A and Partner B must each report $50,000 of income even though they personally did not receive any of the money; this is because the AB Partnership itself does not pay taxes on its income. This eliminates Answer A and Answer C. In a "C" corporation, the corporation pays taxes on its income, and shareholders only pay taxes on dividends that they receive. This eliminates

Answer D because Shareholder C and Shareholder D will only report the $5,000 of dividends that they received.

Question 1-6: The correct answer is E. In both limited liability companies and corporations, the general rule is that owners (members in the case of an LLC and shareholders in the case of a corporation) are *not* personally liable for the debts and obligations of the business entity, such as the loan in this case. (There are some exceptions to this general rule that you will see later in this textbook, but they do not come up in this fact pattern). Thus, regardless of how many members an LLC has, and regardless of whether the corporation is a "C" corporation or an "S" corporation, the general rule applies. Remember, the only distinction between a "C" corporation and an "S" corporation has to do with taxes. In all other respects, they are the same thing: corporations.

Question 1-7: The correct answer is A. Answer A is incorrect because of the lower-of-cost-or-value rule described on page 21 of the textbook. Answer B is incorrect; GAAP is not a law that all companies must follow. Answer C is incorrect because expenses such as deprecation do not represent out-of-pocket payments by the company, as discussed on pages 24-25 of the textbook.

Question 1-8: The correct answer is B. As explained on pages 24-25 of the textbook, the income statement (1) may reflect expenses such as depreciation that don't require cash payments to third parties and (2) may not reflect expenditures that *do* require cash payments to third parties. The cash flows statement is thus needed to tell us the company's actual change in cash from the beginning of the income statement period to the end of the period. To calculate this, one starts with the cash on hand at the beginning of the period (here, that was $50,000), then *adds* the income from the income statement (here, $100,000), *adds* non-cash expenses (here, that would be the $2,000 of depreciation expense using straight-line depreciation under which one simply divides the cost of the machine by its useful life), then *subtracts* cash outlays that cost the business cash but didn't appear as expenses on the income statement (here, that would be the $10,000 cost of the machine). So, $50,000, plus $100,000, plus $2,000, minus $10,000 equals $142,000, making Answer B the correct answer.

Question 1-9: The correct answer is D. Even though he did not have *actual* authority to quote prices to fix DVD players, Arthur had *apparent* authority. Section 2.03 of the *Restatement* provides that:

> Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.

Here, the "manifestation" that Suzy made was hiring Arthur and putting him in a position where he could deal with customers. This manifestation reached Matthew when he saw

Arthur in that position, and it is almost certainly reasonable to think that someone working in Arthur's position at an electronics store would have the authority to agree to repair an item of electronics (the DVD player). Thus, Answer A is incorrect. Answer B is incorrect; whether Arthur was in the scope of his employment is relevant for tort liability, not contractual liability. Answer C is not correct because detrimental reliance is not a requirement to bind the principal on a contract due to the agent's apparent authority.

Question 1-10: The "correct" answer is B. Remember, the call of the question is which answer is *not* correct. Mark is an unidentified principal because Katherine is aware that Ned is acting on behalf of a principal but does not know who the principal is (nor has she been given facts sufficient to determine the identity of the principal). Thus, Section 6.02 of the *Restatement* provides that the principal (Mark), as well as the agent (Ned) who was acting with actual or apparent authority, are liable on the contract, unless otherwise agreed. Answer A is true because Ned did have actual authority to bind Mark to this contract; the fact that Mark was an unidentified principal does not matter. Answer C is correct due to Section 6.02 of the *Restatement*, as discussed above. Answer D is correct because Katherine cannot avoid the contract simply because there was an unidentified principal. As discussed on page 41 of Chapter 2, a third party could only avoid the contract if there were an *undisclosed* principal and certain other conditions were met under Section 6.11(4) of the *Restatement*. This makes Answer B the only incorrect answer.

Question 1-11: The correct answer is C. Here, Katherine notified Ned (the agent) of a fact. The issue is whether knowledge of this fact will be attributed to Mark and, if so, what effect that will have. Under Section 5.02(1) of the *Restatement*, "a notification given to an agent is effective as notice to the principal if the agent has actual or apparent authority to receive the notification, unless the person who gives the notification knows or has reason to know that the agent is acting adversely to the principal as stated in § 5.04." In this scenario, Ned would likely have apparent (or possibly actual) authority to receive the notification and it does not appear that Katherine knew or had reason to know that Ned would act adversely to Mark. Thus, the notification to Ned will be imputed to Mark and he will not be able to rescind the contract. See also Section 5.04 of the *Restatement.* Answer A is not correct because there are some situations in which facts known by agents will not be attributed to their principals. Answers B and D are incorrect for the reasons discussed above, even though Ned has breached his duty of disclosure. See Section 8.11 of the *Restatement.*

Question 1-12: The correct answer is C. Because this scenario involved a tort, the first inquiry is whether Hank is an employer and Frank is an employee, which seems obvious here. The next question is whether Frank was acting in the scope of his employment when the tort occurred. Clearly, Frank was—he was stocking groceries at Hank's grocery store. Thus, not only will Frank be liable for this tort, so too will Hank on a *respondeat superior* theory. The mere fact that Frank ignored Hank's instructions does not mean that he was outside the scope of his employment; thus, Answer A is wrong. Answer B is wrong because, as a sole proprietor, Hank will be personally liable for all of the business's debts and obligations even if they are larger than the assets associated with the business. Answer D is wrong because *respondeat superior* liability can result whenever the two conditions described above are met.

Question 1-13: The correct answer is D. On these facts, Garth's *actual* authority, as stated in the handbook, is to arrange transportation of Empire's products to customers—but only up to $2,000. Given that Garth works in the shipping department, his *apparent* authority would extend to arranging shipping contracts. As discussed above, Section 2.03 of the *Restatement* provides that if a principal makes a manifestation that reaches a third party and, as a result, the third party reasonably believes that the agent is authorized to act, then the agent has apparent authority. Here, the "manifestation" that the company made was hiring Garth as a shipping clerk and putting him in a position where he could deal with customers. This manifestation reached Rumsfeld (and therefore Axis) when he saw Garth in that position, and it is almost certainly reasonable to think that someone working in the shipping department can agree to shipping contracts. However, due to the sign on the wall, Garth's apparent authority would be limited to $3,000; it would not be reasonable for Rumsfeld to think otherwise. Thus, it does not appear that Garth had actual or apparent authority to agree to Contract #1, given that he works in the shipping department and this contract has to do with purchasing copy/fax machines, which has nothing to do with shipping. However, he does have apparent authority to bind Empire to Contract #2. Rumsfeld did not know that Garth's actual authority had been limited to $2,000. Moreover, the sign on the wall would cause Rumsfeld to reasonably believe that Garth could agree to shipping contracts up to $3,000, and Contract #2 was below that limit.

Question 1-14: The correct answer is C. As stated above, apparent authority requires a "manifestation" by the principal that reaches the third party and causes the third party to reasonably believe that the agent is authorized. A "manifestation" can be words or any other conduct. In determining whether Drew had a reasonable belief that Brett was authorized to buy the beer and whether that belief was based on something that Nell did, Answers A and B are clearly relevant. However, because Answer C concerns something that Drew did not know, it could not form the basis of a reasonable belief by Drew as to whether Brett was authorized to buy the beer.

Question 1-15: The correct answer is D. Answer A is incorrect because, to void the contract, Clive would need to show (among other things) that Zelda misrepresented the existence of an agency relationship, which she did not. Answer B is wrong because agency relationships do not need to be documented in writing (although they often are). Answer C is incorrect because an agent with actual authority can bind a principal, even an undisclosed principal. Answer D is correct because Section 6.03 of the *Restatement* provides that, unless otherwise agreed, an agent for an undisclosed principal is a party to the contract.

***Question 1-16**:* The correct answer is C. Under Sections 6.01, 6.02, and 6.03 of the *Restatement*, unless otherwise agreed, an agent for a disclosed principal is not liable on a contract when she is acting within the scope of her actual or apparent authority, but an agent for an unidentified or undisclosed principal will be. Moreover, a servant who commits a tort in the scope of her employment will be liable for the tort (although the master will be *as well*).

Question 1-17: The correct answer is D. Here, Pete is the principal and Annie is his agent, and Pete has given Annie actual express authority to go to France and "scout out" new products for the store and order them from merchants. While Pete never said anything about hiring an interpreter (and therefore Annie would not have actual *express* authority to do so), Section 2.02 of the *Restatement* provides that an agent's actual authority includes the authority to take actions that are "implied in the principal's manifestations … and acts necessary or incidental to achieving the principal's objectives …." Given that Pete sent Annie to *France*, it would seem necessary for her to hire an interpreter if she does not speak the language there. Answer A is incorrect because nothing in the facts indicates that Pete should be estopped from denying liability. Answer B is incorrect because nothing in the facts indicates that Pete made a manifestation that *reached Marcel* and caused Marcel to reasonably believe that Annie was authorized to hire him. Answer C is incorrect for the reasons discussed above.

Question 1-18: The correct answer is D. For the reasons discussed above, Annie had actual authority to order products from French merchants. The issue is when that authority was terminated—when Pete died or when Annie learned that Pete died. Under Section 3.07 of the *Restatement*, the termination of Annie's authority does not occur until she has notice of Pete's death. Because she did not receive notice of Pete's death until May 21, she still had actual authority on May 20. This makes Pete (or, because he was a sole proprietor who is now dead, his estate) liable on the contract. Thus, Answer A is incorrect. Answer B is incorrect because even an undisclosed principal can be liable for her agent's acts if the agent was acting with actual authority, as was Annie. Moreover, an agent who acts within the scope of her actual authority is not liable to the principal, which makes Answer C incorrect.

Question 1-19: The correct answer is D. This is a question about how a principal may terminate an agent's authority. Section 3.06(5) of the *Restatement* provides that an agent's actual authority may be terminated by (among other things) "a manifestation of revocation by the principal to the agent … as stated in § 3.10(1)." Meanwhile, section 3.10(1) provides that "[n]otwithstanding any agreement between principal and agent, an agent's actual authority terminates if … the principal revokes the agent's actual authority by a manifestation to the agent. A revocation or a renunciation is effective when the other party has notice of it." Note that a "manifestation" does not need to be in writing. Also, comment b to this section states in part that the principal's power to revoke an agent's actual authority "is not extinguished because an agreement between [the] principal and [the] agent states that an agent's actual authority shall be irrevocable …." (Sometimes an agent may have irrevocable powers under Sections 3.12 and 3.13 of the *Restatement*, but those sections do not apply here.) All of this means that Answers A, B, and C are incorrect. Note that Answer C is incorrect because any termination of actual authority would terminate both actual express authority and actual implied authority.

Question 1-20: The correct answer is B. By cashing the check and shipping the order, Jack impliedly ratified Joan's actions, making any discussion of whether Joan had authority irrelevant. See Section 4.01(2)(b) of the *Restatement* ("A person ratifies an act by … conduct that justifies a reasonable assumption that the person so consents."). Ratification transforms an unauthorized act into an authorized act. Therefore, Jack is bound to fulfill the order for $9,000. If he did not like the discount, he should not have ratified it.

Question 1-21: The correct answer is D. Answers A and C incorrect because the doctrine of apparent authority from Section 2.03 of the *Restatement* requires not only that the third party (the Hotel) have a reasonable belief that the agent (or other actor) is authorized to conduct the transaction, but that belief must be traceable to the principal's manifestations. Here, there is nothing in the facts that would indicate that Nikola did anything or said anything (through an authorized agent) that caused the Hotel to believe that Ellen (or whatever her true name actually was) was authorized to incur these room charges. Answer B is incorrect because the estoppel doctrine under Section 2.05 of the *Restatement* requires not only that the third party (the Hotel) had a detrimental change of position because of its justifiable belief that the actor was authorized to conduct the transaction, but the "principal" must either have intentionally or carelessly caused that belief or have had knowledge of it and failed to take reasonable steps to notify people that the actor was not authorized.

Question 1-22: The correct answer is A. Although Agent lacked actual authority because he was only authorized to accept $1 million or more, Agent had apparent authority. Apparent authority arises in this case because it was reasonable for the NBA team to rely on Agent as having authority based on Player's manifestation to the team to this effect. Because the team did not know Agent's authority had been limited, its reliance was reasonable. This obviously makes Answers B and C incorrect. Answer D is incorrect because Agent would only be liable for breaching his implied warranty of authority under Section 6.10 of the *Restatement* if he had lacked the power to bind Player to the contract.

Question 1-23: The correct answer is A. An employer is vicariously liable for negligence occurring within the scope of its employee's employment. Here, the PA was an employee and the mistake was within the scope of the employee's duties to see and treat patients. Because the employer was a partnership, this means that each partner is liable as well under RUPA § 306(a).

Question 1-24: The correct answer is C. Paul properly ratified the contract. This is because Paul "manifested assent" that the contract would bind him. See Section 4.01(2)(a) of the *Restatement*. Moreover, the effect of ratification is that it "retroactively creates the effect of actual authority," (see Section 4.02(1) of the *Restatement*) which means that we will treat Adrianna's actions as having been authorized, even though they were not at the time of the contract. None of the other sections in Article 4 of the *Restatement* contradict the conclusion that Paul properly ratified this contract. Answer A is wrong because, as discussed above, once Paul ratified the contract, Adrianna's actions will be considered to have been retroactively authorized. Answer B is wrong because it does not matter than the principal was undisclosed; if an agent was acting with actual authority, the agent can still bind the principal even if the principal was undisclosed. See Section 2.01 of the *Restatement*. Answer D is obviously wrong because the facts specifically state that Paul did not do anything that caused Tammy to believe that Adrianna was authorized at the time of the contract. See Section 2.03 of the *Restatement*.

Question 1-25: The correct answer is A. Section 3.06(5) of the *Restatement* provides that an agent's actual authority may be terminated by (among other things) "a manifestation of revocation by the principal to the agent … as stated in § 3.10(1)." It is not necessary that both parties agree. (Remember, the question asked which answer was not correct.) Answers B, C, and D are incorrect (that is, correct statements) because Section 1.01 of the *Restatement* provides that the agent is subject to the principal's control and that agency is a fiduciary relationship, which means that the agent owes fiduciary duties to the principal. See also Section 8.02 ("An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position.")

Question 1-26: The correct answer is E (motion #3 will be granted; the other two motions will be denied). Motion #1 will be denied because a partnership is responsible for torts committed by its partners in the ordinary course of business (here, performing dental work) or when they were acting with actual or apparent authority from the partnership. RUPA § 305(a). Motion #2 will be denied because it is possible that Dr. Drill will be liable for the injury even though he is not the tortfeasor. Partners are jointly and severally liable for the partnership's debts and obligations. RUPA § 306(a). Motion #3 will be granted because a newly admitted partner is not liable for partnership obligations incurred before he or she became a partner. Dr. Fill joined the partnership in 2015, but the tort occurred earlier, in 2014, which is when the liability was "incurred" (even though the lawsuit was not filed until later). See RUPA § 306(b).

Question 1-27: The correct answer is B. RUPA § 503 allows a partner to sell her "transferable interest" (defined in RUPA § 102(23) as the partner's right to receive distributions) to a third party. However, by itself this does not result in the transferee becoming a partner, nor does it mean that the transferor ceases to be a partner. Moreover, a transfer of a transferable interest does not require the consent of the other partners. *See* RUPA § 503.

Question 1-28: The correct answer is C. Under the "exhaustion rule" of RUPA § 307(d)(1), in a situation such as this, the creditor would first have to recover from the partnership's assets before recovering from the partners' assets. Answer A is incorrect because RUPA § 105(c)(17) provides that a partnership agreement may not restrict the rights of third parties (such as the right of National Bank to hold both partners personally liable for the loan). Thus, this clause is ineffective. Answer B is incorrect because, as a partner, Denard may be liable for the unpaid loan. Answer D is incorrect due to the exhaustion rule of RUPA; in this situation, the bank cannot recover from the partners' personal assets until it has first exhausted the partnership's assets. Answer E is wrong because Jason had apparent authority under RUPA § 301(1) (and perhaps actual authority under RUPA § 301(2), as well) to bind the partnership to things that are in the ordinary course of business, such as obtaining loans. Thus, if the partnership is bound to repay the loan, Denard can be held personally liable if it does not do so.

Question 1-29: The correct answer is B. The payment of distributions is considered a decision that is in the "ordinary course of business." As such, it only requires approval by a majority of the partners. See RUPA §§ 401(h) and (k). In addition, RUPA § 405(a) provides that, before the dissolution of the partnership, any distribution "must be in equal shares among partners," subject to some exceptions that do not apply here. Further, RUPA § 405(a), a partner (or transferee) only has a right to a distribution if the partnership decides to make an interim distribution.

Question 1-30: The correct answer is B. Answer A is incorrect because partners are only liable for the debts and obligations of the *partnership*, not the *personal* debts of other partners. Answer C is incorrect because, if the assets of the partnership are not sufficient to pay partnership creditors in full, the creditors can seek recovery from the partners' personal assets. See RUPA §§ 306 and 307.

Question 1-31: The correct answer is D. Unfortunately for Andre, two of the default rules of RUPA that apply, unless the partnership agreement provides otherwise, are that each partner has equal voting power, and that decisions that are in the "ordinary course of business" are decided by a majority vote. See RUPA §§ 401(h) and (k). Thus, Eric will be outvoted by the other partners, which makes Answer A incorrect. In addition, RUPA § 405(a) provides that, before the dissolution of the partnership, any distribution "must be in equal shares among partners," subject to some exceptions that do not apply here, which makes Answer B incorrect.

Question 1-32: The correct answer is B. The partners' respective partnership accounts varied over time pursuant to the 1997 version of RUPA § 401(a) as follows:

Partner	Contribution	2016	2017	2018	Distribution	Total
A	$5,000	($5,000)	$30,000	$40,000	($50,000)	$20,000
B	$5,000	($5,000)	$30,000	$40,000	($40,000)	$30,000
C	$10,000	($5,000)	$30,000	$40,000	($50,000)	$25,000

Question 1-33: The correct answer is B. Under RUPA § 202(c)(3), a person who receives a share of the profits of the business is presumed to be a partner in the business, unless the profits were received for any of the six reasons listed in subsections (A) through (F), in which case the presumption does not apply. Note that RUPA § 202 never answers the

question of whether people are partners; at most, it might create a *presumption* of partnership. Case-law factors concerning the existence of a partnership include profit-sharing, contributions, and control. Here, Answer A is incorrect because RUPA does not actually state that landlords are not considered to be partners with their tenants; instead, all RUPA § 202(c)(3)(C) says is that someone who receives profits in the form of rent is not *presumed* to be a partner. Answer C is wrong because, as just noted, someone who receives profits in the form of rent is not *presumed* to be a partner. That leaves us to choose between Answer B and Answer D. Because Landlord is not sharing profits (it's getting a percentage of the *revenues*), has no real "control" over the business (approving chemicals doesn't really rise to the level of control; Landlord probably wants that in the lease to protect his property interest), and has not made any sort of contribution to the business. Thus, it is very unlikely to be a partner with Tenant, making Answer B the best answer.

Question 1-34: The correct answer is C. See RUPA § 202(c)(3) and the cases that appear in Chapter 3. Of course, there are factors other than profit-sharing that are important, but none of the choices listed in Answers A, B, D, or E are relevant to the question of whether a partnership has been formed.

Question 1-35: The correct answer is B. Generally speaking, RUPA allows the partners to structure the partnership as they see fit. However, RUPA §§ 105(c) and (d) list that a partnership agreement may not do; provisions in a partnership agreement that run afoul of these sections will be treated as if they were deleted from the partnership agreement. Here, clauses I and IV are permissible (nothing in RUPA § 105 prohibits these clauses, which means that they are permissible) and clause II is no different than the default rule in RUPA concerning this issue (see RUPA § 402(b)(3)). However, clause III violates RUPA § 105(c)(9).

Question 1-36: The correct answer is D. Under RUPA §§ 502 and 503, a partner may transfer her "transferable interest" (defined in RUPA § 102(23)) to a third party, but that transferee does not become a new partner unless the other partners unanimously agree. After all, RUPA elsewhere requires unanimous consent to admit a new partner. See RUPA § 402(b)(3). Thus, each of Answers A, B, and C finds specific support in RUPA §§ 502 and 503, making Answer D ("All of the above are correct") the best answer.

Question 1-37: The correct answer is D. Note that the facts state that the partnership owns the instruments, not the partners themselves. Thus, Little Joe could not sell "his" bass without approval by the partners. Answer A is wrong because the default rule of RUPA § 401(h) is that the partners have equal voting power. Answer B is incorrect because, as a partner, Jeremy has the apparent authority under RUPA § 301(1) to bind the partnership to things that are in the ordinary course of business (unless (1) he lacked actual authority to do so and (2) the third party knew or had received notice that he lacked authority). Here, playing concerts is clearly in the ordinary course of business for a rock band. Answer C is wrong because of RUPA §§ 501 and 401(i).

Question 1-38: The correct answer is C. RUPA § 401(k) requires unanimous partner consent for actions that are outside the ordinary course of business. Answer A is incorrect because Little Joe's approval *would* be needed to admit a new partner under RUPA § 402(b)(3). Answer C is wrong because the partnership is not liable for Little Joe's *personal* debts. The best that Little Joe's personal creditors could do is obtain a charging order on Little Joe's "transferable interest" in the partnership pursuant to RUPA § 504. This charging order operates in much the same way that a garnishment operates with respect to an employee's wages. Finally, Answer D is wrong because partners will be personally liable for partnership debts even if the partnership itself cannot pay them. *See* RUPA §§ 306 and 307. There is no "liability shield" in a partnership, and a partner's liability is not limited to amounts that she contributed to the business.

Question 1-39: The correct answer is B. Under RUPA § 409(c), a partner has a duty of care to the partnership and the other partners "in the conduct … of the partnership business." Here, Brutus was driving the partnership's van. The duty of care is to refrain "from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law." Here, Brutus was found to be reckless, which is a violation of this standard. Brutus did not violate his duty of loyalty because breaches of the duty of loyalty involve some *conflict of interest* between the partner and the partnership. See RUPA § 409(b) for RUPA's nonexclusive list of actions that would violate a partner's duty of loyalty.

Question 1-40: The correct answer is D. Under RUPA § 409(b)(3), one aspect of a partner's duty of loyalty is to "refrain from competing with the partnership," which is what it looks like Rocco would be doing here because his partners are worried that Rocco's new band would take some gigs away from the Downtown Rockers. However, if Rocco were to quit the Downtown Rockers, he would no longer be a partner. Under RUPA § 603(b)(2), upon a partner's dissociation, her duty to refrain from competing with the partnership ceases.

Question 1-41: The correct answer is B. Under RUPA § 401(h), "[e]ach partner has equal rights in the management and conduct of the partnership's business." Thus, Kate will have an "equal voice" in running the partnership, regardless of the level of her capital contributions to the partnership. That makes Answer A incorrect. (Keep in mind that this is a default rule; nothing in RUPA §§ 105(c) or (d) would prevent the partnership from changing that rule in its partnership agreement.) Answer C is incorrect due to RUPA § 401(k), which states that actions that are in the ordinary course of business need only be approved by a majority of the partners. Answer D is incorrect because of RUPA § 402(b)(3), which in most cases requires unanimous approval to admit a new partner.

Question 1-42: The correct answer is B. Under RUPA § 401(j), a "partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership." Thus, even though Helen is doing more than her "fair share" of the work, she is not entitled to any extra pay for it. However, there is nothing in RUPA §§ 105(c) or (d) that would prohibit the *partnership agreement* from providing that Helen can earn a salary. Of course, amending (or creating) the partnership agreement to say this would require Clark's consent. All of this makes Answer B the correct answer.

Question 1-43: The correct answer is A. Under RUPA § 301(1)

> [a]n act of a partner … for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner did not have authority to act for the partnership in the particular matter and the person with which the partner was dealing knew or had notice that the partner lacked authority.

However, selling the store's *entire inventory to a single buyer* would not likely be considered in the ordinary course of the partnership's business. Thus, under RUPA § 301(2), the partnership is bound only if Carol's act was "actually authorized by all the other partners." The facts do not indicate that she had such authorization. Moreover, under RUPA § 401(k), an act that is outside the ordinary course of business can be taken only if all of the partners consent. Thus, Carol cannot act alone in this situation. This true despite whatever Dave may have thought about the situation.

Question 1-44: The correct answer is D. As noted above in the explanation of Question 1-43, a partner has apparent authority to bind the partnership to an ordinary-course action unless the third party knew or had received notice that the partner lacked authority. Here, selling a relatively small piece of property would be in the ordinary course of this partnership's business. Although Adam lacked authority, there is no indication that the Buyer knew that or had received a notice to that effect, which means that the partnership is liable. Answer is A is thus incorrect; in addition, there is no obligation on part of the third party to actually verify that a partner has the authority to take an ordinary-course action. Answer B is incorrect because, although the partnership *is* liable here, it's not because of a failure to register its partnership agreement with the county clerk's office under RUPA § 303. In fact, there is no such requirement, as RUPA § 303 deals instead with (optional) statements of authority. Answer C is wrong because a partnership agreement may not restrict the rights of third parties, such as the right to hold the partnership liable for the actions of one of its partners. See RUPA § 105(c)(17). Answer D is correct. RUPA § 303, which is quite complicated, provides that a partnership may file a "statement of authority" with the secretary of state. Such a statement may contain *limitations* on a partner's authority to transfer real property (among other things). See subsection (a)(3)(A). Further, subsection (h) provides that "if a certified copy of an effective statement containing a limitation on the authority to transfer real property held in the name of a partnership is recorded in the office for recording transfers of that real property, all persons are deemed to know of the limitation." In other words, the whole world would know that Adam lacked authority to sell this real estate, if the partnership had properly filed the statement of authority. In that case, the Buyer would have had notice that Adam could not sell the property and would not be able to enforce the contract against the partnership. See also the first clause of RUPA § 301.

Question 1-45: The correct answer is A. Under RUPA § 203(c)(2), sharing revenues does not establish a partnership or create a presumption of partnership. Specifically, that section states that the "sharing of gross returns [i.e., revenues] does not by itself establish a partnership.…" The other three factors are obviously important. As for profit-sharing, RUPA § 202(c)(3) states that profit-sharing creates a presumption of partnership (unless the profits were received in payment of one of the six "protected" categories listed in subsections (A) to (F), in which case that presumption does not apply). Likewise, profit-sharing was identified as an important factor in both *Ingram v. Deere* and *MacArthur Co. v. Stein.* Decision-making authority (i.e., "control") and the making of contributions were also identified as important factors in both of those cases.

Question 1-46: The correct answer is A. Under RUPA § 401(h), "[e]ach partner has equal rights in the management and conduct of the partnership business." This is sometimes called the "one partner, one vote" rule. Note that this section does not make any reference to a partner's share of the partnership's distributions or the amount of contributions the partner has made to the partnership in determining how many votes the partner has. Instead, it is a simple rule: every partner gets one vote. (Of course, nothing in RUPA §§ 105(c) or (d) would prevent the partners from changing this rule in their partnership agreement, but there is nothing in this fact pattern to indicate that they did so.)

Question 1-47: The correct answer is C. Under RUPA § 301(1), "[e]ach partner is an agent of the partnership for the purpose of its business. An act of a partner … for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner had no authority to act for the partnership in the particular matter and the person with which the partner was dealing knew or had notice that the partner lacked authority." Although Larry lacked authority to order the liquor (having been stripped of that authority by the vote of the partners), nothing in the fact pattern indicates that Bill's Beverages knew that or had been notified of it. Thus, because Larry's act was in the ordinary course of business (this partnership runs a bar, so ordering liquor is obviously common for it), the partnership is bound. This makes Answer A wrong. Answer B is wrong because nothing in RUPA § 301(1) requires Bill's to confirm Larry's authority. (Note here that, if Larry had been doing something outside the ordinary course of business, he could only bind the partnership if he had actual authority. See RUPA § 301(2).) Answer D is wrong because a unanimous vote of the partners was not necessary for this ordinary-course decision (see RUPA § 401(k)).

Question 1-48: The correct answer is D. The partnership is liable for this tort because Partner B was acting in the ordinary course of business (or with actual authority). See RUPA § 305. This will make each partner personally liable for the tort under RUPA § 306(c). But from whom can the plaintiff actually collect the $20,000? Under RUPA § 307(c), in order to collect from a partner's personal assets based on a claim against the partnership, the plaintiff must (1) have a judgment against that partner and (2) show one of the five "grounds" for collection under RUPA § 307(d). Here, the plaintiff has a judgment against each partner (as well as the partnership itself) because she sued all of them and won the case. So far, so good. But it doesn't look like the plaintiff could show any of the grounds in RUPA § 307(d) to collect from Partners A, C, or D—the partnership's assets will not be exhausted by this claim (it has plenty of money with which to pay the claim), the partnership is not in bankruptcy, none of the partners agreed that the plaintiff doesn't have to exhaust partnership assets, there was no court permission, and there is no "other reason" that Partners A, C, or D would be liable for this claim. Again, see RUPA § 307(d). This makes Answers A and B wrong. (Answer B is also wrong because it misstates the nature of joint and several liability.) But Partner B was the tortfeasor. This would make her liable for the claim for some "other reason" beyond simply being a partner. Thus, the plaintiff could recover from Partner B's assets to pay the claim under RUPA § 307(d)(5). This makes Answer C wrong, because the plaintiff would not need to exhaust the partnership's assets before going after Partner B's assets. Finally, Answer E is wrong because the plaintiff could collect from the partnership itself (again, see RUPA § 305) or Partner B.

Question 1-49: The correct answer is D. Although the partnership was formed "to build and manage a health club," this does not make the partnership a partnership for a term or undertaking. In other words, because the partners did not agree that the partnership would *end* after a task was completed or a period of time had passed, this was an "at will" partnership. See RUPA § 102(13), which defines a "partnership at will" as a "partnership in which the partners have not agreed to remain partners until the expiration of a definite term or the completion of a particular undertaking." RUPA § 601 provides that a partner may dissociate from a partnership by express will, which occurred when Robert told Toni he quit the partnership. Moreover, a dissociation from an at-will partnership is "wrongful" only if the partnership agreement were to make it wrongful (which was not the case here). Thus, Answers B and C are incorrect. In an at-will partnership, one partner's dissociation by express will triggers a dissolution (unless the partnership agreement provides otherwise). See RUPA § 801(1). Thus, Answer D is correct. Answer A is incorrect because neither RUPA nor a partnership agreement can *prevent* a partner from dissociating (see RUPA §§ 105(c)(9) and 602(a)); the most that may be done is to make some types of dissociations "wrongful."

Question 1-50: The correct answer is C. Under RUPA § 703, a partner remains liable for partnership obligations incurred before she dissociated from the partnership (and, in some cases, partnership obligations incurred after she dissociated). However, under subsection (c), "[b]y agreement with a creditor of a partnership *and* the partnership, a person dissociated as a partner may be released from liability for a debt, obligation, or other liability of the partnership." (Emphasis added.) Thus, Answers A and B are incorrect because they do not reflect that the consent of both groups (creditors and continuing partners) is required.

Question 1-51: The correct answer is B. Under RUPA § 601(6)(A), if a partner files a bankruptcy petition, he will be dissociated the partnership. Thus, Devin has dissociated. Moreover, because this partnership had a six-year term (i.e., it was a partnership for a term or undertaking), Devin's dissociation was wrongful under RUPA § 602(b)(2)(C). Thus, Answers A, C, and E can be eliminated. As for Peter, he has been expelled (dissociated) under RUPA § 601(5) (either subsection (A) or subsection (C)) by court order. This is also wrongful in the case of a partnership for a term or undertaking. See RUPA § 602(b)(2)(B). This makes Answer D incorrect, leaving Answer B as the only correct answer.

Question 1-52: The correct answer is C. As noted above, in an at-will partnership, the only time that a dissociation is wrongful is if the partnership agreement makes a particular dissociation wrongful. See RUPA § 602(b)(1). Here, the partnership agreement did not specify any types of wrongful dissociation. Thus, even though both Devin and Peter have dissociated, neither dissociation was wrongful.

Question 1-53: The correct answer is B. There is a lot going on in this problem. First, note that this is a partnership for a term, here, ten years. (Even though the partnership agreement was oral, it still suffices to be a partnership agreement. See RUPA § 102(12).) Nancy has dissociated by express will under RUPA § 601(1). Under RUPA § 801(2)(A), if the partnership is a partnership for a term or undertaking, a partner's dissociation by express will does not cause the partnership to dissolve, unless at least half the remaining partners vote, within 90 days, to dissolve the partnership. Answer A is incorrect because the partnership agreement provides that the partnership cannot hire an employee without the unanimous consent of the partners. Here, Nancy did not consent to hiring an employee. Even though the partnership agreement wasn't signed, the fact pattern says that it was an accurate reflection of what the partners had orally agreed. As noted above, partnership agreements can be oral under RUPA; they need not be written. Therefore, the partnership agreement changed the default rule of RUPA 401(k), which provides that matters in the ordinary course of business are decided by a majority vote of the partners. Answers C and D are incorrect because this is a partnership for a term or undertaking. As noted above, Nancy has dissociated by express will under RUPA § 601(1), and RUPA § 801(2)(A) provides that a partner's dissociation by express will does not cause the partnership to dissolve, unless at least half the remaining partners vote, within 90 days, to *dissolve* the partnership. The partners do not have to vote to "save" the partnership; RUPA § 801(2)(A) only speaks about voting to dissolve the partnership during that 90-day window.

Question 1-54: The correct answer is C. Note that this is an at-will partnership and that there is no partnership agreement. When the probate court appointed Paul's wife Marie as Paul's guardian and conservator, Paul was dissociated from the partnership. See RUPA § 601(7)(B). To determine what effect this had on the partnership, we need to examine RUPA § 801(1) (which concerns at-will partnerships). Generally, the dissociation of a partner will trigger the dissolution of an at-will partnership; however, RUPA § 801(1) provides that this is *not* the case where a partner dissociates for any of the reasons listed in RUPA § 601(2) through (10). Thus, Paul's dissociation did not dissolve this partnership.

Thus, Answers A and B are incorrect. Answer D is incorrect because Paul *did* dissociate. Further, Marie could only become a partner with the unanimous consent of the other partners.

Question 1-55: The correct answer is B. If the partnership *had* dissolved, then both it and its partners would remain liable to pay its debts. Because the partnership was liable under these agreements, so too are the partners. See RUPA § 306. It does not matter whether they also signed personal guaranties of these agreements.

Question 1-56: The correct answer is D. Because there is no indication that the partners have agreed on a task or duration that will limit the partnership's "life," this is an at-will partnership. Under RUPA § 801(1), a partner's dissociation by express will triggers the dissolution of an at-will partnership. Thus, the partnership will dissolve if Sally dissociates by express will. (This may strike you as surprising, but read RUPA § 801(1) carefully.) However, nearly anything in RUPA may be modified in a partnership agreement. See RUPA § 105. Thus, because amending a partnership agreement requires the consent of all of the partners (unless the agreement itself provides that it can be amended upon the consent of a smaller percentage of the partners), if Sally and all of the other partners were to agree that the partnership will not dissolve, then it will not dissolve.

Question 1-57: The correct answer is D. Under RUPA § 702(a) a partner who has dissociated (but without triggering a dissolution of the partnership) continues to have the authority to bind the partnership as follows:

> After a person is dissociated as a partner without the dissociation resulting in a dissolution and winding up of the partnership business and before the partnership is merged out of existence, converted, or domesticated under [Article] 11, or dissolved, the partnership is bound by an act of the person only if:
>
> (1) the act would have bound the partnership under Section 301 before dissociation; and
>
> (2) at the time the other party enters into the transaction:
>
> (A) less than two years has passed since the dissociation; and
>
> (B) the other party does not know or have notice of the dissociation and reasonably believes that the person is a partner.

Because (1) this transaction occurred within two years after Sally dissociated; (2) this transaction, being something that is in the ordinary course of the partnership's business, is something that Sally would have had apparent authority for if she were still a partner; and (3) Sam reasonably believed that Sally was still a partner and did not know or have notice that Sally was no longer a partner, the partnership is bound on this contract. Thus, Answers A, B, and C are incorrect.

Question 1-58: The correct answer is D. Because the partners agreed on a five-year term, this was a partnership for a term or undertaking. Glenn may dissociate before the end of the term, but doing so by express will is "wrongful" under RUPA § 602(b)(2)(A). Under RUPA § 801(2), the dissociation of one partner before the end of the partnership's term will not cause the partnership to dissolve. Thus, we will examine Article 7 of RUPA rather than Article 8. Under RUPA § 701(a), the partnership must buy out Glenn's interest for the price determined under subsection (b). Meanwhile, subsection (b) provides that the price is

> the amount that would have been distributable to the dissociating partner the amount that would have been distributable to the person under Section 806(b) if, on the date of dissociation, the assets of the partnership were sold and the partnership were wound up, with the sale price equal to the greater of: (1) the liquidation value; or (2) the value based on a sale of the entire business as a going concern without the person.

However, two other subsections of RUPA § 701 are also important. First, subsection (c) allows the partnership to deduct from the buy-out price any damages that it incurred as a result of Glenn's wrongful dissociation. Second, subsection (h) provides that Glenn is not entitled to this payment until the end of the partnership's term unless he "establishes to the satisfaction of the court that earlier payment will not cause undue hardship to the business of the partnership." (Also, any deferred payment "must be adequately secured and bear interest.")

Question 1-59: The correct answer is B. When Partner A filed bankruptcy, she was dissociated from the partnership under RUPA § 601(6). Thus, Answer A is wrong. But it was not a wrongful dissociation because, as stated in the facts, this is an "at will" partnership and there is nothing to indicate that the partnership agreement makes filing bankruptcy a wrongful dissociation. See RUPA § 602(b)(1). Because it was not a wrongful dissociation, Answers C and E are wrong. Finally, the partnership will not dissolve because, with respect to an at-will partnership, the only type of dissociation that will cause a dissolution is a dissociation by express will under RUPA § 601(1). See RUPA § 801(1). This makes Answer D wrong.

Question 1-60: The correct answer is C. Answer A is wrong because RUPA § 501 states that a "partner is not a co-owner of partnership property and has no interest in partnership property which can be transferred, either voluntarily or involuntarily." In addition, RUPA § 401(i) provides that a "partner may use or possess partnership property only on behalf of the partnership." This also makes Answer B incorrect; in addition, using the bus for concerts would be an act in the ordinary course of business which would not require unanimous approval under RUPA § 401(k). RUPA § 501 also makes Answer C incorrect;

of course, because the bus is an asset that belongs to the partnership, a partnership creditor could recover it upon a claim against the partnership. See RUPA § 307.

Question 1-61: The correct answer is D. Laurie may only transfer her "transferable interest" to Ricky. See RUPA §§ 502 and 503. RUPA § 102(23) defines a "transferable interest" as "the right, as initially owned by a person in the person's capacity as a partner, to receive distributions from a partnership, whether or not the person remains a partner or continues to own any part of the right." Answer A is incorrect because, although it is true that Ricky is not a partner, RUPA §§ 502(a)(3) and (c) provide that Ricky is not entitled to "have access to records or other information concerning the partnership's business," except for "an account of the partnership's transactions only from the date of dissolution" upon the partnership's dissolution. Answer B is incorrect because Ricky did not become a partner; he is just a transferee of Laurie's transferable interest. See RUPA §§ 503(a)(3) and (f). Answer C is incorrect because the mere transfer of a partner's transferable interest does not cause the partnership to dissolve. See RUPA § 503(a)(2). See also RUPA § 801.

Question 1-62: The correct answer is B. (Remember, the question asks which statement is incorrect.) Answer A is incorrect (that is, it is a correct statement), because RUPA § 401(j) provides that a "partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership." Answer B is correct (that is, it is an incorrect statement) because, as a partner, Danny will be liable for all of the partnership's debts and obligations, even if he did not personally contract for them on behalf of the partnership. See RUPA § 306(a). Answer C is incorrect (that is, it is a correct statement) because of RUPA § 402(b)(3). Finally, Answer D is incorrect (that is, it is a correct statement) because of RUPA § 401(a), which provides that "[e]ach partner is entitled to an equal share of the partnership distributions and ... is chargeable with a share of the partnership losses in proportion to the partner's share of the distributions."

Question 1-63: The correct answer is D, which is the only combination of correct responses. As for Boris's duty of care, RUPA § 409(c) states that it "to refrain from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of law." Thus, *ordinary* negligence would not have been a breach of Boris's duty of care to the partnership. As for Natasha's entitlement to salary, RUPA § RUPA § 401(j), a "partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership." Thus, Natasha is not entitled to any extra pay for doing Boris's work. (However, there is nothing in RUPA §§ 105(c) or (d) that would prohibit the *partnership agreement* from providing that Natasha Helen can earn a salary. Of course, amending (or creating) the partnership agreement to say this would require Boris's consent.)

Question 1-64: The correct answer is D. As explained in Chapter 1 and in more detail in Chapter 6, all of the statements in Answers A, B, and C are correct, which makes Answer D the best choice.

Question 1-65: The correct answer is A. RUPA § 401(a) provides that "[e]ach partner is entitled to an equal share of the partnership distributions and, except in the case of a limited liability partnership, is chargeable with a share of the partnership losses in proportion to the partner's share of the distributions." While this does not directly address how profits are allocated for tax purposes, note that, as discussed in the textbook, the comment to RUPA § 405 provides in part that "[t]ax income or loss is allocated to partners according to the partners' economic interests in the partnership, and these interests are based on distributions that would be made to partners on liquidation of the partnership." As a result, because the partners did not have a partnership agreement that changed these rules, they each have an equal interest in any distributions that would be paid and would therefore report equal amounts of profits and loss on their own income tax returns, despite their differing contributions to the partnership.

Question 1-66: The correct answer is C. As noted above, RUPA § 401(j) provides that a "partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership." Thus, Moe is not entitled to any extra pay for his work. While the partnership agreement could provide for Moe to earn a salary, amending the partnership agreement would require Burns's consent. If Burns does not approve it, it won't happen, even if Burns's refusal is "unreasonable." Moe should have thought of all of this when the partnership was formed.

Question 1-67: In terms of liability to third parties, a partner is a partner. See RUPA §§ 306 and 307. In other words, all partners are jointly and severally liable for the partnership's debts and obligations and, assuming that a creditor complies with RUPA § 307, creditors can recover the full amount owing from any single partner (typically after complying with the "exhaustion rule" of RUPA § 307(d)(1)).

Question 1-68: The correct answer is C. Even though the agreement to limit the partnership's business to the bookstore was not in writing, it still suffices as a partnership agreement because all of the partners agreed to it. See RUPA § 102(12) (defining a partnership agreement as "the agreement, whether or not referred to as a partnership agreement and whether oral, implied, in a record, or in any combination thereof, of all the partners of a partnership concerning the matters described in Section 105(a).") See also RUPA § 105(a)(2) ("... the partnership agreement governs ... the business of the partnership and the conduct of that business ...."). Further, unless the partnership agreement itself provides that it may be amended upon a lesser vote (which is not the case here), RUPA § 401(k) requires unanimous partner consent to amend the partnership agreement. (Also, note that, despite their differing contributions, each partner has one vote on partnership business under RUPA § 401(h), unless otherwise agreed in the partnership agreement.)

Question 1-69: The correct answer is D. RUPA § 305(a) provides that a "partnership is liable for loss or injury caused to a person, or for a penalty incurred, as a result of a wrongful act or omission, or other actionable conduct, of a partner acting in the ordinary course of business of the partnership or with the actual or apparent authority of the partnership." Here, even though Mike was grossly negligent, he was nonetheless acting in the ordinary course of the partnership's business, which means that the partnership is liable and thus eliminates Answer A. If the partnership is liable, then Nick will be liable as well simply because he is a partner. See RUPA § 306(a). This eliminates Answer B. Further, Mike has breached his duty of care to the partnership by being grossly negligent (see RUPA § 409(c)). He has also breached his duty of loyalty by keeping the $50 for himself. See RUPA § 409(b)(1) (duty of loyalty includes the duty to "to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner: (A) in the conduct or winding up of the partnership's business; (B) from a use by the partner of the partnership's property ...."). That eliminates Answer C.

Question 1-70: The correct answer is D. As discussed in Chapter 5, in most ways, a limited liability partnership (LLP) is the same thing as a general partnership. Because this question only concerns whether Mega (not any of its partners) is liable, we will thus examine RUPA § 301(1), which provides that:

> Each partner is an agent of the partnership for the purpose of its business. An act of a partner ... for apparently carrying on in the ordinary course the partnership business or business of the kind carried on by the partnership binds the partnership, unless the partner did not have authority to act for the partnership in the particular matter and the person with which the partner was dealing knew or had notice that the partner lacked authority

Here, the facts are clear that Paula's actions were in the ordinary course of this law firm's business. (Moreover, even if Paula lacked authority, the facts do not indicate that Ivan knew that or had received a notice to that effect.) That being the case, Answer D is correct and Answer A is incorrect. Answer B is incorrect due to the first sentence of RUPA § 301(1), which is applicable to all general partnerships, including LLPs. Answer C is wrong because nothing in the facts indicates that Mega's executive committee *expressly* authorized Paula to hire Ivan.

Question 1-71: The correct answer is D. Although Mega is an LLP, this does not mean that Paula can escape liability for her own actions, although the first sentence of RUPA § 305(c) may make it seem that way. That sentence states that a "debt, obligation, or other liability of a partnership incurred while the partnership is [an LLP] is solely the debt, obligation, or other liability of the [LLP]. And, of course, Paula's actions were in the ordinary course of Mega's business, which makes Mega liable. However, note that the second sentence of RUPA § 305(c) provides that a "partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the [LLP] *solely by reason of being or acting as a partner*." (Emphasis added.)

But Paula is liable here for a reason beyond simply having been a partner in Mega: she was the tortfeasor too. That makes Answer D the correct answer. Answer A is incorrect because there is not requirement that a partnership creditor bring suit against all of the partners for a partnership liability. See RUPA § 307. Answer B is incorrect for the reasons discussed above. Answer C is wrong for obvious reasons.

Question 1-72: The correct answer is B. The key facts here are that (1) the malpractice in Lawsuit 1 occurred while the firm was a "regular" general partnership, whereas (2) the malpractice in Lawsuit 2 took place while the firm was an LLP. As noted above, RUPA § 305(c) provides that a "debt, obligation, or other liability of a partnership incurred *while the partnership is [an LLP]* is solely the debt, obligation, or other liability of the [LLP]." (Emphasis added.) This would mean that all of the partners are liable for Lawsuit 1, which occurred while the partnership was a general partnership and was in the ordinary course of the partnership's business (see RUPA § 305), but that only Partner B is liable for her own negligence in Lawsuit 2, which took place while the partnership was an LLP. This makes B the only correct answer.

Question 1-73: The correct answer is A. RUPA § 406(a) provides that:

> A limited liability partnership may not make a distribution, including a distribution under Section 806, if after the distribution:
>
> (1) the partnership would not be able to pay its debts as they become due in the ordinary course of the partnership's business; or
>
> (2) the partnership's total assets would be less than the sum of its total liabilities plus the amount that would be needed, if the partnership were to be dissolved and wound up at the time of the distribution, to satisfy the preferential rights upon dissolution and winding up of partners and transferees whose preferential rights are superior to the rights of persons receiving the distribution.

The call of the question allows you to assume that the test in subsection (1) (the "insolvency test" would be met), so we turn our attention to the second test (the "balance sheet test"). After paying the dividend, the LLP must have assets that are at least equal to its liabilities. Here, its liabilities are $120,000, so it must keep at least that much on hand. Because it now has $200,000 of assets, this would mean that it could pay up to $80,000 in distributions ($200,000 minus $80,000 equals $120,000). Luckily, there were no preferential rights to distributions upon the LLP's dissolution to complicate things in this problem.

Question 1-74: The correct answer is A. The newspaper notice appears to meet all of the requirements of RUPA § 808, which means that all claims against the LLP that were not filed before the deadline stated in the notice (which cannot be shorter than three years from the date of publication) will be barred. Answer B is wrong because, under RUPA §

306(c) partners in an LLP are generally not liable for the LLP's debts and other obligations. Answer C is wrong because RUPA § 808 only requires a minimum three-year deadline, and Answer D is wrong because nothing in RUPA § 808 states that the only creditors whose claims are barred are those who actually see the notice.

Question 1-75: The correct answer is D. Part of the purpose of this question is to point out that LLPs and "regular" general partnerships are both general partnerships and are both governed by RUPA; the only difference between them has to do with things specifically stated in RUPA, such as liability issues in RUPA § 306. Answer A is incorrect because RUPA § 801 (which applies to all types of general partnerships) provides for several ways in which a partnership will dissolved. Answer B is incorrect; although RUPA § 809 provides than an LLP may apply to a court for a determination of how much it must "hold back" after its dissolution (and for how long) to satisfy potential creditors' claims, this section is optional, not mandatory. Answer C is incorrect because of RUPA § 601(1).

PART 2

Answer Key to Part 2:

2-1: D
2-2: C
2-3: C
2-4: A
2-5: A
2-6: D
2-7: B
2-8: A
2-9: E
2-10: A
2-11: D
2-12: D
2-13: A
2-14: B
2-15: B
2-16: C
2-17: A
2-18: C
2-19: D
2-20: A
2-21: B
2-22: D
2-23: C
2-24: D
2-25: D
2-26: A
2-27: C
2-28: B
2-29: B
2-30: C
2-31: D
2-32: A
2-33: E
2-34: B
2-35: B
2-36: B
2-37: B
2-38: D
2-39: A
2-40: C

Explanations to Part 2:

Question 2-1: The correct answer is D. Even though she was not at the restaurant at the time, Karen is still liable for the limited partnership's debts and obligations because she is the general partner. ULPA § 404(a). Answer A is incorrect because Karen appears to have given Rufus actual authority to manage the restaurant, which would include ordering food. Remember, as a "principal," a limited partnership could hire agents who would have authority under the *Restatement (Third) of Agency.* While it is true that ULPA § 303(a) states that a "limited partner is not an agent of a limited partnership solely by reason of being a limited partner," this does not prevent agency law from applying if the limited partner were an agent. See subsection (b): "A person's status as a limited partner does not prevent or restrict law other than this [act] from imposing liability on a limited partnership because of the person's conduct." Thus, Rufus did not actually breach an implied warranty of authority; the limited partnership is in fact bound to pay for this fish. This also makes Answer E incorrect. Answer B is incorrect because it reflects the rule from the 1985 version of *RULPA*; under *ULPA* limited partners are not liable in their capacities as limited partners. ULPA § 303(a). Answer C sounds plausible, but as noted above, a limited partnership may be bound by its *agents*. Here, even though Rufus was a limited partner, he was also acting as an agent.

Question 2-2: The correct answer is C. Under ULPA § 606(a) a limited partnership can be bound by the acts of a dissociated (i.e., former) general partner if:

> (1) the act would have bound the limited partnership under Section 402 before the dissociation; and
>
> (2) at the time the other party enters into the transaction:
>
> > (A) less than two years has passed since the dissociation; and
> >
> > (B) the other party does not have notice of the dissociation and reasonably believes that the person is a general partner.

Here, all of these requirements are met. Thus, Answer A is incorrect. Answer B is incorrect because the relevant time period is two years, not 90 days. (Note, however, that under ULPA § 103(d)(1) provides that a person who is not a partner is deemed to have notice of "a person's dissociation as a general partner 90 days after an amendment to the certificate of limited partnership which states that the other person has dissociated becomes effective or 90 days after a statement of dissociation pertaining to the other person becomes effective, whichever occurs first." Of course, that did not happen in this fact pattern. See also ULPA § 605(a)(3).) Answer D (and therefore Answer E as well) is incorrect because if the limited partnership is liable, then so too is its general partner (Johnny). Note that ULPA § 606(b) will make Jessica liable for any damages that Red Engine, L.P. incurs in this fact pattern.

Question 2-3: The correct answer is C. Here, when General Partner 1 dissociated by express will before the limited partnership was wound up, it was wrongful. See ULPA § 604(b)(2)(A). Similarly, when Limited Partner A dissociated by express will under ULPA § 601(b)(1), it was wrongful. ULPA doesn't expressly say so, but the official comment to ULPA § 601(b)(1) does. Moreover, ULPA § 601(a) states that "A person does not have a *right* to dissociate as a limited partner before the completion of the winding up of the limited partnership." (Emphasis added.) However, Limited Partner B *has not even dissociated*. See ULPA § 601(b).

Question 2-4: The correct answer is A. Under ULPA § 504(a)(2), a limited partnership may not pay a distribution if, following the distribution, its total assets would be less than its total liabilities (plus other amounts not relevant in this question). Thus, the maximum amount of distributions that Yellow, L.P. could pay would be $130,000, which makes Answers C and D incorrect. Moreover, distributions are paid proportionally based on the contributions that the various partners have made. See ULPA § 503. Here, General Partner made 10% of the overall contributions by the partners and so would be entitled to 10% of a $130,000 distribution (i.e., $13,000). And so on.

Question 2-5: The correct answer is A. Under ULPA § 801(a)(2), the consent of all *general* partners would be needed to dissolve the limited partnership, even if all of the *limited* partners wanted to dissolve it. None of the other causes of dissolution set forth in ULPA § 801 would apply here. Answers B and C are incorrect because, if the general partner *had* consented to dissolution, only a majority in interest of the limited partners would need to approve the dissolution, not all of them. Specifically, ULPA § 801(a)(2) provides that a limited partnership will dissolve upon "the affirmative vote or consent of *all general partners* and of limited partners owning a *majority of the rights to receive distributions as limited partners* at the time the vote or consent is to be effective." (Emphasis added.)

Question 2-6: The correct answer is D. Under ULPA § 801(a)(3)(B), if a general partner dissociates and there are no other general partners (as is the case in this fact pattern), then the limited partnership will be dissolved *unless*, within 90 days, "consent to continue the activities and affairs of the [limited] partnership and admit at least one general partner is given by limited partners owning a majority of the rights to receive distributions as limited partners at the time the consent is to be effective; and … at least one person is admitted as a general partner in accordance with the consent." Here, because the three limited partners all have equal rights to distributions and two of the three of them voted to continue the limited partnership the requisite vote was achieved, but it was too late because it occurred more than 90 days after the general partner dissociated.

Question 2-7: The correct answer is B. Under ULPA § 807(d), when a limited partnership dissolves, a claim that is not barred may be enforced:

> (1) against the dissolved limited partnership, to the extent of its undistributed assets;

> (2) except as otherwise provided in Section 808, if assets of the partnership have been distributed after dissolution, against a partner or transferee to the extent of that person's proportionate share of the claim or of the partnership's assets distributed to the partner or transferee after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution; and
>
> (3) against any person liable on the claim under Sections 404 and 607.

Here, the limited partnership has distributed all of its assets, so subsection (1) would not be helpful for Loan Shark, Inc. Subsection (2) would make the partners liable for the claim in proportion to the percentages of overall distributions they received (see the discussion of ULPA § 503 above). Also, subsection (3), by referring to ULPA § 404, would make the general partner liable for the full amount of the claim. Thus, Answer B is the only correct answer.

Question 2-8: The correct answer is A. If Orange were an LLLP, ULPA § 807(d) would still apply, as discussed in the explanation of Question 2-7. However, the General Partner would not be liable for the entire claim under ULPA § 404. This is because ULPA § 404(c) provides that:

> A debt, obligation, or other liability of a limited partnership incurred while the partnership is a limited liability limited partnership is solely the debt, obligation, or other liability of the limited liability limited partnership. A general partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the limited liability limited partnership solely by reason of being or acting as a general partner. This subsection applies:
>
> (1) despite anything inconsistent in the partnership agreement that existed immediately before the vote or consent required to become a limited liability limited partnership under Section 406(b)(2); and
>
> (2) regardless of the dissolution of the partnership.

Thus, General Partner will not be liable for the full amount of the claim, and Answer A is the only correct answer.

Question 2-9: The correct answer is E. As for Susan's liability, as you should know, the rule is that limited partners are not personally liable for the debts and obligations of the limited partnership simply because they are limited partners; ULPA § 303(a) provides that:

> A debt, obligation, or other liability of a limited partnership is not the debt, obligation, or other liability of a limited partner. A limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the partnership solely by reason of being or acting as a limited partner, even if the limited partner participates in the management and control of the limited partnership. This subsection applies regardless of the dissolution of the partnership.

This eliminates Answer A. (Note that Section 303 of RULPA (1985) provides that a limited partner could be liable for the limited partnership's debts if she (1) were also a general partner, or (2) "in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.") Answer C is incorrect because nothing in ULPA supports that statement. Answer D is correct due to ULPA §§ (b) and (c). First, subsection (b) provides in part that a "judgment against a partnership may not be satisfied from a general partner's assets unless there is also a judgment against the general partner." Here, however, Chad has been named as a defendant, which means that Gopher Bank will have a judgment against him if it wins the case. Further, subsection (c) provides that a "judgment creditor of a general partner may not levy execution against the assets of the general partner to satisfy a judgment based on a claim against the limited partnership, unless the partner is personally liable for the claim under Section 404 and" at least one of the following five conditions is satisfied, including in subsection (2) that "the partnership is a debtor in bankruptcy." This means that Gopher Bank need not exhaust the limited partnership's assets before recovering from Chad in this situation. Thus, Answer E is the best answer because both Answer B and Answer D are correct.

Question 2-10: The correct answer is A. (Hopefully, this question was very easy!) Answer B is incorrect due to ULPA § 201(a). (Contrast this to the rule for general partnerships.) Answer C is incorrect because general partners are personally liable for the limited partnership's debts and obligations under ULPA § 404(a). Answer D is incorrect for obvious reasons.

Question 2-11: The correct answer is D. As discussed above, ULPA § 303(a) provides that limited partners are not personally liable for the debts and obligations of the limited partnership solely as a result of being limited partners. However, under Section 303(a) of the 1985 version of RULPA, a limited partner would become liable if she "participates in the control of the business." Even then, however, the limited partner would only be liable to "persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." In addition, subsection (b) of the 1985 version of RULPA provided that certain things were not, standing alone, considered to be participating in the "control" of the business, including "being a contractor for or an agent or employee of the limited partnership," "consulting with and advising a general partner with respect to the business of the limited partnership," and "proposing, approving, or disapproving, by voting or otherwise," certain matters. Answers A, B, and C all reflect such "minor" items and would not, by themselves, be sufficient to find that a limited partner was participating in the control of the business.

Question 2-12: The correct answer is D. Although this may not be an optimal way of doing things, it is permissible. As discussed in the textbook, ULPA does not provide limited partners any power to manage the limited partnership. *See* ULPA § 406(a) (and note that limited partners are omitted from that section). However, a limited partner could be an employee of the limited partnership and thus have agency authority (that is, apparent or actual authority) to bind the limited partnership to contracts. ULPA § 302(a) simply means that, *in her capacity as a limited partner*, she has no power to bind the limited partnership. ULPA § 406(a) states in part that "[e]xcept as otherwise provided in [ULPA], any matter relating to the activities and affairs of the partnership is decided exclusively by the general partner or, if there is more than one general partner, by a majority of the general partners." Again, however, a limited partner could serve as an employee of the limited partnership and, as such, be given authority to make business decisions such as ordering clothes or records to be stocked at the store. This eliminates Answer A. Answer B is incorrect because the certificate of limited partnership is not required to contain this information. See ULPA § 201(b). Answer C is incorrect under ULPA § 303(a). (But see the discussion of the 1985 version of RULPA in the explanation of Question 2-11.)

Question 2-13: The correct answer is A. Answer B is incorrect because ULPA § 102(7) defines a "general partner" as a "person that: (A) has become a general partner under Section 401 or was a general partner in a partnership when the partnership became subject to this [act] under Section 112; and (B) has not dissociated as a general partner under Section 603." Meanwhile, ULPA § 102(15) defines "person" as including not only individuals, but corporations and other types of entities as well. Thus, a general partner could be a corporation. Answers C and D are not supported by anything in ULPA; in fact, as discussed above, ULPA § 303(a) provides that limited partners are generally not personally liable for the debts and obligations of the limited partnership. Although there are some situations where a limited partner could become liable (for example, by reason of her own actions, such as by committing a tort), merely serving as an officer or director of a corporate general partner will not subject a limited partner to liability for the debts and obligations of the limited partnership. Again, note that ULPA § 303(a) provides that a "limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation, or other liability of the partnership solely by reason of being or acting as a limited partner, *even if the limited partner participates in the management and control of the limited partnership*." (Emphasis added.) With respect to Answer A, note that the corporate general partner would be liable for the limited partnership's debts and obligations. While shareholders of a corporation are generally not liable for *its* debts and obligations, courts in some cases can impose liability on a corporation's shareholders for its debts under the "piercing the corporate veil" doctrine. See Chapter 8 for more details.

Question 2-14: The correct answer is B. ULPA § 801(a)(2) specifies that one of the causes of dissolution of a limited partnership is where the dissolution receives "the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective." Answer A is thus incorrect because the general partner would not have the power to dissolve the limited partnership over the objections of a majority in interest of the limited partners. (But see ULPA § 801(a)(3).) Answer C is incorrect for the reasons discussed above. Answer D is incorrect because the dissolution of a limited partnership does not always require court approval (although a court could dissolve a limited partnership in the circumstances described in ULPA § 801(a)(6).)

Question 2-15: The correct answer is B. As discussed above, Section 303 of the 1985 version of RULPA provided that a limited partner could be liable for the limited partner's debts if she (1) was also a general partner, or (2) "in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner." Here, Mike *does* appear to be participating in the "control" of the limited partnership by managing it for six months, and the facts specifically state that Mohawk reasonably believed Mike was a general partner—probably as a result of his conduct. However, the facts indicate that the Rotgut order was made by Terri, so it's difficult to see how Rotgut could hold Mike personally liable for this order; Rotgut may not even be aware that Mike exists.

Question 2-16: The correct answer is C. Answer A is incorrect because, under the IRS's "check-the-box" regulations, an LLC will generally be taxed like a partnership (or a disregarded entity like a sole proprietorship if there is only one member), regardless of whether it would meet the requirements to be an "S" corporation (which are discussed in Chapter 1). Answer B is incorrect because neither members nor managers are personally liable for the debts and other obligations of the LLC, unless the LLC "veil" is pierced. Finally, Answer D is incorrect because it states the standards for when a *limited partner of a limited partnership* may become personally liable for the debts and other obligations of the limited partnership under the 1985 version of RULPA; it has nothing to do with LLCs.

Question 2-17: The correct answer is A. This is because ULLCA § 201(d) provides that an LLC is "formed when the certificate of organization becomes effective and at least one person has become a member." Answer B is incorrect because ULLCA § 201(b) does not require an LLC's certificate of organization to state whether the LLC is member-managed or manager-managed. Answer C is incorrect because ULLCA § 108(b) provides that an LLC "may have any lawful purpose, regardless of whether for profit." Finally, Answer D is incorrect because ULLCA § 407(a) provides the opposite: it provides that an LLC is *member*-managed unless the operating agreement provides otherwise.

Question 2-18: The correct answer is C. Answer A is incorrect because the ULLCA § 407(b)(2) provides that, in a member-managed LLC, "[e]ach member has equal rights in the management and conduct of the [LLC's] activities and affairs." (The second part of Answer A is correct, however. See ULLCA § 407(c)(2).) Answer B is incorrect because ULLCA § 301(a) provides that a "member is not an agent of [an LLC] solely by reason of being a member." (Of course, a member could serve as a manager or an employee, and have agency authority in *that* capacity.) Answer D is incorrect because even in a manager-managed LLC, there are some major decisions upon which members must vote. See ULLCA § 407(c)(3), which provides that, even in a manager-managed LLC, the affirmative vote or consent of all members is required to undertake an act outside the ordinary course of the company's activities and affairs or amend the operating agreement.

Question 2-19: The correct answer is D. Of the choices, Option I is correct under ULLCA §§ 409(i)(1). Option II is correct due to ULLCA §§ 409(a), (b), and (c). However, Option III is incorrect because ULLCA § 105(c)(5) and (d) do not allow an operating agreement to *completely* eliminate the fiduciary duties of care and loyalty (although *alterations* are permissible, as described in those sections). Thus, because Options I and II are correct, but Option III is incorrect, Answer D is the correct answer.

Question 2-20: The correct answer is A. The last sentence of Del. § 18-402 provides that "[u]nless otherwise provided in [an operating] agreement, each member and manager has the authority to bind the [LLC]." This rule applies regardless of whether the LLC is member-managed or manager-managed. Answer B is incorrect because the ULLCA § 301(a) provides that a "member is not an agent of a limited liability company solely by reason of being a member." (Note here that *agency law* could give a member authority to bind the LLC, but the ULLCA itself does not do so. See page 175 of the textbook.) Answer C is incorrect due to Del. § 18-402, as discussed above. Finally, Answer D is incorrect because, as discussed on page 179 of the text, the ULLCA is actually *silent* on the issue of a manager's apparent authority (although the comment to section 407 makes clear that managers will very likely have apparent authority to act on behalf of the LLC in most situations).

Question 2-21: The correct answer is B. As discussed on pages 194-195 of the textbook, ULLCA § 404(a) provides that distributions made by an LLC "must be in equal shares among members and dissociated members," with some exceptions. (Of course, the LLC's operating agreement could provide for a different rule.) Further, ULLCA § 404(b) provides that a person has a right to an interim distribution (that is, a distribution that occurs before the LLC is dissolved) "only if the [LLC] decides to make an interim distribution," and that a "person's dissociation does not entitle the person to a distribution." That makes Answer C incorrect.

Question 2-22: The correct answer is D under ULLCA § 701(a)(4)(C)(ii). Answer A is incorrect because having a guardian or conservator appointed for Maggie would only dissociate her from the LLC if it were *member-managed*. See ULLCA § 602(7)(B)(i). Answer B is incorrect because a member's dissociation from the LLC would not, under the statute, cause an LLC to dissolve. See ULLCA § 701. Answer C is incorrect because dissolution generally requires unanimous member consent. See ULLCA § 701(a)(2).

Question 2-23: The correct answer is C. See ULLCA § 1043(a). Answer A is incorrect because ULLCA § 802(2) would excuse a demand before filing a derivative lawsuit if making a demand would be "futile." Answer B is incorrect because courts in some cases will "pierce the veil" and make LLC members liable for the LLC's debts. See, e.g., *Sheffield Services Company v. Trowbridge* beginning on page 187 of the textbook. Finally, Answer D is incorrect because members have greater informational rights than those described in this answer; see pages 205-06 of the textbook.

Question 2-24: The correct answer is D. In Delaware, when an LLC is dissolved and creditors have been fully paid, Del. § 18-804(a)(3) provides that members are paid "first for the return of their contributions and second respecting their limited liability company interests, the proportions in which the members share in distributions." (The default rule in the Delaware LLC statute is that members share distributions based on the relative values of their contributions to the LLC.) Further, if there are not sufficient assets to do so, then Del. § 18-804(b) states that "claims and obligations shall be paid or provided for according to their priority and, among claims of equal priority, ratably to the extent of assets available therefor." Mathematically, this makes Answer A and Answer B correct, which makes Answer D the best answer.

Question 2-25: The correct answer is D; in other words, Options II and III are correct. Option II is correct because Del. § 18-801(3) provides that:

> Unless otherwise provided in a limited liability company agreement, [an LLC will be dissolved] upon the affirmative vote or written consent of members who own more than 2/3 of the then-current percentage or other interest in the profits of the limited liability company owned by all of the members.

Option III is correct because ULLCA § 701(a)(2) provides that an LLC will be dissolved upon the "affirmative vote or consent of all the members" (among other possible causes).

Question 2-26: The correct answer is A. As noted in the textbook, when an LLC is organized under the law of a given state, every *other* state will consider the LLC to be a "foreign" LLC. Further, before the LLC may "do business" in another state, it must register to do business in that state. *See* ULLCA § 902(a). Further, ULLCA § 104 states that the law of "this state" (that is, the state in which the LLC was organized) governs the "internal affairs" of an LLC. Here, because this LLC is organized under the law of the State of Circle but is "transacting business" in the State of Square (its headquarters and all of its employees are in the State of Square) it must register to do business in the State of Square. See also ULLCA § 902(b) (consequences of failure to do so). This also means that the law of the State of Circle will govern the "internal affairs" of this LLC. However, neither of the lawsuits described in Answers B or C involve "internal affairs," not even the lawsuit brought by the employee. Instead, for those lawsuits, normal choice-of-law rules would dictate that the law of the state where the events occurred (here, the State of Square) will apply to the case. This eliminates answers B, C, and D.

Question 2-27: The correct answer is C. ULLCA § 407 provides the answers for this question. First, note that subsection (c) provides that, in a manager-managed LLC such as this one:

> (1) Except as expressly provided in this [act], any matter relating to the activities and affairs of the company is decided exclusively by the manager, or, if there is more than one manager, by a majority of the managers.
>
> (2) Each manager has equal rights in the management and conduct of the company's activities and affairs.
>
> (3) The affirmative vote or consent of all members is required to: (A) undertake an act outside the ordinary course of the company's activities and affairs; or (B) amend the operating agreement.

Here, the LLC manufactures widgets, so selling widgets would be in the ordinary course of the LLC's business, but selling *all of the LLC's assets* would be outside the ordinary course of business. As such, subsection (c)(3) above will require that the members unanimously approve the sale—despite the fact that this is a manager-managed LLC. (Remember, the instructions to Part 2 of this Appendix state that you should assume that the LLC does not have an operating agreement that changes the applicable rules of the ULLCA, unless otherwise noted.) This obviously eliminates all of the answers except Answer C.

Question 2-28: The correct answer is B. The newspaper notice appears to meet all of the requirements of ULLCA § 705, except that that section requires that the notice state that a claim against the company will barred unless an action to enforce the claim is commenced not later than *three* years after publication of the notice. This eliminates Answer A and Answer C. Answer D is incorrect because ULLCA § 705 only requires the notice to be published in "a newspaper of general circulation in the [county] in this state in which the dissolved limited liability company's principal office is located or, if the principal office is not located in this state, in the [county] in which the office of the company's registered agent is or was last located." In other words, publication in a national newspaper is not required.

Question 2-29: The correct answer is B. First, because Julia's actions (allegedly) harmed the LLC (and only harmed the members indirectly), this would be a derivative lawsuit, not a direct lawsuit. See page 207 of the textbook. (Also, note that ULLCA § 801(b) provides that a "member maintaining a direct action … must plead and prove an actual or threatened injury that is not solely the result of an injury suffered or threatened to be suffered by the [LLC].") This eliminates Answer C. With respect to derivative lawsuits, ULLCA § 801 provides that:

> A member may maintain a derivative action to enforce a right of a limited liability company if:
>
> (1) the member first makes a demand on the other members in a member-managed limited liability company, or the managers of a manager-managed limited liability company, requesting that they cause the company to bring an action to enforce the right, and the managers or other members do not bring the action within a reasonable time; or
>
> (2) a demand under paragraph (1) would be futile.

Although "futile" is not defined in the ULLCA, Frank seems to have a good argument that it would be futile in this case because he is essentially asking Julia to have the LLC file a lawsuit against her. (On the other hand, see the explanation to Question 4-54 below for how such an argument would be handled under the Model Business Corporation Act.) Answer D is incorrect because nothing in the ULLCA requires that a majority in interest of the members join the lawsuit.

Question 2-30: The correct answer is C. ULLCA § 805(a) provides that "an LLC may appoint a special litigation committee to investigate the claims asserted in the proceeding and determine whether pursuing the action is in the best interests of the company." Further, subsection (b) provides that a "special litigation committee must be composed of one or more disinterested and independent individuals, who may be members." Here, the two members of the special litigation committee appear to be disinterested and independent; they have no "stake" in the lawsuit and do not appear to have any relationships with Julia that would call their disinterestedness into question. But may Julia—the defendant—in the lawsuit appoint the special litigation committee? Perhaps surprisingly, the answer is yes. Subsection (c)(2) provides that, in a manager-managed LLC, the committee may be appointed "(A) by a majority of the managers not named as parties in the proceeding; or (B) if all managers are named as parties in the proceeding, by a majority of the managers named as defendants." That eliminates Answer B. Under subsection (d), after "appropriate investigation," the committee may move to dismiss the case (among other options). That eliminates Answer A. Finally, subsection (e) provides in part that:

> After making a determination under subsection (d), a special litigation committee shall file with the court a statement of its determination and its

> report supporting its determination …. The court shall determine whether the members of the committee were disinterested and independent and whether the committee conducted its investigation and made its recommendation in good faith, independently, and with reasonable care, with the committee having the burden of proof. If the court finds that the members of the committee were disinterested and independent and that the committee acted in good faith, independently, and with reasonable care, the court shall enforce the determination of the committee. Otherwise, the court shall … allow the action to continue under the control of the plaintiff.

Answer D is incorrect because the court does not make its own determination of whether the lawsuit is in the LLC's best interests. Instead, it evaluates the disinterestedness of the committee members and the quality of its decision-making process, as discussed above.

Question 2-31: The correct answer is D. Answer A is incorrect because ULLCA § 105(c)(11) provides that an operating agreement may not "unreasonably restrict" a member's right to maintain a lawsuit under Article 8 of the ULLCA, which concerns direct and derivative lawsuits. The clause described in Answer A is basically a complete elimination of a member's right to bring a derivative lawsuit and thus is an "unreasonable restriction" on that right. Answer B is incorrect because ULLCA § 105(c)(6) provides that an operating agreement may not "eliminate the contractual obligation of good faith and fair dealing under Section 409(d)" although it may prescribe "standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured." Finally, Answer C is incorrect because ULLCA § 105(c)(1) provides that an operating agreement may not "vary the law applicable under Section 104." Section 104, meanwhile, provides that the internal affairs will be governed by the law of the state in which the LLC is organized.

Question 2-32: The correct answer is A. This is a veil-piercing question. As discussed in the textbook and in cases such as *Sheffield Services Company v. Trowbridge* (see page 187), courts sometimes pierce the veil and make the members and/or managers of an LLC personally liable for the LLC's debts and obligations. *Trowbridge* identified factors that are traditionally used in (corporate) veil-piercing cases, including whether (1) the corporation is operated as a distinct business entity, (2) assets and funds are commingled, (3) adequate corporate records are maintained, (4) the nature and form of the entity's ownership and control facilitate misuse by an insider, (5) the business is thinly capitalized, (6) the corporation is used as a "mere shell," (7) shareholders disregard legal formalities, and (8) corporate funds or assets are used for noncorporate purposes. Similar factors should be relevant in an LLC-veil-piercing case as well. However, note that ULLCA § 304(b) provides that:

> The failure of [an LLC] to observe any particular formalities relating to the exercise of its powers or management of its activities and affairs is not a

> ground for imposing liability on the members or managers for the debts, obligations, or liabilities of the [LLC].

This language, arguably at least, should eliminate Answer B. Similarly, Answer C (Construction has several other unpaid creditors) is not directly relevant (unless it somehow shows that the business was thinly capitalized). Answer A, however, is relevant under factor (2) and factor (8) set forth above.

Question 2-33: The correct answer is E. ULLCA § 102(24) defines a "transferable interest" as "the right … to receive distributions from a limited liability company, whether or not the person remains a member or continues to own any part of the right." In other words, a "transferable interest" is basically a member's economic rights in the LLC. Further, under ULLCA § 502, a member may transfer her transferable interest to a third party, but such a transfer does not, by itself, cause the transferor to be dissociated as a member or entitle the transferee to participate in the management or conduct of the LLC's activities and affairs or to inspect the LLC's books and records. Thus, when a member transfers her transferable interest, she remains a member and the transferee does not become a member. In case there was any doubt on that point, subsection (g) provides that "if a member transfers a transferable interest, the transferor retains the rights of a member other than the transferable interest transferred and retains all the duties and obligations of a member" (although the transferor could be "voted out" of the LLC under ULLCA § 602(5)(B) afterwards). Answer A is incorrect because ULLCA § 502 does not require manager approval for the transfer of a member's transferable interest. (Note that, even if the *operating agreement* did require such approval, ULCLA § 502(f) provides that a transfer "in violation of a restriction on transfer contained in the operating agreement is ineffective if the intended transferee has knowledge or notice of the restriction at the time of transfer.") Answers B and C are incorrect because a member cannot transfer his *entire* membership to a third party. (However, note that a person can become a member in an LLC after its formation under ULLCA § 401(c), such as pursuant to the operating agreement or with the approval of all of the current members.) In addition, the second sentence of Answer B is incorrect for the reasons discussed above. Answer D is incorrect because a manager need not be a member. See ULLCA § 407(c)(5). (Note that this section goes on to say that if a manager *dissociates as a member*, she will be removed as a *manager*. Conversely, if "a person that is both a manager and a member ceases to be a *manager*, that cessation does not by itself dissociate the person as a *member*.") (Emphasis added.)

Question 2-34: The correct answer is B. Although the ULLCA itself does not require that members make contributions to the LLC, here the operating agreement did. As far as excusing an obligation to make a contribution, ULLCA § 403(c) provides that the obligation could be compromised by a unanimous vote of the members. This eliminates Answer D, as well as Answer E. However, subsection (c) further provides that if a creditor of an LLC (such as Bank) "extends credit or otherwise acts in reliance on an obligation described in subsection (a) without knowledge or notice of a compromise under this subsection, the creditor may enforce the obligation." Here, it appears likely that Bank made the loan in reliance of the members' forthcoming contributions; the facts state the Bank read the operating agreement, so it seems likely that the Bank would know about the contributions. Moreover, since the aggregate amount of the contributions ($150,000) was greater than the amount of the loan ($100,000), Bank may have made the loan in reliance on these contributions, at least in part. That being the case, Answer A is incorrect because it is incomplete, and Answer B seems to be the best answer. Answer C is incorrect under ULLCA § 403(a).

Question 2-35: The correct answer is B. Answer A is incorrect because ULLCA § 301(a) provides that a "member is not an agent of [an LLC] solely by reason of being a member." However, subsection (b) provides that a "person's status as a member does not prevent or restrict *law other than this [act]* from imposing liability on a limited liability company because of the person's conduct." (Emphasis added.) In other words, we need to analyze this question under "general" agency law from the *Restatement (Third) of Agency*, not the ULLCA itself. (Contrast this approach to RUPA § 301, as discussed in Question 1-47 above.) Under Section 2.03 of the *Restatement*, Beverages has a good argument that Mike had apparent authority to make this order and that the LLC is therefore bound to pay for it. Section 2.03 of the *Restatement* provides that:

> Apparent authority is the power held by an agent or other actor to affect a principal's legal relations with third parties when a third party reasonably believes the actor has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.

Here, the "manifestations" (words of other conduct) that the LLC made were putting Mike in charge of ordering liquor and paying for the orders that he made during the first several months of the year. These manifestations caused Beverages to have a reasonable belief that Mike was authorized to make these orders; after all, the LLC paid the bills with no objections. Unless and until the LLC informs Beverages that Mike's authority has been reduced to $3,000 per month, Beverages would continue to have this belief. This makes Answer D incorrect. Answer C is incorrect because ULLCA § 407(b)(3) provides that, in a member-managed LLC, a "difference arising among members as to a matter in the ordinary course of the activities and affairs of the company may be decided by a majority of the members." Ordering liquor for a bar would almost certainly be considered to be in the ordinary course of business.

Question 2-36: The correct answer is B. Option I (the LLC is member-managed and the member files bankruptcy) is correct under ULLCA § 602(8)(A). Option II is incorrect because nothing in ULLCA § 602 provides that a member will be dissociated when she transfers her transferable interest in the LLC to a third party (although the other members could *afterward* vote to "oust" her under ULLCA § 602(5)(B); see also section 602(3)). Option III (the LLC is member-managed and a guardian or conservator is appointed for the member) is correct under ULLCA § 602(7)(B)(i). However, because that section only applies when the LLC is *member-managed*, Option IV (the LLC is *manager*-managed and a guardian or conservator is appointed for the member) is incorrect. Because Option I and Option III are the only correct options, Answer B is the correct answer.

Question 2-37: The correct answer is B. Obviously, Keith has dissociated as a member under ULLCA § 602(1). Because Keith was the manager, his dissociation as a *member* also means that he is no longer the *manager* because the first sentence of ULLCA § 407(c)(5) provides that: "A person need not be a member to be a manager, but the dissociation of a member that is also a manager removes the person as a manager." Further, Keith's dissociation did not cause the LLC to dissolve; it is not one of the events that would cause the LLC to dissolve under ULLCA § 701. Finally, Keith will have to wait until the LLC dissolves to be paid any distributions with respect to his interest in the LLC; ULLCA § 404(b) provides that a person has a right to an interim distribution "only if the company decides to make an interim distribution," and that a "person's dissociation does not entitle the person to a distribution." Unlike the case with a partnership, a member's dissociation from an LLC does not trigger a right on the member's part to have her interest in the LLC bought out. Thus, a dissociated member may have to wait until the LLC is dissolved to receive a payout.

Question 2-38: The correct answer is D. Normally, members are not liable for an LLC's debts, but here the LLC distributed to the members money that should have gone to Creditor instead in the dissolution and winding-up process. ULLCA § 705(d)(2) provides that, after an LLC's dissolution, a claim that was not barred may be enforced as follows:

> [E]xcept as otherwise provided in Section 706 [which is not applicable in this fact pattern], if assets of the company have been distributed after dissolution, against a member or transferee to the extent of that person's proportionate share of the claim or of the company's assets distributed to the member or transferee after dissolution, whichever is less, but a person's total liability for all claims under this paragraph may not exceed the total amount of assets distributed to the person after dissolution.

Here, each member had a one-third ownership interest in the LLCs, so each member will be liable to repay one-third of the claim, or $6,666.67 (rounded to the nearest cent), which makes Answer D the correct answer. Answer A is incorrect for the reasons noted above (although it states the *general* rule). Answer B is incorrect because nothing in the ULLCA provides that only the manager would be liable; ULLCA § 705 talks about the liability of *members* for unpaid claims after dissolution. Answer C is incorrect because ULLCA § 705 does not make the members jointly and severally liable for the entire amount of the unpaid claim; they are liable only for their *proportionate* shares of the claim (based on their respective ownership interests in the LLC).

Question 2-39: The correct answer is A. An LLC may have a single member, whereas a limited partnership must have at least two partners. This is because ULPA § 201(d) provides that a "limited partnership is formed when: (1) the certificate of limited partnership becomes effective; (2) at least two persons have become partners; (3) at least one person has become a general partner; and (4) at least one person has become a limited partner." (However, note that a general partner can also be a limited partner under ULPA § 109.) Answer B is incorrect because both LLCs and LPs are treated as flow-through entities for tax purposes (although there are some exceptions to this statement that are beyond the scope of this textbook). See page 140 of the textbook. Answer C is incorrect because in a limited partnership, the general partner is personally liable for the limited partnership's debts and obligations. Thus, a limited partnership does not provide for a better liability "shield" than does an LLC (in which the members and managers are generally not personally liable for the LLC's debts and obligations). Answer D is incorrect; nothing in ULPA or the Internal Revenue Code provides that a limited partnership may not have foreign owners. Answer E is incorrect because Answers B, C, and D are incorrect.

Question 2-40: The correct answer is C. Answer A is incorrect because both LLCs and "S" corporations may have a single owner. Answer B is incorrect because both LLCs and "S" corporations get "flow-through" tax treatment. See page 7 of Chapter 1. Answer D is incorrect because both LLCs and "S" corporations may exist for an indefinite amount of time. Answer E is incorrect because Answer C is correct; "S" corporations may only have U.S. citizens and resident aliens as shareholders.

PART 3

Answer Key to Part 3:

3-1: E
3-2: B
3-3: B
3-4: A
3-5: A
3-6: B
3-7: D
3-8: E
3-9: C
3-10: B
3-11: B
3-12: D
3-13: A
3-14: A
3-15: C
3-16: C
3-17: C
3-18: C
3-19: A
3-20: A
3-21: D
3-22: A
3-23: B
3-24: A
3-25: D
3-26: A
3-27: A
3-28: C
3-29: B
3-30: C
3-31: C
3-32: A
3-33: A
3-34: C
3-35: D
3-36: A
3-37: D
3-38: D
3-39: D
3-40: C
3-41: B

3-42: C
3-43: C
3-44: D
3-45: B
3-46: A
3-47: A
3-48: B
3-49: B
3-50: D
3-51: D
3-52: A
3-53: A
3-54: C
3-55: D
3-56: D
3-57: E
3-58: B
3-59: C
3-60: E
3-61: D
3-62: D

Explanations:

Question 3-1: The correct answer is E. Answer A is true, as is Answer C, which makes Answer E the best answer. Answer A is true because MBCA § 7.31(a) provides in part that "[t]wo or more shareholders may provide for the manner in which they will vote their shares *by signing an agreement for that purpose."* (Emphasis added.) Thus, *oral* shareholder voting agreements are not enforceable under the MBCA. Answer C is true because subsection (b) of this section makes a voting agreement—such as the one that Mr. Sleep and Ms. Slumber signed last year—specifically enforceable. Thus, Mr. Sleep must vote his shares according to that agreement, which makes Answer B incorrect. Note that the section only requires that "two or more" shareholders, not all of them, be parties to the agreement. Answer D is wrong because, as discussed above, oral shareholder voting agreements are not enforceable.

Question 3-2: The correct answer is B. Under MBCA § 16.02(a), a shareholder is entitled to inspect the items listed in MBCA § 16.01(e), including the corporation's bylaws, upon at least five business days' written notice. However, if a shareholder wishes to inspect the documents listed in MBCA § 16.02(b), such as the list of shareholders, she must additionally show a "proper purpose" for doing so. See MBCA § 16.02(d). Here, Joe wants to see the shareholder list to advertise his new—and competing—business. This is not likely a "proper purpose."

Question 3-3: The correct answer is B. As discussed in Chapter 8, the formula to determine the number of shares that a shareholder would need to own to elect a given number of directors under cumulative voting is

$$\frac{N \times S}{D + 1} + \text{“1”} = X$$

where “N” is the number of directors that you wish to elect to the board; “S” is the number of shares that will be voted at the shareholder meeting; and “D” is the total number of directors that will be elected to the board at the shareholder meeting. Further, the “1” that is in quotation marks means either to add one, or to round up to the next whole number. Here, the question asks how many shares would it take to elect one director, so “N” is 1. Further, “S” is 10,000 and “D” is 9 because all nine directors are elected annually. Thus, (1 x 10,000) divided by (9 + 1) is 1,000. Because that is a whole number, we add 1, to get 1,001.

Question 3-4: The correct answer is A. Although the notice of the meeting was required to state the purpose of this special shareholders meeting but did not (see MBCA § 7.05), the fact that all of the shareholders attended the meeting without objecting to the holding of the meeting or conduct of any business means that they waived any defect in the notice. See MBCA § 7.06(b). Answer B is wrong for this reason, as well as the fact that shareholder meetings only require a minimum of ten days’ notice (and a maximum of 60 days’ notice). See MBCA § 7.05(a). Answer C seems plausible, but as noted above the defect in the notice was waived when all of the shareholders attended the meeting. Answer D is wrong because the mere fact that a majority of the shares were voted in favor of a proposal would not cure defective notice. But again, *all* of the shareholders waived the defective notice in this problem.

Question 3-5: The correct answer is A. With respect to special board meetings, every director must either receive proper notice of the special board meeting or waive the notice. Here, the notice was not sufficient because it was not given at least two days before the meeting. See MBCA § 8.22(b). A director may waive the required notice in any of the ways described in MBCA § 8.23, but here only five directors waived notice (by attending the meeting). Thus, four directors neither received proper notice nor waived the defective notice of the special board meeting, making the approval of any action at the meeting invalid. Answer B is incorrect because special board meetings only require two days’ notice, not ten days’ notice. Answer C is incorrect because it is not necessary to state the purpose of a special board meeting, just the date, time, and place. Answer D seems plausible, but is incorrect because, as discussed above, *every* director must either get proper notice of a special board meeting or waive the defective notice.

Question 3-6: The correct answer is B. The notice of the special board meeting was proper because it was given to every director at least two days before the meeting and specified the date, time, and place of the meeting. MBCA § 8.22(b). However, a quorum of directors (unless otherwise provided in the articles or bylaws, this is a majority) was not present—only three out of seven directors were present. See MBCA § 8.24. (Unlike shareholders, directors may not use proxies unless an agreement under MBCA § 7.32 authorizes them to do so.) Thus, no business could be conducted at the meeting. Answer A is wrong because, while it is true that a quorum was not present, notices of special board meetings do not have to be sent at least ten days before the meeting (that is the time period for shareholder meetings). Answer C is wrong because a quorum was not present. In addition, notices for special board meetings do not need to state the purpose of the meeting. Answer D is incorrect because a quorum of directors was not present at the meeting, as discussed above.

Question 3-7: The correct answer is D. Answer A is wrong because this was a *regular* board meeting and, unless the corporation's articles or bylaws provide otherwise, no notice is required for regular meetings. MBCA § 8.22(a). Answer B is wrong because a quorum is a majority of the directors. Here, that would be at least six of the eleven directors. Five directors were physically present and the sixth director was present through a conference call. See MBCA § 8.20(b). Answer C is wrong because since a quorum was present when the vote was taken, we only need a majority of the directors *present* to vote yes for the action to be approved. Here, six were present and four voted yes. See MBCA § 8.24(c).

Question 3-8: The correct answer is E. Under MBCA § 7.22(d), a proxy is revocable unless (1) it states that it is irrevocable and (2) it is "coupled with an interest," meaning that the person who holds the proxy has an interest in the shares that are subject to the proxy. (Some examples of such an interest are given in the statute.) Here, even though Buffy is a shareholder in the same corporation, she has no interest in *Allie's* shares. Thus, despite the fact that the proxy stated that it was irrevocable, Allie can still revoke it.

Question 3-9: The correct answer is C. Under MBCA § 6.40(c)(2), a distribution (dividend) may not be paid if, *afterwards*, "the corporation's total assets would be less than the sum of its total liabilities plus … the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution [i.e., preferred stock with a liquidation preference]." Here, since there is no preferred stock, we need only make sure that, after the dividend is paid, the corporation's assets will be at least equal to its liabilities. Its liabilities are $70,000, so it must keep at least $70,000 of assets on hand. This means that it lawfully may pay a maximum of $300,000 of dividends.

Question 3-10: The correct answer is B. Here, the corporation must keep on hand enough assets to cover both (1) its liabilities ($70,000) and the liquidation preference of the preferred stock (which computes to $50,000), because the preferred stock is "superior" to the shares that would receive the distribution (the common stock). Thus, it needs to keep at least $120,000 of assets on hand, which means that it could lawfully pay $250,000 in dividends.

Question 3-11: The correct answer is B. As discussed above, the formula for cumulative voting is:

$$\frac{N \times S}{D + 1} + \text{“1”} = X$$

Applying that formula to the facts here, we have (2 x 300) divided by (9 + 1), which equals 60. Because this is a whole number, we add 1 to get 61. Note that "N" was 2 because the question asked how many shares it would take to elect two directors. Also, note that the reference to the 1,000 *authorized* shares was a "red herring."

Question 3-12: The correct answer is D. Applying the formula for cumulative voting to the facts here, we have (2 x 300) divided by (10 + 1), which equals 54.5454. Because this is a fraction (rather than a whole number), we round up to the next whole number, which is 55.

Question 3-13: The correct answer is A. This question concerns two concepts: plurality voting and record dates. As discussed in Chapter 8, under plurality voting, someone who owns a majority of the shares of voting stock of a corporation will be able to elect *every* director. Also as discussed in Chapter 8, for purposes of deciding who gets to vote at a shareholders meeting (and how many shares they get to vote), the corporation looks at the list of shareholders as of the record date. It does not matter who owns shares as of the meeting date. Here, the record date was April 2 and the facts indicate that, as of that date, Mr. Black owned 501 shares and Mr. White owned 499 shares. Thus, Mr. Black will be able to elect all of the directors under plurality voting.

Question 3-14: The correct answer is A. The meeting notice was proper (see MBCA § 7.05), there was a quorum (see MBCA § 7.25(a)), and there were more yes votes than no votes (see MBCA 7.25(c)). Answer B is incorrect because the notice was proper: it was mailed at least ten but not more than 60 days before the meeting; it was mailed to all persons who owned stock on the record date; and it is contained information about the date, time, place and (because it was a special meeting) purpose of the shareholders meeting. Answer C is wrong because a majority of the *outstanding* shares is not required; MBCA § 7.25(c) merely requires that a majority of the votes that are *cast* be cast in favor of the resolution. Answer D is wrong for similar reasons.

Question 3-15: The correct answer is C. Under MBCA § 7.27(b):

> An amendment to the articles of incorporation that adds, changes, or deletes a greater quorum or voting requirement must meet the same quorum requirement and be adopted by the same vote and voting groups

> required to take action under the quorum and voting requirements then in effect or proposed to be adopted, *whichever is greater*.

(Emphasis added.) Here, the proposal was to amend the articles to require that at least 66.67% of the outstanding shares of Stereo stock must vote in favor of a merger in order for any merger to occur. Because there are 100,000 shares outstanding, we thus would need 66,667 shares to vote in favor of this "supermajority" articles provision in order for it to be adopted. The proposal did not receive that many votes.

Question 3-16: The correct answer is C. Because Janice is a *shareholder* and not a director, she has no direct power to overturn this decision. See MBCA § 8.01. The only viable way to express her displeasure is to remove the current directors and replace them with new directors that will reverse this decision. Answer A is thus incorrect. Answer B is incorrect for the same reason: shareholders do not have the power to make business decisions for the corporation. Instead, shareholders elect the directors (who then make business decisions). In addition, shareholders may vote on "major" transactions such as mergers, but only after those transactions have been proposed by the board. Answer D is wrong because, unless the shareholder has a "buy-sell" agreement with the corporation, the corporation has no obligation to repurchase shares from a shareholder. Nothing in this fact pattern indicates that Janie and MRC are parties to a buy-sell agreement.

Question 3-17: The correct answer is C. Because the lease was signed before Two Friends Coffee, Inc. was incorporated, it is a pre-incorporation contract and Hassan was a promoter. MBCA § 2.04 provides that "[a]ll persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this Act, are jointly and severally liable for all liabilities created while so acting." However, one can "contract around" this rule. Here, Hassan tried to do that but was probably unsuccessful. If there is a way to interpret the contract that is consistent with the general rule, then most courts will do so. Here, the contact only states that the corporation will be liable if it adopts the lease. It does *not* state that Hassan would no longer be liable as well. Thus, Hassan most likely will continue to be liable if the corporation cannot perform. Note that *Pete* probably will not be liable, because he did not know about the lease before Hassan signed it. Answer A is incorrect because veil-piercing is not a prerequisite to imposing liability on a promoter. Answer B is incorrect for the reasons stated above. Answer D is incorrect because Hassan and Pete hadn't yet taken any steps to start running the business. Thus, they probably had not formed a partnership as of the time that the contract was signed; they were merely in the "talking phase."

Question 3-18: The correct answer is C. While different courts have used different lists of factors that are important in deciding whether to "pierce the corporate veil," options I, III, and IV would likely not be considered important by a court. On the other hand, options II and V would clearly be helpful in arguing to pierce the corporate veil in this case.

Question 3-19: The correct answer is A. Keep in mind that this fact pattern gives you very limited facts. Based only on these facts, none of options I through IV would be correct. Option I is wrong because shareholders do not have preemptive rights (that is, the right to purchase additional shares if the corporation offers new shares for sale in the future) unless the corporation's articles of incorporation provide for them. See MBCA § 6.30. Option II is wrong because owning 25% of the stock would not necessarily allow you to elect 25% of the directors. For example, if plurality voting were used, and the holder(s) of the other 75% of the stock voted to elect different directors, your client would not be able to elect *any* directors. Options III and IV are wrong because, unless the shareholder has agreed to transfer restrictions or has a buy-sell agreement with the corporation and/or other shareholders, shares are freely transferable; conversely, neither the corporation nor the other shareholders are under an obligation to buy your shares from you in the absence of a buy-sell agreement.

Question 3-20: The correct answer is A. It is likely that Mr. Alpha, the "bad guy" under these facts, will be held personally liable on a veil-piercing claim, whereas Mr. Beta probably will not, because he was a passive shareholder (although not all courts would agree). Answer B is incorrect because it assumes that one can never pierce the corporate veil. Answer C is wrong because being a closely held corporation does not—standing alone—mean that the corporate veil will be pierced. Although it is true that veil piercing does not occur in publicly held corporations, this does not mean that *all* closely held corporations are at risk of veil-piercing. Answer D is wrong because being a closely held corporation does not somehow guarantee that the corporate veil will never be pierced.

Question 3-21: The correct answer is D. Under MBCA § 7.31, two or more shareholders (not necessarily all of the shareholders) may sign a voting agreement specifying how they will vote their shares. Such an agreement may continue for as long as specified in the agreement; MBCA § 7.31 does not contain a "sunset" clause. Moreover, shareholder voting agreements are specifically enforceable. For these reasons, Answers A and B are incorrect. Under cumulative voting, because there are 3,000 outstanding shares and nine members of the board, it would take 301 shares to elect someone to the board, assuming that are 3,000 shares are voted. (See the formula described in the explanation of Question 3-11 above.) Ms. Bass only owns 300 shares, so she is not guaranteed of having enough shares to elect herself to the board, thus making Answer C wrong.

Question 3-22: The correct answer is A. Under MBCA § 7.22(d), a proxy is revocable unless (1) it states that it is irrevocable and (2) it is "coupled with an interest," meaning that the person who holds the proxy has an interest in the shares that are subject to the proxy. Here, Frank was a shareholder on the record date, so he presumably is entitled to vote the shares (even though he no longer owned them on the date of the meeting). As between Frank and Ralph, Frank "wins" because he did not give Ralph a proxy to vote the shares. As between Frank and Arthur, Frank also "wins" because (1) it is unclear from the facts whether the proxy stated that it was irrevocable, and (2) even if the proxy did state that it was irrevocable, Arthur has no interest in the shares that are subject to the proxy.

Question 3-23: The correct answer is B. Although courts have used a variety of factors to determine whether to pierce the corporate veil, of the choices given in this question, Answer B is clearly the most significant. Unlike Answer B, the other factors, standing alone, would not necessarily be considered important in deciding whether to pierce the corporate veil.

Question 3-24: The correct answer is A. Hopefully, this question was obvious. See MBCA § 1.41(c).

Question 3-25: The correct answer is D. Answer A is simply wrong; it is very common for individuals to be both officers and directors of a corporation. Answer B is incorrect (unless the corporation's articles of incorporation require directors to own stock in the corporation). Answer C is wrong because MBCA § 8.08(a) provides that the "shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause."

Question 3-26: The correct answer is A. Answer B is incorrect because officers can have both actual authority (including actual express and actual implied authority) and apparent authority. In other words, officers of the corporation are agents of the corporation. Answer C is incorrect because shareholders only elect directors; they have no direct influence over the identities of the corporation's officers. See MBCA § 8.40.

Question 3-27: The correct answer is A. The contract with Marcus was a pre-incorporation contract because Interesting Books Corp. did not exist at the time that the contract was signed. After incorporation, Interesting Books Corp. would not automatically liable on the contract, making Answer B incorrect. However, it will be liable if it adopts the contract. A corporation may adopt a pre-incorporation contract either expressly (such as through a board resolution) or impliedly, which makes Answer C incorrect. Note that, even if the corporation does adopt the contract, the promoter (Melina) is still liable on the contract unless there is a novation. This makes Answer D incorrect.

Question 3-28: The correct answer is C. As discussed in the explanation to Question 3-27, a promoter will be liable on a pre-incorporation contract unless there is a novation that releases the promoter from liability (or unless the contract itself contains language that clearly states that the promoter is not personally liable on the contract).

Question 3-29: The correct answer is B. This answer is the result of using the formula (N x S) divided by (D+1) and then rounding up to the next whole number (i.e., the "1" in the formula, as we discuss it in class). "N" is the number of directors the shareholder wants to elect; here, that would be 2. "S" is the number of shares that will be voted (we assume that all outstanding shares will be voted); here, that would be 100, for the 100 shares of common stock. (Note that the preferred stock is nonvoting, so we ignore it here.) "D" is the number of directors that would be elected to the board at a shareholders meeting; here, that would be 5. Applying these figures would be (2 x 100) divided by (5+1), which results in 33.333. Since this is not a whole number, we round up to the next whole number, which is 34.

Question 3-30: The correct answer is C. Under MBCA § 6.40(c), a corporation must pass both the "insolvency test" (i.e., remain able to pay its debts as they become due in the usual course of business) *and* the balance sheet test for a dividend to be legal. This makes answer D wrong because it *only* refers to the insolvency test, whereas the other three answers note that passing the insolvency test is a requirement. Under the balance sheet test, after paying the dividend, the corporation's assets may not be less than its liabilities. (Luckily, there is no preferred stock with a liquidation preference to complicate things in this problem.) Here, since the company's liabilities are $120,000, its assets cannot fall below this amount after the paying the dividend. It has $200,000 of assets now, so that would mean that the maximum dividend it could pay would be $80,000 ($200,000 minus $120,000).

Question 3-31: The correct answer is C**.** Briefly stated, the rules for promoters are that the promoter is personally liable on a pre-incorporation contract unless the contract very clearly and unambiguously states that the promoter is not liable. The corporation only becomes liable on the contract if it (1) actually comes into existence by being incorporated and then (2) adopts the contract. If the corporation adopts the contract, the promoter remains liable (unless the contract very clearly and unambiguously states otherwise). However, the promoter could be released from liability through a novation. Here, Joe was acting as a promoter when he signed the lease. Although JBGI did adopt the contract, there was never any novation releasing him from liability. This makes Answer A wrong. Answer B is wrong because JBGI's adoption of the lease is not what caused Joe to be liable in the first place. Answer D is wrong because the mere fact that Cheers was aware that Joe was acting for a corporation that had not yet been formed would not mean that Joe is not liable. Instead, the contract would need to have clearly and unambiguously stated that Joe would not be liable.

Question 3-32: The correct answer is A. The notice was proper because it was given to all of the directors at least two days before the special board meeting and stated the date, time and place. See MBCA § 8.22(b). This makes Answers B and C wrong. The notice was given to all directors, so there is no need to show that a director or directors waived improper notice. A quorum was present because a majority of the ten directors were present. See MBCA § 8.24(a). This makes Answer D wrong. Finally, a majority of the seven directors who were present at the meeting voted in favor of the Proposal (and a quorum was present when the vote was taken), so it passed. See MBCA § 8.24(c). This makes Answer E wrong.

Question 3-33: The correct answer is A. The notice was proper because it was given at least ten but fewer than 60 days before the annual shareholder meeting and stated the date, time and place. See MBCA § 7.05. This makes Answer B wrong. A quorum was present because a majority of outstanding shares were present. See MBCA § 7.25(a). This makes Answer C wrong. Finally, more shares were voted in favor of the Proposal than were voted against it, so the Proposal passed; shareholder abstentions are ignored under the MBCA because they are not votes that were "cast." See MBCA § 7.25(c). This makes Answer D wrong.

Question 3-34: The correct answer is C. Answer A is incorrect because a "purpose" clause is an option provision in articles of incorporation under the MBCA. See MBCA § 2.02(b)(2)(i). Answer B is incorrect for the same reasons. In addition, note that MBCA § 3.01 provides that "[e]very corporation incorporated under this Act has the purpose of engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation," and that MBCA § 2.02(c) provides that the articles "need not set forth any of the corporate powers enumerated in this Act." Answer C is correct because MBCA § 2.02(b)(2)(iv) makes a par value for stock an optional provision in the articles.

Question 3-35: The correct answer is D. In other words, each of Answers A, B, and C were correct. Answer is correct because Alex was the incorporator of the corporation. See MBCA § 2.01 ("One or more persons may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing.") Answers B and C are also correct, because both Alex and Sara were acting as promoters, entering into preincorporation contracts on behalf of the corporation. See MBCA § 2.04.

Question 3-36: The correct answer is A. Because X Corporation is incorporated under the law of the State of Red but is "transacting business" in the State of Blue (its headquarters and all of its employees are in the State of Blue) it must obtain a certificate of authority to transact business in the State of Blue. See MBCA § 15.01; see also MBCA § 15.02 (consequences of failure to have a required certificate of authority). This also means that the law of the State of Red will govern the "internal affairs" or "corporate governance" issues of X Corporation. However, neither of the lawsuits described in Answers B or C involve "internal affairs," not even the lawsuit brought by the employee. Instead, for those lawsuits, normal choice-of-law rules would dictate that the law of the state where the events occurred (here, the State of Blue) will apply to the case. This eliminates answers B, C, and D.

Question 3-37: The correct answer is D. MBCA §§ 6.21(b) and (c) should suffice to explain this answer. Those sections provide:

> (b) The board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, *promissory notes, services performed, contracts for services to be performed,* or other securities of the corporation.
>
> (c) Before the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate. That determination by the board of directors is

> conclusive insofar as the adequacy of consideration for the issuance of shares relates to whether the shares are validly issued, fully paid, and nonassessable.

(Emphasis added.)

Question 3-38: The correct answer is D. Normally, it is true that the board has the sole discretion as to whether to issue shares, to whom to issue the shares, how many shares to issue, etc. However, MBCA § 6.21(f) provides that shareholder approval is *also* required if (1) the shares are issued for "consideration other than cash or cash equivalents" *and* (2) the number of shares to be issued would cause the number of voting shares to increase more than 20%. Here, the will be a 30% increase if the corporation issues 300 shares to Bob (300 is 30% of the 1,000 shares currently outstanding; there would be 1,300 shares outstanding after this issuance). Thus, if Bob pays for the shares with something *other than* cash or cash equivalents, shareholder approval would be required. Note that answer B is simply wrong on the facts. Before this issuance, each of Alex and Sara are 50% shareholders. After this issuance, they will each be 38.5% shareholders (each owning 500 out of 1,300 shares).

Question 3-39: The correct answer is D. Answer A is incorrect because nothing in the MBCA prohibits directors from being compensated for their services as directors. (However, see Chapter 10 for some possible duty-of-loyalty issues with respect to director compensation.) Under Section 8.06, a corporation's board may be "staggered" into either two or three classes. If it is staggered into two classes, then directors would serve overlapping two-year terms; if it is staggered into three classes, then directors would serve overlapping three-year terms. But if the board is not staggered into classes, then candidates for each director position would be elected by the shareholders each year and newly elected directors would serve until the next annual meeting of shareholders. See MBCA § 8.05(b). This obviously makes Answer B incorrect. Answer C is incorrect because directors may be removed by the shareholders before the ends of their terms, with or without "cause," unless the articles provide that directors may only be removed for cause. See MBCA § 8.08(a).

Question 3-40: The correct answer is C. Yet another cumulative voting question! Note that in cumulative voting, the number of *votes* that you have is equal to (1) the number of *shares* you own multiplied by (2) the number of director positions to be filled. This means that Sara will have 9,000 votes (3,000 shares multiplied by three director positions) and Alex will have 21,000 votes (7,000 shares multiplied by three director positions). This eliminates Answer A. Answer B is wrong for what should be obvious reasons. If there are three positions to be filled, the top three "vote getters" will be elected to the board. So, if Sara casts all of her 9,000 votes for herself, Alex will only be able to allocate his 21,000 votes to different candidates to beat Sara two times, not three times. Answer C is thus a correct mathematical description of how cumulative voting would work in this problem. Answer D is wrong because Alex only has a *total* of 21,000 votes to allocate to his candidates, not 21,000 votes for each director position to be filled.

Question 3-41: The correct answer is B. Until we get to Chapter 12 (closely held corporations) and Chapter 13 (controlling shareholders), it is a true statement that shareholders do not owe fiduciary duties, and ABC Corp. is not a closely held corporation and Buddy is clearly not a controlling shareholder of ABC Corp. Answer A is incorrect because stock is equity, not debt. Answer C is incorrect because nothing in corporate law prevents a shareholder like Buddy from owning stock in a competing corporation. Answer D is wrong for obvious reasons; shareholders vote to elect the directors, as explained in Chapter 8.

Question 3-42: The correct answer is B. MBCA § 7.25(a) clearly answers this question. Count *shares*, not *shareholders*.

Question 3-43: The correct answer is C. Voting trusts are governed by MBCA § 7.30. Although the MBCA used to provide a 10-year limit on voting trusts, the first sentence of subsection (c) now provides that "[l]imits, if any, on the duration of a voting trust shall be as set forth in the voting trust." That eliminates Answer A. Answer B is incorrect because a voting trust is an entirely different thing than a proxy (although they are somewhat similar to a proxy in that the trustee of a voting trust is authorized to vote the shares that are in the trust).

Question 3-44: The correct answer is D. Under MBCA § 16.02(a), a shareholder is entitled to inspect the items listed in MBCA § 16.01(e), including the corporation's bylaws and the minutes of shareholder meetings, upon at least five business days' written notice. However, if a shareholder wishes to inspect the documents listed in MBCA § 16.02(b), such as the minutes of board meetings (other than board resolutions relating to stock under MBCA § 16.01(e)(3)) and the accounting records of the corporation, she must additionally show that her demand is made in good faith and for a "proper purpose"; she must describe with reasonable particularity her purpose and the records she desires to inspect; and the records must be directly connected with the shareholder's purpose. All of this makes Answer D the best choice.

Question 3-45: The correct answer is B. The corporation had 1,000 authorized shares of common stock, but previously had issued 850. Because there are now only 150 authorized-but-unissued shares left, this stock issuance of 300 shares simply cannot occur unless the articles are amended to increase the number of authorized shares. Answer A is incorrect because shareholders are not entitled to preemptive rights unless the articles provide for them and there is no indication in the facts that they did. See MBCA § 6.30. Answer C is incorrect; as a general matter, directors can own shares and can approve the corporation's issuance of shares to themselves. (Beware of the duty of care and the duty of loyalty in doing so, however. See Chapters 9 and 10.) Answer D has no basis in the MBCA, although the board must determine that the consideration that the corporation receives for a stock issuance is adequate under MBCA § 6.21(c).

Question 3-46: The correct answer is A. For a special board meeting, all directors must either (1) get at least two days' notice of the date, time, and place or (2) waive the required notice. A director may waive the required notice in any of the ways described in MBCA § 8.23, including attending the meeting without objecting to the improper notice, or by signing a waiver of notice, either before or after the meeting. Here, there are seven directors, and none of them will get two days' notice if the meeting will be held within 24 hours. If four directors attend a special meeting (the director in Tokyo will be considered present due to MBCA § 8.20(b)), they will have waived notice. But we would need the other three to waive the notice when they are available; if they do not then the meeting would have been improper and the loan agreement would not have been properly approved. All of this makes Answer A the best answer. Answer B is incorrect because a written consent resolution of the board must be signed by all of the directors, not just a majority of them. See MBCA § 8.21(a). Answer C is incorrect because, although the president would have apparent authority to bind Corporation to various types of transaction, this particular transaction is something that is so large and important that it will required board approval. Answer D is incorrect because we found a solution to this dilemma in Answer A. Also, notice of a special board meeting would typically be sent to the director's contact information on file with the corporation; we do not have to track the director down wherever she may be.

Question 3-47: The correct answer is A. Shareholders do not have the right to approve *all* "major" business transactions; instead, that is the function of the board. However, shareholder do have the right to vote on most amendments to the articles of incorporation, which makes Answer B incorrect. See MBCA § 10.03(b). They also have the right to approve a sale of substantially all of the corporation's assets not in the regular course of business (see MBCA § 12.01 and 12.02), which makes Answer C incorrect. Finally, Answer D is incorrect because MBCA § 7.03 provides that a court shall order a corporation to hold a shareholder meeting "on application of any shareholder of the corporation entitled to participate in an annual meeting if an annual meeting was not held within the earlier of 6 months after the end of the corporation's fiscal year or 15 months after its last annual meeting."

Question 3-48: The correct answer is B. As stated above, the formula for cumulative voting is:

$$\frac{N \text{ x } S}{D + 1} + \text{“1”} = X$$

Applying that formula to the facts here, we can see that it would take 143 shares to elect one director (1,000 divided by (6+1) = 142.67, rounded up to 143) and 286 shares to elect two directors (2,000 divided by (6+1) = 285.71, rounded up to 286). Mike owns 190 shares, which is more than enough to elect one director but not enough to elect two directors, which makes Answer B the correct answer.

Question 3-49: The correct answer is B. If the board is classified and only four directors at elected each year, this will change "D" in the formula for cumulative voting, with the result that Mike needs to own at least 201 shares to elect one director to the board. But Mike only has 190 shares, so he will no longer be guaranteed of being able to elect any directors to the board (unless many of the other shares are not voted).

Question 3-50: The correct answer is D. This is basically a knock-off of the facts of the *Ringling Brothers* case in Chapter 8. As discussed in that case, shareholder voting agreements are permissible. MBCA § 7.31 takes this a step further, making shareholder voting agreements specifically enforceable as well. The statute does not impose any limit on the duration of a shareholder voting agreement.

Question 3-51: The correct answer is D. Proper notice of this meeting was given under MBCA § 8.22(b) (two days' notice of the date, time, and place), which eliminates Answers B and C. However, MBCA § 8.24(c) provides that: "*If a quorum is present when a vote is taken*, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors." Because there are four directors, a quorum would be three. See MBCA § 8.24(a). However, when Mr. Meyer left the meeting, there was no longer a quorum. (Contrast this to the rule for shareholder meetings under MBCA § 7.25(b).) Answer E is incorrect because the board appoints and can remove the officers such as the CEO, not the shareholders.

Question 3-52: The correct answer is A. MBCA § 2.01 simply provides that a person (or persons) "may act as the incorporator or incorporators of a corporation by delivering articles of incorporation to the secretary of state for filing." There is no requirement that an incorporator must be a shareholder of the corporation (and, if fact, the corporation technically does not exist yet), which makes Answer A the only incorrect answer (remember that the call of the question asked which answer was incorrect). Incorporators may, but need not, be attorney, which eliminates Answer B. Answer C is a correct statement (and thus an incorrect answer) because the articles must be signed in most states before they are delivered, although technically MBCA § 2.01 does not require this. Answer D is also a correct statement because of MBCA § 2.05(a).

Question 3-53: The correct answer is A. Although MBCA § 3.02(13) provides that corporations have the power to "make donations for the public welfare or for charitable, scientific, or educational purposes," the first clause of this section states that this only true if the articles do not provide otherwise. Here, the corporation's articles specifically prohibit this transaction, and the articles would need to be amended (which would require shareholder approval) to allow it. That being the case, the proposed donation is *ultra vires*. MBCA § 3.04(b)(1) allows a shareholder to sue for an injunction against an *ultra vires* act.

Question 3-54: The correct answer is C. The notice was proper under MBCA § 8.22, so that eliminates Answer A. Answer B is factually incorrect: a majority of the five directors actually was present, so there was a quorum at the meeting. Answer D is incorrect because there is nothing in the MBCA that says that a director's non-attendance at a meeting means that he approved any actions taken at the meeting. (*Compare* MBCA § 8.24(d).)

Question 3-55: The correct answer is D. Essentially, the directors tried to do a unanimous consent resolution without a meeting, but the problem is that MBCA § 8.21 requires that they all "sign" in, thus prohibiting an oral consent resolution without a meeting.

Question 3-56: Last question about cumulative voting! Applying the formula for cumulative voting as stated above, we can see that it would take 17,700 shares to elect four directors because "N" is 4; "S" is 35,400; and "D" is 7. (4 x 35,400) divided by (7 + 1) = 17,700. Smith and Jones have more than this amount, so they are guaranteed of being able to elect four directors under cumulative voting.

Question 3-57: The correct answer is E. It does not matter whether the trustee of a voting trust is—or is not—a director of the corporation. It also does not matter how many shares are in the trust; in fact, one shareholder could create a voting trust. However, the trustee is required under MBCA § 7.30(a) to "prepare a list of the names and addresses of all voting trust beneficial owners, together with the number and class of shares each transferred to the trust, and deliver copies of the list and agreement to the corporation's principal office," which eliminates Answer A. MBCA § 7.30(a) also requires the shareholders must create the trust by signing it, which eliminates Answer C.

Question 3-58: The correct answer is B. Under MBCA § 2.03(a), "[u]nless a delayed effective date is specified, the corporate existence begins when the articles of incorporation are filed." Thus, because the pedestrian was injured before the articles were filed, the corporation, with its liability shield, did not yet exist. Further, because Smith was the only one who knew the corporation had not yet been formed, only he will be liable for the accident, because MBCA § 2.04 provides that "[a]ll persons purporting to act as or on behalf of a corporation, *knowing there was no incorporation under this Act*, are jointly and severally liable for all liabilities created while so acting." (Emphasis added.) This makes Answer A incorrect. Further, as explained in Chapter 8, under the *de facto* corporation doctrine, a defectively formed corporation will still be considered a "real" corporation in the eyes of everyone except the state government if a good faith attempt to incorporate was made. Here, however, no steps to form the corporation were taken. That makes Answer C incorrect. Finally, the corporation by estoppel doctrine merely prevents a person who dealt with the "corporation" on the assumption that it was properly formed from arguing that the corporation was not properly formed. But that does not describe the pedestrian in this problem, making Answer D incorrect.

Question 3-59: The correct answer is C. Answer A is incorrect because the President, without additional facts, would not have actual implied authority to undertake such a major transaction. See Section 2.02(a) of the *Restatement (Third) of Agency.* Instead, that is something that would require board approval. Similarly, Answer B is incorrect because while the President likely would have apparent authority due to the "power of her position" to undertake transactions in the ordinary course of business, the other party to the transaction likely would not have a reasonable belief that the President could undertake such a major transaction without board approval. See Section 2.03 of the *Restatement (Third) of Agency.* That makes Answer B incorrect. However, because the corporate secretary is commonly understood to have the power to certify the accuracy of board resolutions, the third party in this case has a good argument that she had apparent authority to do so in this fact pattern and that when she did so the third party had a reasonable belief that the board had approved the transaction. That makes Answer C the best answer.

Question 3-60: The correct answer is E. In other words, none of the answers are correct. Answer A is incorrect because it is essentially describing a rule from *partnership* law (see RUPA § 401(k)) rather than the rule for board resolutions or actions, which requires the approval of a majority of the directors who are present at a meeting at which a quorum is present. See MBCA § 8.24(c). Answer B is not correct because shareholders may use proxies (see MBCA § 7.22), not directors (unless MBCA § 7.32 applies, but that is not discussed until Chapter 12). Answer C is also incorrect; directors, in their capacities as directors, are not considered agents of the corporation. Finally, similarly to Answer A, Answer D is incorrect because it essentially describing a rule from *partnership* law (see RUPA § 401(k)) rather than the rule for shareholder resolutions or actions, which requires more "yes" votes than "no" votes. See MBCA § 7.25(c).

Question 3-61: The correct answer is D. Because the bylaws specified that meetings would be held on the first Tuesday of every month, these were regular board meetings. No notice is required for a regular board meeting. See MBCA § 8.22(a). That eliminates Answer A. Answer B is incorrect for similar reasons (and also because there is nothing in the MBCA that specifically requires that directors be given notice of the schedule for regular meetings; one assumes, however, that this is something they would find out on their own if they were not specifically informed). Answer C is incorrect because, if the notice *had* been improper, the meeting would not have been validly held and any resolution adopted at the meeting would have been of no force and effect. But as discussed above, the meeting was validly held.

Question 3-62: The correct answer is D. Under MBCA § 6.40(c)(2), a distribution (dividend) may not be paid if, *afterwards*, "the corporation's total assets would be less than the sum of its total liabilities plus … the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution [i.e., preferred stock with a liquidation preference]." Here, since there is no preferred stock, we need only make sure that, after the dividend is paid, the corporation's assets will be at least equal to its liabilities. Its liabilities are $50,000, so it must keep at least $50,000 of assets on hand. This means that it lawfully may pay a maximum of $350,000 of dividends.

PART 4

Answer Key to Part 4:

4-1: B
4-2: D
4-3: D
4-4: C
4-5: A
4-6: C
4-7: B
4-8: B
4-9: C
4-10: D
4-11: A
4-12: C
4-13: D
4-14: E
4-15: D
4-16: C
4-17: A
4-18: B
4-19: A
4-20: A
4-21: C
4-22: A
4-23: D
4-24: A
4-25: C
4-26: A
4-27: A
4-28: D
4-29: D
4-30: D
4-31: E
4-32: A
4-33: A
4-34: D
4-35: E
4-36: D
4-37: A
4-38: A
4-39: D
4-40: A
4-41: B

4-42: B
4-43: D
4-44: A
4-45: C
4-46: B
4-47: C
4-48: C
4-49: D
4-50: B
4-51: D
4-52: B
4-53: A
4-54: B
4-55: A

Explanations:

Question 4-1: The correct answer is B because MBCA § 8.31(b) does in fact require that the person suing the directors for a breach of the duty of care and seeking money damages on behalf of the corporation has the burden of proving causation and damages. Answer A is incorrect because directors only have a duty to act *as they reasonably believe to be* in the best interests of the corporation. If the standard were that directors must always act "in the best interests of the corporation," then the directors might be liable for every decision or action that turns out badly. See MBCA § 8.30(a)(2). Answer C is wrong as a result of the *Caremark* case that appears in Chapter 9; directors have a duty to implement such a system even before they have actual or constructive notice of illegal activities occurring within the corporation (although the actual design of the system is a matter of business judgment). Finally, Answer D is wrong because directors may, in accordance with MBCA §§ 8.30(e) and (f), rely on the opinions of persons who are not professionals, so long as, depending on the person or persons, she or they are "reliable and competent" or "merit confidence" with respect to the subject matter of the opinion.

Question 4-2: The correct answer is D. As discussed in Chapter 9, courts ordinarily require a showing of gross negligence before finding that directors breached their duty of care, and the comments to MBCA § 8.30(b) also suggest that negligence is not sufficient to find that a director breached her duty of care. Answer B is wrong due to the *Caremark* case that appears in Chapter 9. Answer C is wrong because a finding that a majority of directors were not interested in a transaction would not necessarily shield them from liability. For example, if the plaintiff could show that the directors were grossly negligent in not informing themselves of all material facts reasonably available to them before making a decision, the plaintiff would be able to overcome the business judgment rule and hold the directors liable for the consequences of that decision. Whether the directors were disinterested in the challenged transaction is more relevant to the duty of loyalty than the duty of care.

Question 4-3: The correct answer is D. Answer A is incorrect because the mere fact that the board made a terrible decision does not result in director liability; the plaintiff must still overcome the business judgment rule by showing that the directors were motivated by a conflict of interest; were grossly negligent in not informing themselves of all material facts reasonably available to them before making the decision; or that the decision was "irrational." While this decision might seem "irrational," it is actually very difficult to show that a decision was irrational; it typically requires a showing that the decision was "removed from the realm of reason" or some similar standard. Here, the board thought that the author's fame would sell a lot of books. They were wrong, but probably not irrational. Answer B is wrong because "fairness" usually is not an issue when the board is being sued for a breach of the duty of care. (Instead, it may be relevant if the board were being sued for a breach of the duty of loyalty.) Answer C is wrong because it's not the board's burden to prove they were properly informed; instead, the plaintiff could make this showing as one way to overcome the business judgment rule.

Question 4-4: The correct answer is C, because honest errors of judgment that are made with due diligence would be protected by the business judgment rule, as well as MBCA §§ 8.30 and 8.31. On the other hand, diverting corporate opportunities to herself or gross negligence in the performance of her duties as a director could result in personal liability for Shelia.

Question 4-5: The correct answer is A. MBCA § 2.02(b)(4) would shield the directors from monetary liability unless they received a financial benefit to which they were not entitled; intentionally inflicted harm on the corporation or its shareholders; violated MBCA § 8.33 (which concerns excessive distributions); or intentionally violated a criminal law. None of these four exceptions is present under these facts. Answer B is incorrect because the mere fact that the directors are defendants in a lawsuit does not mean that they have a conflict of interest sufficient for the plaintiff to overcome the business judgment rule. (Also, because the directors are not being sued for a *decision* that they made, the business judgment rule would not be directly applicable. Instead, this would be a *Caremark*-based claim.) Answer C is simply nonsensical. The directors *were unaware* that the illegal bribery was taking place. The standard stated in this answer (the directors were grossly negligent in not reasonably informing themselves) would be an appropriate way to overcome the business judgment rule with respect to a decision that the board made. But remember, this is a *Caremark*-based claim; the court in that case stated that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." Finally, Answer D is incorrect because the plaintiff would not need to prove that the directors made a decision; liability could rest on inaction (although, as discussed above, it would be a difficult case for the plaintiff).

Question 4-6: The correct answer is C. Answer A is incorrect because this question concerns the duty of care (here, an alleged lack of oversight) rather than the duty of loyalty (which typically involves a conflict of interest). Answer B is wrong because one does not "breach" the business judgment rule; instead, it is a rule of law that protects director decisions unless the plaintiff rebuts the business judgment rule. In addition, because this case would be based on lack of oversight, rather than a *decision* that the board made, the business judgment rule would not be applicable. Answer C is correct based on MBCA § 8.31(b).

Question 4-7: The correct answer is B. This question is (obviously) modeled on the facts in *Barnes v. Andrews*, which appears in Chapter 9. In that case, the director *did* breach his duty of care by not paying sufficient attention to the corporation's business. Nonetheless, he avoided liability essentially because the plaintiff could not quantify what damages the corporation incurred as a result. Perhaps the company would have been wildly successful if the defendant director had better performed his duties, but perhaps it still would have failed. As such, the plaintiff could not prove causation and damages. See also MBCA § 8.31(b). Answer A is incorrect because the business judgment rule does not apply when the allegation is that the director was not devoting sufficient oversight to the corporation; there was no "judgment" made in such a case. Answer C is incorrect because a finding that the director breached his duty of care is, standing alone, insufficient to impose liability on the director. As discussed above, the plaintiff must still prove causation and damages if it is seeking monetary recovery from the director. Answer D is incorrect for similar reasons.

Question 4-8: The correct answer is B. Because this would be considered a director's conflicting interest transaction (DCIT) with respect to Mr. Drum, as discussed in Chapter 10, he must either have it approved by the disinterested directors or disinterested shareholders after full disclosure, or show that it was "fair" to BOC. See MBCA § 8.61(b). Demonstrating a conflict of interest is also one way for a plaintiff to overcome the business judgment rule. Answer A is incorrect because Mr. Drum had an undisclosed conflict of interest in approving the Eureka design given that his daughter—a "related person" under MBCA § 8.60(5)—is the majority shareholder of Eureka. Answer C is wrong because the mere fact that BOC was fined should not impose liability on a director; generally, directors would only be liable if they knowingly approved an illegal act. Answer D is clearly wrong—Mr. Drum did not act in good faith!

Question 4-9: The correct answer is C. Because Ms. Crude had no conflict of interest in the choice of the Eureka design, a suit against her would be based on the duty of care. Even though she did not appear to do much in this fact pattern, the board as a whole appears to have been sufficiently informed to retain the protection of the business judgment rule (or, more precisely, the plaintiff will not be able to overcome the business judgment rule, other than with respect to Mr. Drum.) As noted in Chapter 9, the comment to MBCA § 8.30 indicates that we usually evaluate the conduct of the board as a whole when evaluating "case cases" (as opposed to "loyalty cases"). Answer A seems plausible at first, but remember that she did not vote in favor of the Eureka design *because she was absent*, not because she thought the other design was safer. Answer B is incorrect because directors should not be liable simply as a result of missing a meeting at which a particular decision was made. Answer D is wrong because, even though the plaintiff likely *would* be able to show causation and damages, if the plaintiff cannot overcome the business judgment rule, the plaintiff will lose.

Question 4-10: The correct answer is D, for reasons explained in the explanation of Question 4-9 above. Answer A is incorrect because a suit against Mr. Drill would be based on the duty of care, not the duty of loyalty, because he had no conflict of interest in the choice of the Eureka design. Answer B is wrong; below average intelligence and chronic intoxication would not be a defense to a claim against a director. Answer C is wrong because, even though *some* experts thought the design was unsafe, other experts thought it was sufficiently safe and the board is allowed to rely on the opinions of experts pursuant to MBCA § 8.30(e) unless it has knowledge that makes such reliance unwarranted, which it did not have in this fact pattern. Finally, Answer E is wrong because (as stated in the explanation of Question 4-8 above), the mere fact that BOC was fined should not impose liability on a director; generally, directors would only be liable if they knowingly approved an illegal act.

Question 4-11: The correct answer is A, for the reasons set forth in the explanation to Questions 4-9 and 4-10. However, a few other words are in order. Answer C is wrong because simply choosing the cheapest design does not mean that you did reasonably believe it was in the best interests of the corporation. What if the risks of the design outweighed the cost savings? Answer D is wrong because the facts do not state that BOC had a MBCA § 2.02(b)(4) provision in its articles, and Answer D describes some of the situations in which directors would be liable even if the corporation had a section 2.02(b)(4) provision in its articles.

Question 4-12: The correct answer is C. Answer A is wrong because director's conflicting interest transactions (DCITs) are not *automatically* voidable; that was the rule at common law before statutes such as MBCA §§ 8.60 to 8.63 were enacted. Under that statute, a DCIT cannot be challenged because of the director's interest in it if (1) it was properly approved by the qualified directors pursuant to MBCA § 8.62; (2) it was properly approved by the qualified shares pursuant to MBCA § 8.63; *or* (3) it is established to have been "fair" to the corporation at the time it was entered into. Answer B is wrong because MBCA § 8.62 requires *more* than that the interested director not participate in the meeting. For example, the interested director must fully disclose the facts that she knows about the DCIT and the DCIT must be approved by a majority of the qualified directors who vote on the transaction. Answer C is correct, but remember it is only one of the three choices to defend a DCIT.

Question 4-13: The correct answer is D. As noted in the explanation of Question 4-12, a director's conflicting interest transaction (DCIT) such as this cannot be successfully challenged because of the director's interest in it if (1) it was properly approved by the qualified directors pursuant to MBCA § 8.62; (2) it was properly approved by the qualified shares pursuant to MBCA § 8.63; *or* (3) it is established to have been "fair" to the corporation at the time it was entered into. Thus, there are three ways to defend a

DCIT. Answer A is wrong because Duane's shares are not "qualified" shares and therefore do not count under MBCA § 8.63. Answer B is incorrect because "sanitization" under MBCA § 8.63 requires that a "majority of the votes cast by the holders of all qualified shares are [voted] in favor of the transaction ….", not that *all* of the qualified shares at the meeting are voted in favor of the DCIT. Answer C is wrong under MBCA § 8.63(d); that section provides that a majority of the qualified shares entitled to be voted constitutes a quorum for purposes of a meeting at which a DCIT will be considered.

Question 4-14: The correct answer is E. As noted above, a director's conflicting interest transaction (DCIT) cannot be challenged because of the director's interest in it if (1) it was properly approved by the qualified directors pursuant to MBCA § 8.62; (2) it was properly approved by the qualified shares pursuant to MBCA § 8.63; *or* (3) it is established to have been "fair" to the corporation at the time it was entered into. Here, there are three interested (non-qualified) directors, who made full disclosure to the two disinterested (qualified) directors. The two qualified directors then approved the transaction outside the presence of the interested directors. This action meets the requirements of MBCA § 8.62. *In addition*, a majority of the qualified shares that were cast were voted in favor of the DCIT after full disclosure. This action meets the requirements of MBCA § 8.63. Thus, the DCIT was approved two ways, even though only one was necessary to shield it from challenges due to the interest of three of the directors. This makes Answer C and D correct (and Answers A and B incorrect), which makes Answer E the best answer.

Question 4-15: The correct answer is D. As noted in Chapter 10, MBCA § 8.11 provides that, unless the articles of bylaws provide otherwise, "the board of directors may fix the compensation of directors." However, the comment to MBCA § 8.61 indicates that director compensation could still be a breach of directors' duty of loyalty, unless it was approved by the disinterested shareholders or otherwise "fair" to the corporation. Thus, Answers A and B are incorrect. Answer C is clearly incorrect because directors may receive compensation other than stock options for their service.

Question 4-16: The correct answer is C. Because the shares owned by the directors *and* the shares owned by the directors' spouses would not be considered qualified (disinterested) shares for purposes of MBCA § 8.63, that means that there are only 560,000 qualified shares (800,000 minus 240,000). MBCA § 8.63 requires that a majority of the qualified shares that are "cast" (i.e., voted) must be voted in favor of the transaction. Answer A is incorrect because MBCA § 8.62 requires that at least two qualified (disinterested) directors approve the transaction, if this is the method that one uses to "sanitize" the transaction. Because there is only one qualified director (Mr. Lion is the only director with no interest in the transaction), that isn't enough. Answer B is incorrect because it does not reflect the fact that the shares owned by the directors' spouses would not be considered qualified (disinterested) shares for purposes of MBCA § 8.63. See MBCA § 8.63(c)(2), and note that your spouse would be a "related person" to you within the meaning of MBCA § 8.60(5). Finally, Answer D is incorrect because MBCA § 8.63 requires that a majority of the qualified shares that are *cast* (i.e., voted) must be voted in favor of the transaction. Here, there are 560,000 qualified shares (those not owned by the four disinterested directors or related persons, here their spouses). A majority of the 560,000 shares that are voted must be voted in favor of the transaction.

Question 4-17: The correct answer is A. As noted above, a director's conflicting interest transaction (DCIT) such as this cannot be challenged because of the director's interest in it if (1) it was properly approved by the qualified directors pursuant to MBCA § 8.62; (2) it was properly approved by the qualified shares pursuant to MBCA § 8.63; *or* (3) it is established to have been "fair" to the corporation at the time it was entered into. Under Answer A, if a majority of the disinterested directors approve the DCIT, then Sam would not have to show that the DCIT was fair. (Note that MBCA § 8.62 only requires that a majority, but not fewer than two, of the disinterested directors *who vote* on the DCIT voted in favor of it. This makes Answer D incorrect.) Answer B is incorrect because fairness and loyalty are not issues if the disinterested directors or shareholders approve a DCIT. Answer C is incorrect because both director approval under MBCA § 8.62 and shareholder approval under MBCA § 8.62 require full disclosure; if full disclosure was not made, then Sam would have to show that the DCIT was "fair," not that he was acting in good faith.

Question 4-18: The correct answer is B. Under the ALI's *Principles of Corporate Governance*, a corporate opportunity is defined as *any* of the following:

- Any opportunity to engage in a business activity of which a director or senior executive becomes aware in connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation; or

- Any opportunity to engage in a business activity of which a director or senior executive becomes aware through the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation; or

- Any opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage.

Note that Dave is a director, but not an officer, of Bomb Corp. Thus, the third definition of corporate opportunity set forth above does not apply to him because it only refers to senior executives, whereas the other two refer to both. Option I would be helpful to Dave, because it would show that the opportunity did not come to him in his "official capacity" (see the first bullet point above). Option II is irrelevant to Dave because he is not an officer of Bomb Corp. and thus the third bullet point above (the line of business test) does not apply to him. Option III is irrelevant under the ALI test and therefore would not be helpful to Dave. Finally, option IV would be helpful to Dave because it would show that he did not use "corporate resources" to learn of the opportunity (see the second bullet point above).

Question 4-19: The correct answer is A. Under the *Guth* test used in Delaware to decide if an opportunity is a "corporate opportunity," four factors are important. To quote the *Broz* case that appears in Chapter 10:

> The corporate opportunity doctrine, as delineated by *Guth* and its progeny, holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation. The Court in *Guth* also derived a corollary which states that a director or officer may take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity. [Citation omitted.]

Each of the four items listed in the question (options I through IV) appear on this list. Thus, each of them would be helpful to Dave in arguing that this is not a "corporate opportunity."

Question 4-20: The correct answer is A. This is another example of a director's conflicting interest transaction (DCIT) because some of the directors are engaging in a transaction (a loan) with the corporation. As noted above, a DCIT cannot be challenged because of the director's interest in it if (1) it was properly approved by the qualified directors pursuant to MBCA § 8.62; (2) it was properly approved by the qualified shares pursuant to MBCA § 8.63; *or* (3) it is established to have been "fair" to the corporation at the time it was entered into. Here, options 1 and 2 clearly were not met. However, because the loan was at the prime interest rate, it is likely fair to the corporation. The Hatfield directors were not charging an excessive (and unfair) interest rate.

Question 4-21: The correct answer is C. This is not a director's conflicting interest transaction (DCIT) because neither Steve nor any related person to him is engaging in a transaction with MAC or any of MAC's affiliates. See MBCA § 8.60(1). Thus, Answer A is incorrect. Answer B is incorrect because Steve's actions implicate the duty of loyalty rather than the duty of care. Answer C is correct because the opportunity to have Fashionista become a client may have been a "corporate opportunity" with respect to MAC and Steve was a director of MAC.

Question 4-22: The correct answer is A. Directors A and B properly "sanitized" this transaction by having the disinterested (qualified) directors approve it pursuant to MBCA § 8.62. Directors C, D, and E, however, theoretically could still be sued for breaching their duty of care. (Note that directors A and B could not be sued on *care* grounds because they abstained from voting on the transaction.) However, when you are suing directors with respect to a decision that they made, they will be protected by the business judgment rule (BJR) and the plaintiff must "overcome" the BJR in order to win the case. Here, because directors C, D, and E did not have a conflict interest, appear to be well-informed, and did not make an "irrational" decision, they will be protected by the BJR.

Question 4-23: The correct answer is D. This transaction was not a director's conflicting interest transaction (DCIT) because it did not take place between MMI (or an affiliate of MMI) and Vince (or a related person to Vince). This eliminates Answer B. However, Answer A is wrong because the mere fact that this is not a DCIT does not insulate Vince from liability; after all, there are other theories of liability. Answer C would be incorrect because the mere fact that the land belonged to his wife rather than himself would not shield Vince from liability. This leaves Answer D. Under these facts, it appears that the opportunity to have Julius purchase land was a corporate opportunity that Vince should have disclosed to MMI.

Question 4-24: The correct answer is A. Under Delaware law, if the disinterested *directors* approve an interested director transaction after full disclosure, the transaction will be protected by the business judgment rule. As such, the fairness (or lack thereof) of such a transaction would not be relevant. This eliminates Answers C and D. However, under *Lewis v. Vogelstein* and other cases discussed in Chapter 10, if the disinterested *shareholders* approve an interested director transaction after full disclosure, the transaction could still be challenged—but only successfully if the plaintiff proves that the transaction amounted to "waste." Because the plaintiff has the burden of proof on this issue, Answer B is incorrect.

Question 4-25: The correct answer is C. Here, there was only one "interested" director (Jon) out of a total of eleven. Moreover, Jon did not vote on his compensation nor did he take part in the deliberations concerning his compensation. The board of directors has the power to set the compensation levels of officers. Because this was a board decision, the business judgment rule applies. Unless the shareholder could somehow overcome the business judgment rule (which seems extremely unlikely on these facts), the fairness (or lack thereof) of Jon's compensation is not a matter for a court to review. Note that Answer D seems plausible, due to the comment to MBCA § 8.11 which is discussed in Section 10.04 of Chapter 10. However, that comment pertains to directors setting *their own* compensation. Here, the board is setting the compensation of an officer who just happens to be a director. They were not setting the compensation levels of the entire board for their service as directors.

Question 4-26: The correct answer is A. Note that BCC was harmed in 2015, when it incurred the $25 million in costs relating to the recall. Frank, however, did not own any

BCC stock until April 2016. Under MBCA § 7.41, to have proper standing to bring a derivative lawsuit, a shareholder must (1) have owned stock at the time of the alleged injury to the corporation (or have acquired stock by operation of law from someone else who owned stock at that time) and (2) be a fair and adequate representative of the corporation. Even if Frank would be a fair and adequate representative of BCC, the fact remains that he did not satisfy the "contemporaneous ownership" requirement and therefore does not have standing.

Question 4-27: The correct answer is A. The MBCA imposes a "universal demand" requirement. There are no exceptions to the requirement to make a demand. See MBCA § 7.42. Thus, Answers C and E can be eliminated. In Delaware, demand would be excused if the plaintiff can allege particularized facts which create a reasonable doubt that (1) the directors (cases after *Aronson* have clarified that this means a majority of the directors) are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. In New York, demand would be excused if the plaintiff alleges with particularity that (1) that a majority of the board of directors is interested in the challenged transaction, (2) the board of directors did not fully inform themselves about the challenged transaction to the extent reasonably appropriate under the circumstances, or (3) the challenged transaction was so egregious on its face that it could not have been the product of sound business judgment of the directors. None of these grounds are present on these facts. First, there really isn't any "challenged transaction" because the board didn't decide anything. Instead, BCC was merely the victim of Engine Parts's defective parts. Second, there is no indication in the facts that any of BCC's directors have any conflict of interest with respect to the subject matter of this lawsuit. Therefore, a demand would be required in all three jurisdictions.

Question 4-28: The correct answer is D. Here, Frank's demand has been rejected. If he still wishes to file the lawsuit, he must allege with particularity at least one of the grounds described in MBCA 7.44(c), to wit: either that (1) "a majority of the board of directors did not consist of qualified directors at the time the determination [i.e., the rejection] was made or (2) that the requirements of subsection (a) have not been met." Subsection (a) requires that one of the groups listed in subsection (b) or (f) have "determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation." Assuming that the June 1 letter is true, then it does not appear that Frank would be able to allege either of these grounds as a way to "overcome" the rejection. As such, it does not look like he will be able to file the lawsuit, making Answer D correct. Answer A is incorrect because, while it is true that Frank normally must wait 90 days after making the demand to file the lawsuit, he may do so immediately if the board earlier rejects the demand (assuming that he could satisfy one of the requirements discussed above). Answer B is incorrect because Frank must make one of the particularized allegations described above in his complaint and it does not appear that he can do so successfully. Finally, Answer C is incorrect because nothing in the MBCA provides for this result.

Question 4-29: The correct answer is D. MBCA § 7.44(a) provides that a "derivative proceeding shall be dismissed by the court on motion by the corporation if one of the groups specified in subsections (b) or (f) has determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation." One of the groups listed in subsection (b) is a "committee consisting of two or more qualified directors [as defined in MBCA § 1.43] appointed by majority vote of qualified directors present at a meeting of the board of directors, whether or not such independent directors constituted a quorum." Given that none of the BCC directors have a personal interest in this lawsuit, they all would be qualified directors, including Mr. Jones and Ms. Smith. Further, because Mr. Jones and Ms. Smith appear to acted in good faith and to have conducted a reasonable inquiry, the court will dismiss the lawsuit.

Question 4-30: The correct answer is D. In option I, the shareholder was harmed, not the corporation; therefore, this would be a direct lawsuit. Option II would be a derivative lawsuit because the corporation was harmed by receiving an allegedly inadequate price. For similar reasons, option III would be a derivative lawsuit. Option IV would be a direct lawsuit because the *corporation* would not have been harmed by the allegedly inadequate price that its former shareholders received for their shares.

Question 4-31: The correct answer is E. While some of the answers partially state the tests for excusing demand under Delaware or New York law, the key is in the application of those tests to the facts. Note that the Bob is only one of six members of the board, and the board obviously did not know about his actions before he took those actions. In other words, there was no *board* decision that is being challenged here, nor are a majority of the directors "interested" in the lawsuit. Thus, to say, for example as in Answer B, that demand should be excused because the board was not reasonably informed is nonsensical.

Question 4-32: The correct answer is A. This question essentially applies MBCA § 7.44(c) and the explanation of it would be very similar to the explanation of Question 4-28 above. In sum, if the qualified (disinterested) directors rejected the demand, were reasonably informed, and were acting in good faith, the rejection of the demand will be upheld.

Question 4-33: The correct answer is A. This question essentially applies MBCA § 7.44(a) and the explanation of it would be very similar to the explanation of Question 4-29 above.

Question 4-34: The correct answer is D. As stated in the facts, Gator is incorporated in New York. Under New York law, there are three situations in which demand is excused; Answers A, B, and C, respectively, describe these situations. Here, the facts are such that all three grounds for futility are likely present. This makes Answer D the best answer (even though, standing alone, each of Answers A, B, and C are correct.)

Question 4-35: The correct answer is E. The MBCA imposes a "universal demand" requirement. There are no exceptions to the requirement to make a demand. See MBCA § 7.42.

Question 4-36: The correct answer is D. In Delaware, demand would be excused if the plaintiff can allege particularized facts which create a reasonable doubt that (1) the directors (cases after *Aronson* have clarified that this means a majority of the directors) are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. Answer A reflects the first option and Answer C reflects the second option, which makes Answer D the best answer.

Question 4-37: The correct answer is A. Under the rule from the *Zapata* case, which applies if demand had been excused, if a special litigation committee moves to dismiss the derivative lawsuit:

> First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. … [If] the Court is satisfied … that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, *in its discretion*, to the next step.
>
> The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. …

(Emphasis added.)

Question 4-38: The correct answer is A. MBCA § 7.42 imposes a "universal demand" requirement, thus making all of the other answers incorrect. Also, note that Answer B is incorrect because the "irreparable injury" exception only applies to the 90-day waiting period that normally applies *after* a demand has been made; it does not excuse a shareholder from having to make a demand at all.

Question 4-39: The correct answer is D. Under MBCA § 7.44(a), if a special litigation committee that consists of two or more "qualified" (basically, that means independent, but see MBCA § 1.43 for the precise definition) directors has "determined in good faith after conducting a reasonable inquiry upon which its conclusions are based that the maintenance of the derivative proceeding is not in the best interests of the corporation," then the court must dismiss the lawsuit. Thus, if Hector could show that any of the required elements (represented in Answers A, B, and C) are *missing*, then the court should deny the motion to dismiss the lawsuit. Note that Hector would have the burden of proof on these issues because the board consists of a majority of qualified directors. See MBCA § 7.44(d).

Question 4-40: The correct answer is A. Outside of a few narrow exceptions, monetary recovery in a derivative lawsuit will go to the corporation. After all, the "hallmark" of a derivative lawsuit is that the corporation was harmed.

Question 4-41: The correct answer is B. Clearly, this is a director's conflicting interest transaction (DCIT) for Jim. See MBCA § 8.60(1)(iii), and § 8.60(5)(iv). However, MBCA § 8.61(b) provides that a DCIT "may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if: (1) directors' action respecting the transaction was taken in compliance with section 8.62 at any time; (2) shareholders' action respecting the transaction was taken in compliance with section 8.63 at any time; or (3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation." Jim made no attempt to secure a "sanitization" defense shield either through a qualified director (MBCA § 8.62) or qualified shareholder (MBCA § 8.63) vote; for one thing, he never disclosed that he was the owner of Seller. (See the definition of the "required disclosure" in MBCA § 8.60(7).) Thus, fairness is the correct standard; the MBCA and case law define that as entire fairness (fair dealing and fair price, and arguably under the MBCA, a business purpose). Answer A is wrong because "bad faith" is not the standard. (Also, note that only Jim is being sued, not the whole board.) Similarly, Answer C is an incorrect statement of directors' action because it suggests that full disclosure was not required. Again, Jim must make the "required disclosure" to properly secure approval by the disinterested directors or the disinterested shareholders. Obviously, Answer D is wrong.

Question 4-42: The correct answer is B. Read MBCA § 8.63 carefully. Under this section, a DCIT like this one (remember that Earl and Francine are directors of Corporation and are the ones selling the property to Corporation) must approved by a "majority of the votes cast by the holders of all qualified shares." Also, under subsection (d), a "majority of the votes entitled to be cast by the holders of all qualified shares constitutes a quorum for purposes compliance with this section." Thus, the first step in our analysis is to determine which shares are "qualified" shares. Applying the definition of that term in MBCA § 8.63(c)(2), we can see that Bob's 200 shares are not qualified shares since Earl is his father. (It does not matter that they rarely see each other.) That leaves 800 qualified shares. This means that a quorum of at least 401 qualified shares must be present at the meeting. This makes Answer A wrong, which refers to 501 shares. In addition, a majority of the qualified shares *that are voted* (as opposed to an absolute majority of all of the qualified shares, as in prior versions of the MBCA, or a majority of the qualified shares present at the meeting) must be voted in favor of the transaction for it to be sanitized. This makes Answer B the only correct answer. Answer C is wrong because it states that a majority of the shares present must vote in favor; that is a different standard because then abstentions would essentially count as "no" votes. Answer D is obviously wrong.

Question 4-43: The correct answer is D. If the opportunity to invest in Tom's project is a "corporate opportunity," and Phil invests in the project without offering the chance to do so to FLVI, then Phil will have "usurped" a corporate opportunity from FLVI. Under the ALI *Principles of Corporate Governance*, there are three ways that an opportunity of which a senior executive becomes aware (and not that Phil, as the President of FLVI, is a senior executive of it) could be a "corporate opportunity":

- an "opportunity to engage in a business activity of which a director or senior executive becomes aware ... [i]n connection with the performance of functions as a director or senior executive, or under circumstances that should reasonably lead the director or senior executive to believe that the person offering the opportunity expects it to be offered to the corporation" [ALI § 5.05(b)(1)(A)];

- an "opportunity to engage in a business activity of which a director or senior executive becomes aware ... [t]hrough the use of corporate information or property, if the resulting opportunity is one that the director or senior executive should reasonably be expected to believe would be of interest to the corporation" [ALI § 5.05(b)(1)(B)]; or

- an "opportunity to engage in a business activity of which a senior executive becomes aware and knows is closely related to a business in which the corporation is engaged or expects to engage." [ALI § 5.05(b)(2).]

Here, Answer A is incorrect because, while the Tom project mainly involves a golf course, it could also include some houses. Moreover, FLVI is involved in other real-estate related activities, such as running shopping malls, not just residential real estate. Thus, it seems hard to conclude that the Tom deal is not "closely related to a business in which the corporation is engaged or expects to engage." Answer B is incorrect because nowhere in the ALI definition of corporate opportunity is the corporation's financial ability to exploit the opportunity a factor. (That is a factor under Delaware law, but not the ALI.) Answer C is wrong because, even though Phil and Tom are friends from college, the facts state that Tom called to ask whether FLVI would be interested to invest. As such, this looks like a situation that reasonably should have led Phil to believe that Tom was offering the opportunity to FLVI. See ALI § 5.05(b)(1)(A). This leaves Answer D as the only correct answer.

Question 4-44: The correct answer is A. Under the *Tooley* test, to determine whether a lawsuit is derivative we ask (1) who has been harmed: the shareholder or the corporation? and (2) who would benefit from the recovery if the plaintiff wins the lawsuit: the shareholder or the corporation? If the answers to these questions are the shareholder (and not the corporation), then the lawsuit is direct. Conversely, if the answers to these questions are the corporation, then the lawsuit is derivative. Here, Answer B and C both involve situations where the corporation has been harmed and the corporation would recover if the lawsuit is successful. Thus, Answer B and C both describe derivative lawsuits. (This obviously makes Answer D incorrect.) In Answer A, however, the shareholder is arguing that he (and the other shareholders) were harmed by the company not observing their preemptive rights (i.e., their right of first refusal to purchase more shares when the company issues more shares). If this lawsuit is successful, then the shareholders would benefit from the injunction. Thus, Answer A involves a direct lawsuit.

Question 4-45: The correct answer is C. According to MBCA § 7.41, a "shareholder may not commence or maintain a derivative proceeding unless the shareholder: (1) was a shareholder of the corporation at the time of the act or omission complained of or became a shareholder through transfer by operation of law from one who was a shareholder at that time; and (2) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation." Here, the "harm" occurred at some point between April and June. But because Dave did not purchase shares until September, he does not meet the "contemporaneous ownership" rule of subsection (1). Julie meets that rule because she has owned ABC shares for many years, but her relationship to one of ABC's directors may mean that she would not be a fair and adequate representative of ABC in a suit against her cousin. Although Chad is perhaps less "impressive" than Dave or Julie on paper, he does meet the contemporaneous ownership rule because he inherited shares from his grandmother, which is a transfer by "operation of law" and presumably his grandmother owned shares at the time of the harm. (She died in June.) Also, there are no facts to call into question his ability to be a fair and adequate representative of ABC. Thus, given a choice from among these three shareholders, Chad appears to be the best choice.

Question 4-46: The correct answer is B. Answer A is incorrect because, even though Joe is a billionaire and probably doesn't care too much about a $20,000, the fact of the matter is that he is a *party* to the transaction because it is his car. Thus, it is a director's conflicting interest transaction (DCIT) for Joe. See MBCA § 8.60(1)(i). Answer B is correct because it appears that Joe properly "sanitized" the transaction through the approval of the qualified directors after he made the required disclosure. See MBCA § 8.62. Answers C and D are incorrect because qualified shareholder approval under MBCA § 8.63 and showing that the transaction was "fair" (which case law has interpreted as requiring "entire fairness") are different *alternatives* to defending oneself against a lawsuit alleging that a DCIT was a breach of one's duty of loyalty to the corporation. See MBCA § 8.61(b).

Question 4-47: The correct answer is C. MBCA § 7.41 provides that, in order to have standing to bring a derivative lawsuit on behalf of the corporation, a shareholder must (1) have been a "shareholder of the corporation at the time of the act or omission complained of or [have become] a shareholder through transfer by operation of law from one who was a shareholder at that time"; and (2) fairly and adequately represent "the interests of the corporation in enforcing the right of the corporation." Note that it takes only one share to be considered a shareholder. Thus, Answers A and B, which both refer to the fact that Shareholder did not own a "significant number" of shares, are incorrect. Answer D is incorrect because the MBCA does not permit *any* shareholder to bring a derivative lawsuit; a shareholder must have proper standing. Answer C correctly notes the second requirement for standing.

Question 4-48: The correct answer is C. In Delaware, demand would be excused if the plaintiff can allege particularized facts which create a reasonable doubt that (1) the directors (cases after *Aronson* have clarified that this means a majority of the directors) are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment. If neither of these can be shown, a demand would be required, which makes Answer D incorrect. Answer A is incorrect because Delaware (unlike the MBCA) *does* excuse demand in some situations, as discussed above. Here, because twelve of the fifteen directors would be receiving stock options under the stock option plan, a majority of the directors are "interested" in the challenged transaction. This makes the demand futile, which means that the demand is excused and that Answer C is correct.

Question 4-49: The correct answer is D. Under the rule from the *Zapata* case, which applies if demand had been excused, if a special litigation committee moves to dismiss the derivative lawsuit:

> First, the Court should inquire into the independence and good faith of the committee and the bases supporting its conclusions. … [If] the Court is satisfied … that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, *in its discretion*, to the next step.
>
> The second step provides, we believe, the essential key in striking the balance between legitimate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee. The Court should determine, applying its own independent business judgment, whether the motion should be granted. … [Emphasis added.]

Answer A is incorrect because the *Zapata* court specifically stated that, even in a demand-excused case such as this, a special litigation committee retains the power to move for a dismissal of the case. As the court stated, it is "clear that an independent committee possesses the corporate power to seek the termination of a derivative suit. [Section 141(c) of the Delaware General Corporation Law] allows a board to delegate all of its authority to a committee. Accordingly, a committee with properly delegated authority would have the power to move for dismissal or summary judgment if the entire board did." Similarly, Answer B is incorrect because the *Zapata* court also stated that "We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest." Answer C is incorrect because, as noted above, even if the court finds that the special litigation committee was independent, did a reasonable investigation, and was acting in good faith, the court could still decide to use its own business judgment to deny the motion to dismiss the case.

Question 4-50: The correct answer is B. The facts in this problem are modeled on the *Lewis v. Vogelstein* case from Chapter 10. Before getting to that, however, note that MBCA § 8.61(b)(2), as well as Section 144 of the Delaware General Corporation Law, seem to provide that if the disinterested shareholders approve a directors' conflicting interest transaction (DCIT) such as this after full disclosure, the DCIT cannot be challenged on the grounds that the defendant directors had an interest in it. Nonetheless, *Lewis v. Vogelstein* noted that "informed, uncoerced, disinterested shareholder ratification of a transaction in which corporate directors have a material conflict of interest has the effect of protecting the transaction from judicial review *except on the basis of waste*." (Emphasis added.) Further, the cases in Chapter 10 following *Lewis v. Vogelstein* make clear that the party attacking the transaction (i.e., the plaintiff) has the burden of showing that the transaction was wasteful. All of this makes Answer B correct.

Question 4-51: The correct answer is D. Section 10.04 of the textbook explains this, noting that MBCA § 8.11 provides that, unless the articles of bylaws provide otherwise, "the board of directors may fix the compensation of directors," but that the official comment to MBCA § 8.61 provides in part that "board action on directors' compensation and benefits would be subject to judicial sanction if they are not favorably acted upon shareholders pursuant to section 8.63 or if they are not in the circumstances fair to the corporation pursuant to section 8.61(b)(3)." Answer A is incorrect because, as noted above, the MBCA gives the board the power to set their compensation as directors. Answer B is incorrect because the shareholders are not in all cases required to approve director compensation (although, as noted above, it might be a good idea to seek shareholder approval, so that the directors would not need to show that their compensation was fair to the corporation). Answer C is incorrect because directors may receive compensation for their service as such. This leaves Answer D as the correct answer.

Question 4-52: The correct answer is B. It should be obvious that Answer A is incorrect; if these contracts were a breach of Jones's duty of loyalty to Superior, they would have harmed Superior itself (and only its shareholder *indirectly*). These contracts clearly are director's conflicting interest transactions (DCITs) because X Corporation is a "related person" to Jones (see MBCA § 8.60(5)) and is a party to contracts with Superior Corporation (see MBCA § 8.60(1)(iii)). That being the case, they would be a breach of Jones's duty of loyalty to Superior unless they were "sanitized" either through disinterested (qualified) director approval after full disclosure, disinterested (qualified) shareholder approval after full disclosure, or were fair to Superior. See MBCA § 8.61(b). Further, MBCA § 8.60(7)(ii) provides that the "required disclosure" includes "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction." Thus, an *affirmative misrepresentation* is not required, making Answer C incorrect. Further, because Jones clearly has a conflict of interest here, the business judgment rule would not protect him from liability, making Answer D incorrect.

Question 4-53: The correct answer is A. Under MBCA § 7.41, to have proper standing to bring a derivative lawsuit, a shareholder must (1) have owned stock at the time of the alleged injury to the corporation (or have acquired stock by operation of law from someone else who owned stock at that time) and (2) be a fair and adequate representative of the corporation. Answer B is incorrect because this section does not have an exception to the "contemporaneous" ownership rule where there was a deliberate concealment of the facts. Answer C is incorrect regardless of whether Superior is incorporated under the MBCA or in Delaware or New York. Under MBCA § 7.42, a demand is *always* required. While both Delaware and New York excuse a demand in various circumstances (as discussed in detail above), here, only *one* director, not a majority of the board, was interested in the challenged transactions and there are no facts to suggest that the board was not properly informed or that they made an "egregious" decision; the board can hardly be blamed for Jones's concealment of the fact that he owned X Corporation.

Question 4-54: The correct answer is B. Under MBCA § 7.44(c), if a shareholder files a derivative lawsuit after a demand has been rejected, the "complaint shall allege with particularity facts establishing either (1) that a majority of the board of directors did not consist of qualified directors at the time the determination was made or (2) that the requirements of subsection (a) have not been met." Further, subsection (d) provides that if a majority of the directors were qualified directors at the time the demand was rejected, the "plaintiff shall have the burden of proving that the requirements of subsection (a) have not been met; if not, the corporation shall have the burden of proving that the requirements of subsection (a) have been met." So, how many "qualified" directors are there? MBCA § 1.43(a)(1) provides that, for purposes of MBCA § 7.44, a qualified director is one who does *not* have either a "material interest in the outcome of the proceeding, or … a material relationship with a person who has such an interest." A "material interest" is defined in subsection (b)(2) as "an actual or potential benefit or detriment (other than one which would devolve on the corporation or the shareholders generally) that would reasonably be expected to impair the objectivity of the director's judgment when participating in the action to be taken." Here, at first it seems that none of the directors would be qualified director because, if they lose the case, they could be on the hook for millions of dollars in damages to CBC. However, we have to keep in mind that MBCA § 1.43(c)(3) provides that status as a named defendant does not *automatically* prevent a director from being considered a qualified director. (If the rule were otherwise, a plaintiff could simply name all of the directors as defendants and then claim that none of them were qualified directors.) The official comment to MBCA § 1.43 helps shed some light on this issue. See your statutory supplement. Here, as discussed in the explanation of the next question, it doesn't appear that the shareholder has a very good case for imposing liability on the directors. As such, it is likely that the directors are all qualified directors. While this conclusion is not entirely free from doubt, it probably eliminates Answer A. Answer C will be incorrect because, if it is true that a majority of board members were qualified directors, MBCA § 7.44(d) specifically places the burden of proof on the shareholder-plaintiff, not the board. Answer D is incorrect because, as discussed above, the rejection of a demand can be "overcome" for reasons other than that the directors acted irrationally when they rejected the demand.

Question 4-55: The correct answer is A. The defendant directors will likely prevail because they used the "care that a person in a like position like position would reasonably believe appropriate under similar circumstances." See MBCA § 8.30(b). They did do months of market research and consumer testing and relied on an outside expert. See MBCA § 8.30(e). Although MBCA § 8.30(b)'s standard of care seems like a negligence standard, the drafters of the MBCA were trying to convey the idea that the directors must have been worse than ordinarily negligent before they will be found to have breached their duty of care. While this is an issue that will be decided by a jury (if we have a jury trial), it doesn't seem that the directors were grossly negligent here. Moreover, even if the directors did fall short of the standard of care in MBCA 8.30(b), the plaintiff has more work to do to win the lawsuit. First, under MBCA 8.31(a)(2), the plaintiff would have to establish that the directors' conduct met one of the five types of "substantive" liability listed in that section. Here, because the board made a decision (and there does not appear to be any conflict of interest and the directors did not receive any financial benefit to which they were not entitled), the most likely choice would be subsection (a)(2)(ii), which describes "a decision (A) which the director did not reasonably believe to be in the best interests of the corporation, or (B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances." (This will be discussed further below in connection with the business judgment rule.)

Further, the plaintiff would have to show that the directors' action proximately caused harm to the corporation under MBCA § 8.31(b)(1) if the plaintiff is seeking money damages. That would not seem terribly difficult here; after all, the directors' decision to discontinue the Jupiter Bar and replace it with the Saturn Bar did lead to a drop in CBC's profits.

However, in addition, because the plaintiff is suing the directors as a result of a *decision* that the board made, the plaintiff will have to overcome the business judgment rule (BJR). The BJR is a presumption that, when making the decision, the board was acting in good faith and on a reasonably informed basis. To overcome the BJR, the plaintiff would have to show that the board lacked good faith (e.g., fraud, illegality, or a conflict of interest), that the board was not informed of all material information reasonably available to it before it made the decision (*Smith v. Van Gorkum* used a gross negligence standard here), or that the board made an "irrational" decision. This makes it likely that the plaintiff will lose. First, there is no fraud, illegality of conflict of interest involved here. Second, again, the board did do "several months" of market research, so arguably it was sufficiently informed before it made its decision. Finally, while this turned out to be a bad decision, it was not likely "irrational," which has been interpreted as meaning "beyond the realm of reason."

Answer B is incorrect because, as noted above, the plaintiff has the burden of showing harm and proximate cause, not the directors. Answer C is incorrect because fairness only really comes into play if the plaintiff is able to overcome the BJR or is suing for a duty-of-loyalty issue that was not properly "sanitized" by disinterested director or disinterested shareholder approval. See MBCA § 8.61(b). Answer D is incorrect because this was not something, such as a merger or dissolution, that would require shareholder approval. See MBCA § 8.01.

PART 5

Answer Key to Part 5:

5-1: B
5-2: D
5-3: C
5-4: D
5-5: C
5-6: B
5-7: A
5-8: D
5-9: A
5-10: D
5-11: B
5-12: A
5-13: C
5-14: B
5-15: E
5-16: B
5-17: B
5-18: D
5-19: A
5-20: D
5-21: B
5-22: D
5-23: B
5-24: E
5-25: D

Explanations:

Question 5-1: The correct answer is B. The "call" of the question is which of the ideas would prevent Ted from excluding Michael from participating in the business. They all would, except a classified board. Obviously, an employment agreement would protect Michael's employment with the company. Cumulative voting would ensure that Michael is able to elect someone (probably himself) to the board. (As a 40% shareholder, Michael will have enough shares to elect one director under cumulative voting, as discussed in several of the problems in Part 3.) An agreement under MBCA § 7.32 requiring that Michael be appointed as an officer would also help. However, a classified board will not help—all it would do is have one director elected every year, rather than three directors. This could actually make things *worse* for Michael—after all, Ted owns 60% of the stock and would be able to out vote Michael on the election of a board candidate.

Question 5-2: The correct answer is D. As noted in the question, you are following Massachusetts case law, but not MBCA § 14.30. As such, Answer D, which reflects the test used in the *Wilkes* case from Massachusetts, is correct. Answer A is incorrect because it reflects the approach under the "reasonable expectations" test from *Kemp & Beatley*, which is commonly used to interpret oppression statutes such as MBCA § 14.30, but the question directors you to assume that you are not in such a jurisdiction. Answer B is incorrect because Michael may have a remedy under the *Wilkes* case. Answer C is incorrect because shareholders in a closely held corporation are not automatically entitled to jobs with the corporation.

Question 5-3: The correct answer is C. (Remember, the call of the question asks which of the following techniques would *not* protect a minority shareholder.) Answer A is incorrect because preemptive rights would prevent a minority shareholder from having her percentage ownership in the company "diluted," assuming she has the money to buy new shares issued by the corporation. See MBCA § 6.30. For example, if a shareholder barely has enough shares to elect herself to the board under cumulative voting, any decrease in the percentage of shares that she owns would mean that she no longer would be able to do so; conversely, if she can retain her percentage ownership, she would still be able to elect herself to the board under cumulative voting. (See Chapter 8 for more details about cumulative voting.) Answer B is incorrect because setting a higher quorum requirement could allow a minority shareholder to prevent votes from being taken on certain actions by refusing to attend the meeting. Answer D is incorrect because multiple classes of stock could be used to protect the minority. For example, a class of stock owned only by the minority shareholder could be given rights to elect a set number of persons to the board. However, no par or low par value stock will do nothing to protect a minority shareholder from abuse. A par value (which is not required by the MBCA) is simply the minimum amount of money that the corporation must receive when it sells newly issued shares.

Question 5-4: The correct answer is D. Note that Hank is a minority shareholder and not a member of the controlling group (in this case, a family). Thus, even though SSI is incorporated in Massachusetts, the "equal opportunity" rule from the *Donahue* case does not apply to any repurchases of Hank's stock. It would only apply if SSI were repurchasing shares from a member of the *controlling* group. While Answer C is correct in pointing out that this is a director's conflicting interest transaction, it is *not* true that such transactions may *only* be completed if they are "fair." (See Chapter 10.) Answer E is obviously incorrect; corporations can, and often do, repurchase shares from shareholders.

Question 5-5: The answer is C. Remember, the call of the question is which answer is *not* correct. Answers A, B, and D are all true pursuant to MBCA § 7.32. However, Answer C is incorrect because the failure to note the elimination of the board of directors conspicuously on the front or back of both Abe's and Ben's shares does not render the provision or agreement void. At most, it would allow a purchaser of the shares to rescind the purchase if she did not know about the provision.

Question 5-6: The correct answer is B. Answer A is incorrect because transfer restrictions are not *per se* impermissible under the MBCA. However, MBCA § 6.27(a) provides in part that a "restriction does not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction." Thus, even though this would at first glance appear to be an articles amendment that was properly adopted, because Sven did not vote in favor of it, his shares are not affected by it. Answer C is incorrect because the fairness of the price is irrelevant under these facts.

Question 5-7: The correct answer is A. This agreement met the requirements of MBCA § 7.32, in that it was signed by all shareholders and "made known" to the corporation (by being placed in the corporate minute book). See MBCA § 7.32(b)(1)(B). That being the case, it is enforceable as written, despite the fact that it would seem to violate the rule in *McQuade v. Stoneham*. But that is something that one can do with a Section 7.32 agreement. See MBCA §§ 7.32(a)(1) and (3). Answer C is incorrect because MBCA § 7.32 allows agreements that would restrict the board's discretion in violation of the common law rule from cases like *McQuade v. Stoneham.* Answer D is incorrect because MBCA § 7.32 provides that such agreements are valid for as long as specified in the agreement. (The statute used to provide for a 10-year limitation, unless the agreement provided for a different time period. See MBCA § 7.32(h).)

Question 5-8: The correct answer is D. This question concerns the *Wilkes* case and its two-part test for breach-of-fiduciary claims in closely held corporations under Massachusetts law. If there was no legitimate business reason for firing Courtney, she would win the case, and the court would not need to proceed to part two of the *Wilkes* test. As a technical matter, please note that Courtney did not have the burden to establish that there was no legitimate business purpose for firing her. Instead, Henry and Dave would have the burden to show that they did have a legitimate business purpose to fire her. On these facts, it does not look like Henry and Dave had a legitimate business purpose to fire Courtney, which makes Answer A incorrect. Answer B is incorrect because, under Massachusetts law, shareholders in closely held corporations such as this one do owe fiduciary duties to each other. Answer C is not correct because "cause" is a different standard than the legitimate business purpose part of the *Wilkes* test. Also, this answer neglects to apply the *Wilkes* test in any way.

Question 5-9: The correct answer is A. This question concerns the "reasonable expectations" test, which the court in the *Kemp & Beatley* case applied in interpreting New York's counterpart to MBCA § 14.30. Answer B is incorrect because the mere fact that a shareholder has been removed from an officer position is not automatically oppressive; a court would still have to evaluate the requirements of the reasonable expectations test. Answer C is incorrect because, even though MBCA § 14.30 doesn't specifically provide for personal liability on the part of the shareholder-defendants, this does not foreclose the possibility that Courtney will win the case and get the court to order dissolution of the corporation. Answer D is incorrect because continued employment could be a protected interest; see the *Kemp & Beatley* case itself for proof.

Question 5-10: The correct answer is D. Essentially, this question requires students to correctly apply MBCA § 14.34(a). Although other state statutes explicitly authorize remedies other than dissolution of the corporation (or have been interpreted that way by courts), MBCA § 14.30 seems to provide that dissolution is the only remedy. Nonetheless, MBCA § 14.34 essentially allows the defendants or the corporation to make the lawsuit "go away" by agreeing to buy the plaintiff's shares for fair value. Although MBCA § 14.34(b) does contain a deadline for this election, it may be extended in the court's discretion and, even if a court does find that the plaintiff has been oppressed and order dissolution of the corporation, the dissolution order often will be conditioned on allowing the defendants to prevent dissolution by buying the plaintiff's shares for "fair value" (however that may be determined).

Question 5-11: The correct answer is B. One of the "radical" things that may be done with an agreement under MBCA § 7.32 is to eliminate the board of directors, which makes Answer A, as well as Answer C, incorrect. Also, note that MBCA § 7.32(f) provides that the "existence or performance of an agreement authorized by this section shall not be a ground for imposing personal liability on any shareholder for the acts or debts of the corporation even if the agreement or its performance treats the corporation as if it were a partnership or results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement." Thus, a Section 7.32 agreement doesn't make veil-piercing any more likely than it would otherwise be. Answer D is incorrect because nothing in MBCA § 7.32 requires the elimination of officers if the board is eliminated. Finally, Answer B correctly states one of the three ways of documenting a MBCA § 7.32 agreement (the other being amendments to either the articles or the bylaws that are approved by all shareholders).

Question 5-12: The correct answer is A. With respect to agreement I, because it only concerns how Brian and Harold would vote their *shares*, it is permissible as a shareholder voting agreement under MBCA § 7.31. However, agreement II is not permissible—unless MBCA § 7.32 validates it. (Note that one of the things that may be accomplished with an agreement under MBCA § 7.32(a)(4) is the use of director proxies.) However, because agreement II was not signed by all of the shareholders (or unanimously put in the articles or bylaws), it is invalid.

Question 5-13: The correct answer is C. MBCA § 7.32(a)(1) specifically provides that the board of directors could be eliminated through a Section 7.32 agreement. (Note that because this is something that "traditional" corporation law would prohibit, the only way that the agreement would be valid is if it complies with Section 7.32.) In terms of how to "document" such an agreement, subsection (b) provides three choices: either it must appear in the articles (and be approved by all of persons who are shareholders at the time), or it must appear in the bylaws (and be approved by all of persons who are shareholders at the time), or it must be in a written agreement that is signed by all of persons who are shareholders at the time and "made known" to the corporation. Further, subsection (b)(2) provides that such an agreement can be amended only by all of the persons who are shareholders at the time (unless the agreement itself provides for a lesser requirement for amendments). Thus, Answers A and B are correct statements, and thus incorrect answers. (Remember, the question asked which answers are not correct.) Answer D is also a correct statement of the law under subsection (d). Subsection (c) does require that the existence of the Section 7.32 to be "conspicuously" noted on the stock certificates; however, that section also states that the failure to do so "shall not affect the validity of the agreement or any action taken pursuant to it." The means that Answer C is an incorrect statement of the law, and thus the correct answer.

Question 5-14: The correct answer is B. MBCA §§ 6.27(b), (c), and (d) specifically answer this question. Note that nothing in MBCA § 6.27 requires that the corporation be closely held. However, transfer restrictions typically are only more frequently in closely held corporations than in other types of corporations.

Question 5-15: The correct answer is E. This question is somewhat complex in that the 1999 is both a "garden variety" shareholder voting agreement under MBCA § 7.31, as well as a Section 7.32 agreement. Answer A is incorrect for the reasons discussed in the answer to Question 5-13 above. Answer B is incorrect because MBCA § 7.32 does not require that such an agreement be set forth in the articles or bylaws; instead, subsection (b)(1) provides that it may be in a written agreement that is signed by all of persons who are shareholders at the time and "made known" to the corporation. Answer C is incorrect because, although common law cases such as *McQuade v. Stoneham* would invalidate "director voting agreements" such as this, they are specifically allowed under Section 7.32, specifically subsection (a)(3). Answer D is incorrect because of MBCA § 7.31, which specifically provides that shareholders may enter into agreements specifying how they will vote their shares. Finally, Answer E is incorrect because the 1999 agreement is enforceable on these facts, but MBCA § 7.32(c) would allow Ms. E a right of rescission if she did not know of the existence of the agreement.

Question 5-16: The correct answer is B. Under MBCA § 6.30(b)(1), if the corporation's articles provide for preemptive rights, this means that each shareholder has a right of first refusal to "acquire proportional amounts of the corporation's unisssued shares upon the decision of the board of directors to issue them." Here, since each of the four shareholders currently owns 25% of the shares, that would mean that they each have a right to purchase 25 of the 100 that are to be issued to Ms. E. That eliminates Answer A. Answer C is incorrect because MBCA § 6.30(b)(iv) provides that there are no preemptive rights with respect to shares that shares are "sold otherwise than for money." Answer D is incorrect because Answer B is a correct statement of the result in this case. See MBCA § 6.30 for more details.

Question 5-17: The correct answer is B. First of all, Answer A is incorrect because it is likely applying a rule from partnership law (RUPA § 401(k) requires that an amendment to a partnership agreement requires unanimous approval, unless the agreement requires less than unanimous approval) rather than a rule from corporate law. After all, a closely held corporation is still a corporation and in our case will be governed by the MBCA. Answer C is incorrect because MBCA § 7.27 provides that an amendment to the articles that adds *or deletes* a "supermajority" voting provision such as this must be approved by the *greater of* (1) the voting requirements then in effect (here, that is an 80% vote requirement) or (2) the voting requirements proposed to be adopted (here, that would be going back to the usual "more yes votes than no votes" rule of MBCA § 7.25(c)). Here, while 66.7% of the shares voted in favor of removing this provision from the articles, that is less than the 80% vote that would be required under the terms of this provision of the articles. Answer D is incorrect for the same reason. In addition, the mere fact that the articles have been amended does not necessarily mean that Shareholder C has been oppressed.

Question 5-18: The correct answer is D. This is a difficult question, so bear with me. As the facts stated, each of the three shareholders owns 100 shares and there is currently a three-person board, with directors elected through cumulative voting. This means that, under the formula for cumulative voting, which is:

$$\frac{\text{N x S}}{\text{D + 1}} + \text{“1”} = \text{X}$$

where "N" is the number of directors that you wish to elect to the board; "S" is the number of shares that will be voted at the shareholder meeting; and "D" is the total number of directors that will be elected to the board at the shareholder meeting, Curt has enough shares to get elected to the board because he has more than 76 shares. That being the case, Curt also has enough shares to prevent himself from being removed from the board under MBCA § 8.08(c) ("If cumulative voting is authorized, a director may not be removed if the number of votes *sufficient to elect him* under cumulative voting *is voted against his removal*") (emphasis added). All Curt has to do to prevent his removal from the board is to vote his shares against this removal. This eliminates Answer A. Answer B is wrong for the same reason; in addition, it is not necessary to show cause to remove a director from the board unless the articles require it. See MBCA § 8.08(a).

Answer C sounds promising at first, but ends up being wrong. Here's why. If there were a two-person board, the formula for cumulative voting would tell us that it would take 201 shares to elect two directors to the board. However, Adrian and Brian only have 200 shares total. This ends up meaning that there would be a three-way tie for two positions on the board, unless Adrian and Brian want Carl to be on the two-person board. To see why, remember that under cumulative voting, each shareholder would have a number of *votes* equal to the number of shares he owns, multiplied by the number of director positions. So, if there's a two-person board, each shareholder would have 200 votes to cast for one or more candidates. The two candidates who receive the highest number of votes will get elected to this two-person board. Adrian will probably want to cast all of his 200 shares for himself, as will Brian. If either Adrian or Brian wants to get more than 200 votes, he will need to convince the other shareholder to cast at least one vote for him, but this does not seem likely because if would mean that that shareholder would come in third place for the two board spots. Meanwhile Carl will, of course, cast his 200 votes for himself. All of this likely means that they will end up in a tie and will have to agree on some resolution.

Question 5-19: The correct answer is A. This question was designed simply to illustrate the importance of having a "buy-sell" agreement. Without one, a corporation is under no obligation to repurchase your shares from you.

Question 5-20: The correct answer is D. MBCA § 8.24 answers this question. Subsection (b) provides that the articles or the bylaws "may authorize a quorum of a board of directors to consist of no fewer than one-third of the fixed or prescribed number of directors …." Further, subsection (c) provides that, "[i]f a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors *unless the articles of incorporation or bylaws require the vote of a greater number of directors*." (Emphasis added.)

Question 5-21: The correct answer is B. Clearly, Gizmo is a controlling shareholder of Omega, owning 90% of its stock. This means that Gizmo owes fiduciary duties to Omega, which makes Answer E wrong. Under *Sinclair Oil*, if this transaction involves "self-dealing," then the intrinsic fairness (which is similar to, but not quite the same as, the entire fairness test) is appropriate. If not, then the standard of review would be the business judgment rule. Because Gizmo appears to have diverted a corporate opportunity from Omega to itself, it appears that self-dealing was present because Gizmo got something to the exclusion of the other shareholders of Omega. This would make Answer B the correct answer. Answers C and D are wrong because, on these facts, the plaintiff would not have the burden of proof.

Question 5-22: The correct answer is D. According to Delaware case law (see page 503 of the textbook), even if a self-dealing transaction involving a controlling shareholder is approved by the disinterested shareholders after full disclosure (as was the case here) or by the disinterested directors after full disclosure, the plaintiff could still challenge the transaction. To do so successfully, the plaintiff must show that either fair dealing or fair price (or both) were lacking.

Question 5-23: The correct answer is B. Clearly, Monkey Corp. is the controlling shareholder of Zoo Corp. because it has the ability to elect a majority of the Zoo Corp. directors. This problem was designed to illustrate the hypothetical described in the *Sinclair Oil* case; because the dividends were paid only on the shares owned by the controlling shareholder, the intrinsic fairness test is appropriate.

Question 5-24: The correct answer is E. Fizz and his family own 6% of the shares of SPC Stock. Although he is the largest shareholder, he does not appear to be a "controlling" shareholder; he obviously is not a majority shareholder and he appears to no longer have any influence over SPC's board. See *Kahn v. Lynch Communication Systems, Inc.* in the textbook. Therefore, any transaction between Mr. Fizz and SPC would *not* be one that involves a controlling shareholder. If the board wishes to redeem his shares, it would be an "ordinary" board decision protected by the business judgment rule. But note that the shareholders are attempting to sue *Mr. Fizz*, not the board. Because he is not a controlling shareholder, he does not owe duties to SPC and the court should dismiss the case.

Question 5-25: The correct answer is D. In the *Kahn v. M & F Worldwide Corp.* case in the textbook, the court held as follows:

> To summarize our holding, in controller buyouts, the business judgment standard of review will be applied *if and only if:* (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

All of this means that neither Answer A nor Answer B, standing alone, would suffice to shift the standard of review from entire fairness to the business judgment standard of review. That obviously makes Answer C wrong as well. Admittedly, even if you didn't study this area of the law beforehand, you probably would have chosen Answer D, if only because it sounds the "safest," so perhaps this wasn't the world's best multiple-choice question. On the other hand, it gave you a chance to review the rule from *Kahn v. M & F Worldwide Corp.*

PART 6

Answer Key to Part 6:

6-1: B
6-2: C
6-3: A
6-4: D
6-5: A
6-6: D
6-7: A
6-8: A
6-9: C
6-10: C
6-11: E
6-12: B
6-13: B
6-14: C
6-15: B
6-16: A
6-17: E
6-18: B
6-19: A
6-20: D
6-21: B
6-22: B
6-23: C
6-24: C
6-25: B
6-26: A
6-27: A
6-28: A
6-29: D
6-30: D
6-31: A
6-32: B
6-33: B
6-34: E
6-35: E

Explanations:

Question 6-1: The correct answer is B. Normally, shareholders are not liable for corporate debts, but here the company distributed to the shareholders money that should have gone to its creditor (Gas Corp.) instead. In fact, the $100,000 that the company distributed to shareholders would not have been sufficient to fully pay Gas Corp. Thus, outside of a veil-piercing scenario (which is not present in these facts), each shareholder will have to give back what he or she received. Mr. Solid owned 10% of Liquid Corp.'s stock and therefore received $10,000 upon dissolution. He will have to repay this amount. See MBCA § 14.07(d)(2). He would have been liable for 10% of the claim if the amount of the claim had been less that the amount that was distributed to shareholders upon dissolution.

Question 6-2: The correct answer is C. Because there are 10,000 shares of preferred stock, each with a $10 liquidation preference, it will take $100,000 to pay that amount. This leaves $900,000. Record Corp.'s articles essentially provide that shares of common stock and preferred stock will then be "lumped" together and treated equally in sharing this amount. (This type of preferred stock is sometimes called "participating" preferred.) Thus, there are a total of 100,000 shares (90,000 shares of common and 10,000 shares of preferred) dividing $900,000, which means that each share will receive $9. Thus, the preferred stock got a total of $19 per share and the common stock got $9 per share.

Question 6-3: The correct answer is A. An unpaid and "unbarred" creditor can recover from the shareholders amounts that the corporation owed, proportionally but subject to a cap (no shareholder would have to return more than the amount that she received upon dissolution of the corporation). This question asks which answer is <u>in</u>correct. Answer A is the only answer that is incorrect, because it does not matter whether shareholders knew about the unpaid claim. Answer B is therefore correct. Answers C and D are correct because if $900,000 were distributed to the shareholders, the first $20,000 would go to the 1,000 shares of preferred stock to pay their $20-per-share liquidation preference. Afterward, there would be $880,000 left, to be divided among 1,000 shares of common stock, which would result in $880 per share of common stock.

Question 6-4: The correct answer is D. If SC sells the assets of its cookie division and its bagel division to Buyer Corp., it will be left with only the cake division, which represents 24% of SC's overall assets, generates 25% of its pre-tax income, and generates 33% of its revenues (in each case looking at last year). Thus, it does not meet the "safe harbor" of MBCA § 12.02 because SC would not retain at least 25% of the assets that it had as of the end of the last fiscal year. However, this does not mean shareholder approval *is* required, only that *we cannot be absolutely sure* that shareholder approval is *not* required. Thus, Answer D is correct. Answer A is wrong because this transaction is clearly outside the ordinary course of business. Answer B is wrong because, as discussed above, SC will not meet the "safe harbor" of MBCA § 12.02. Answer C is wrong because, as discussed above, the failure to meet the safe harbor does not necessarily mean that SC would not retain a significant continuing business activity (although, of course, the farther away that one gets from the safe harbor, the less likely this would be).

Question 6-5: The correct answer is A. If Corporation sells the assets of the Division, it will be left with assets that: represent 72% of Corporation's overall assets as of the end of last year; generated 63% of its pre-tax income last year; and generated 20% of its revenues last year. This falls into the "25% and (25% or 25%)" safe harbor of MBCA § 12.02, thus meaning that shareholder approval clearly is not required for this asset sale.

Question 6-6: The correct answer is D. If Precipitation sells Sleet to Snow, it will be left with business activities that constitute 30% of its total assets (as of the end of the prior fiscal year), generate 20% of its pre-tax income (for the past year), and generate 25% of its revenues (for last year). Because this falls into the "25% and (25% or 25%)" safe harbor of MBCA § 12.02, Precipitation does not need to seek shareholder approval before this sale may occur.

Question 6-7: The correct answer is A. Unlike many state statutes, which require that a majority of the *outstanding* shares vote in favor of a merger, the MBCA treats a merger like anything else that the shareholders would vote on, requiring only more "yes votes" than "no votes" and ignoring abstentions. See MBCA § 7.25(c). Here, more shares were voted in favor of than against the merger. Answer B is incorrect because Guitar would be issuing 20 million new shares, increasing the number of its outstanding shares by more than 20%. See MBCA §§ 11.04(h), 6.21(f). Answer C is wrong because, as discussed above, the MBCA does not require a majority of outstanding shares to approve the merger. Finally, a quorum was present because more than half of the outstanding shares attended the meeting, which makes Answer D wrong. See MBCA § 7.25(a).

Question 6-8: The correct answer is A. Mark is a shareholder of Stressed, which is closely held and is the target corporation in this merger. Answer B is incorrect because shareholders are not *automatically* entitled to assert dissenters' rights; they must, among other things, notify the board of their intent to dissent before the vote is taken. Answer C is wrong because MBCA § 13.01(b)(1) would not "take away" Mark's dissenters' rights simply because he would be *receiving* publicly traded stock in the merger. Answer D is wrong because it is only impermissible for a shareholder who is dissenting from a merger to vote "for" the merger. Abstentions and "no" votes are both acceptable.

Question 6-9: The correct answer is C. Answer A is incorrect because the language is based on *partnership* law (see RUPA § 807(b)). Answer B is factually incorrect because Stressed is a closely held corporation; therefore, there *is* no public market for its shares. Moreover, a judge would not be bound to use the market price in deciding the fair value of the stock. Answer D is wrong because it likely would include a "minority discount" and a "marketability discount," neither of which are appropriate in determining the fair value of shares in a dissenters' rights proceeding. See MBCA § 13.01(4)(iii).

Question 6-10: The correct answer is C. Answer A is incorrect because MBCA § 11.04(h) and MBCA § 11.05 both provide that shareholder approval of a constituent corporation is unnecessary in certain circumstances. Answer B is wrong because mergers often are, in fact, used to "cash out" minority shareholders, although such transactions could give rise to oppression claims (see Chapter 12) or claims that a controlling shareholder breached its fiduciary duties (see Chapter 13). With respect to Answer C, note that MBCA § 13.02(a)(1) would grant dissenters' rights to the shareholders of a target corporation in a merger. Subsection (b)(1) would "take away" dissenters' rights if the target's shares are publicly traded within the meaning of that section. (And, subsection (b)(3) would in some situations restore dissenters' rights that were taken away under subsection (b)(1).)

Question 6-11: The correct answer is E. Answers A and B are incorrect because there are some (minor) amendments that may be approved by the board without shareholder approval. See MBCA § 10.05. Answer C is wrong because most articles amendments require shareholder approval. See MBCA § 10.03(b). Answer D is wrong because the shareholders may amend the bylaws under MBCA § 10.20. (And, in some cases, the board can too.)

Question 6-12: The correct answer is B. See MBCA § 12.01. Answer A is incorrect because asset sales, even if they are outside the usual and regular course of business, need not be approved by the shareholders if the corporation will retain a "significant continuing business activity" following the sale. See MBCA § 12.02. Answers C and D are incorrect because the shareholders of the *buying* corporation generally are not required to approve an asset purchase. Instead, this is a board decision. Shareholder approval by the buying corporation would only be necessary if MBCA § 6.21(f) applied, which would be the case if the outstanding voting stock of the buyer would increase by more than 20% as a result of the transaction.

Question 6-13: The correct answer is B. Trash's shareholders will need to approve the merger because Trash will not survive the merger. See MBCA §§ 11.04(b), (h). This eliminates Answers A and D. Basket's shareholders, however, will not need to approve the merger because all four of the requirements of subsection (h) are met with respect to Basket: Basket will survive the merger; its articles will not be amended; its currently outstanding shares will not be changed in any way; and, because Basket is paying cash for Trash's shares, there will not be any increase at all in the number of outstanding shares of Basket following the merger, let an increase of more than 20%. The fact that Basket will need to borrow $400 million to complete the merger is irrelevant to this question. The board would have the authority to borrow money on behalf of the corporation and, if the shareholders, didn't like it, perhaps they could sue the board for a breach of the duty of care (although that will be a tough case to win, as discussed in Chapter 9). In any event, Basket's shareholders need not approve this merger in order for it to occur.

Question 6-14: The correct answer is C. If VSC sells the assets of its baseball division, it will be left with two divisions that collectively represent 49% of VSC's assets and that generate 49% of its pre-tax income and 20% of its revenues (in each case, as of last year). This clearly falls into the "safe harbor" of MBCA § 12.02, making the approval of VSC's shareholders unnecessary. As for Buyer Corp., its outstanding voting stock would increase by 10% (going from 10 million shares to 11 million shares), but this is below the 20% threshold that would require a shareholder vote under MBCA § 6.21(f) when shares are being issued in exchange for something other than cash or cash equivalents. As a result, the only correct answer is Answer C.

Question 6-15: The correct answer is B. Of the choices given, the best way to avoid successor liability is to pay for the assets with cash. Paying with stock or a combination of cash and stock could open the buying corporation up to a "de facto" merger argument because there could be a "continuity of ownership" if some of those shares ended up in the hands of the seller's shareholders. See the *Cargo Partner* case in Chapter 14. Thus, Answers A and C would not be good advice. Similarly, Answer D would not be good advice; paying with stock *could* give rise to a "de facto" merger argument even if the buyer does not operate at the same physical location as the selling corporation.

Question 6-16: The correct answer is A. In the merger, Glass will issue 10 million new shares of its stock (100 multiplied by 100,000) to the soon-to-be-former shareholders of Beverage. This means that Glass will go from having 30 million outstanding shares to 40 million, a 33% increase. This means that one condition of MBCA § 11.04(h) would not be met (the 20% limit on the increase in new voting shares under MBCA § 6.21(f)), and the approval of Glass's shareholders would be needed, making Answer B incorrect. As for Beverage, as the disappearing or target corporation, its shareholders must vote on the merger. Answer C is wrong because the characteristics of the merger consideration are irrelevant to whether shareholder approval is required for the target company's shareholders. (Instead, it might be relevant for deciding whether target's shareholders have dissenters' rights.) Answer D is wrong because MBCA § 11.04(h) has four conditions, each of which must be satisfied to conclude that shareholder approval is not necessary. As discussed above, this merger will result in a greater than 20% increase in the number of voting shares of Glass, meaning that one of the four conditions in MBCA § 11.04(h) is not met. Thus, shareholder approval is needed.

Question 6-17: The correct answer is E, because both Answer A and Answer D are correct. Answer B is wrong because Glass's shareholders lack dissenters' rights, not because Glass is publicly traded, but because *their* stock will remain outstanding following the merger. See MBCA § 13.02(a)(1). Answer C is incorrect because the target company's shareholders would have dissenters' rights unless, per MBCA § 13.02(b)(1), *their* stock was publicly traded. The fact that they would *receive* publicly traded stock would not take away their dissenters' rights under MBCA § 13.02(b)(1).

Question 6-18: The correct answer is B. In the merger, Kite will issue 1 million new shares of its stock to the soon-to-be-former shareholders of String. This means that Kite will go from having 10 million outstanding shares to 11 million, a 10% increase, which is below the 20% limit in MBCA § 11.04(h). The other three conditions of MBCA § 11.04(h) would also be met, because Kite will survive the merger, its articles of incorporation will not be changed, and its currently outstanding shares will not change. Therefore, approval by Kite's shareholders is not necessary. This makes Answer A wrong. As for String, as the disappearing or target corporation, its shareholders must vote on the merger. Whether they have publicly traded stock is irrelevant to whether they must *vote* on the merger, so Answer C is wrong. Answer D is also irrelevant to the question of whether shareholder approval is necessary.

Question 6-19: The correct answer is A. In this merger, Kite's shareholders will not have dissenters' rights because, not only are they not required to vote on the merger, their stock will remain outstanding immediately after the merger. See MBCA § 13.02(a)(1). Thus, Answers B and C are wrong. The difficult question is whether the shareholders of String have dissenters' rights. Initially, MBCA § 13.02(a)(1) gives them dissenters' rights because they have the right to vote on the merger and their String stock will no longer be outstanding following the merger. However, because String stock is publicly traded within the meaning of MBCA § 13.02(b)(1), that section takes away their dissenters' rights. Nonetheless, MBCA § 13.02(b)(3) would "restore" dissenters' rights if the String shareholders would be required to accept anything that is not, as of the effective date of the merger, cash or publicly traded stock within the meaning MBCA §13.02(b)(3). Here, the Kite stock will not "fit the bill," which means that String shareholders *do* have dissenters' rights.

Question 6-20: The correct answer is D. Answer A is incorrect because MBCA § 14.07 only requires three years notice, not five years. Answer B is incorrect because MBCA § 14.07 only requires that the notice be published once. Answer C is wrong because MBCA § 14.07 only requires that the notice be published in a newspaper of general circulation in the county of the corporation's principal office.

Question 6-21: The correct answer is B. Answer A isn't correct because a triangular merger still runs the risk that the target corporation's liabilities could bankrupt the subsidiary used in the triangular merger. By contrast, the general rule in an asset transaction is that the buyer does not assume the seller's liabilities. Answer C is incorrect because in a forward triangular merger, the target corporation merges into the subsidiary of the acquiring corporation, not vice versa. Answer D is wrong because if MBCA § 11.05 applies (where the parent owns at least 90% of the outstanding voting stock of the subsidiary), then the approval of *neither* the subsidiary's board nor its shareholders is required.

Question 6-22: The correct answer is B. As discussed above, in order to have dissenters' rights as an initial matter under MBCA § 13.02(a)(1), a shareholder must (1) be entitled to vote on the merger and (2) own shares that will not be outstanding after the merger. Here, Bucket Corp.'s shareholders would have the right to *vote* on the merger because Bucket will need to issue 1 million new shares of stock in this merger (10,000 multiplied by 100), which will cause its outstanding shares to increase by 33.3%. However, because Bucket stock will remain outstanding following the merger, Bucket's shareholders will not have dissenters' rights. This eliminates Answers A and C. With respect to Drop's shareholders, they will have the right to vote on the merger (because Drop will not survive the merger) and their shares will not remain outstanding after the merger. This gives them dissenters' rights under MBCA § 13.02(a)(1). Subsection (b)(1) does not take away Drop's shareholders' dissenters' rights because Drop is not publicly traded within the meaning of that section. This means that Drop's shareholders' have dissenters' rights (eliminating Answer D) and there is no need to proceed to consider subsection (b)(3).

Question 6-23: The correct answer is C. This is an *asset* sale; the Rats stock that SC owns is one of SC's assets. So, Answer D is a "red herring" and is wrong. If SC sells the Rats stock, it will still be retaining assets that, as of the end of last year, were 58% of SC's total consolidated assets, and that had generated 40% of SC's consolidated revenues and 52% of its consolidated pre-tax income. This clearly falls into the "safe harbor" of MBCA § 12.02(a), which says that assets that were "at least 25 percent of total assets at the end of the most recently completed fiscal year, and [generated] 25 percent of either income from continuing operations before taxes or revenues from continuing operations for that fiscal year," are conclusively considered to be a "significant continuing business activity." And, if a seller will retain a significant continuing business activity following an asset sale, it does not need shareholder approval for that sale. Id. Answer A is wrong because SC *will* have a significant continuing business activity following the sale. Answer B is wrong because we fall into MBCA § 12.02's "safe harbor." Thus, there is no need to have a court determine whether what SC will retain is a significant continuing business activity. NOTE: The reference to SC's "consolidated" assets, revenues, and pre-tax income refers to SC and its subsidiaries taken as a whole. Note the phrase "in each case of the corporation and its subsidiaries on a consolidated basis" in MBCA § 12.02(a).

Question 6-24: The correct answer is C. Under MBCA § 11.04(b), the shareholders of each corporation involved in a merger must approve the merger, except as provided in subsection (h) (or section 11.05, which is not applicable here). Subsection (h) provides that the shareholders need not approve the merger if (1) the corporation will survive the merger, (2) its articles of incorporation will not be changed (except for the minor amendments permitted by section 10.05), (3) each shareholder of the corporation whose shares were outstanding immediately before the merger "will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the" merger, and (4) "the issuance in the merger of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f)." Here, Bolts will not survive the merger, so its shareholders must approve the merger. This eliminates Answers A and D. The shareholders of Nuts also must approve the merger. Although Nuts will survive the merger, there will be an amendment to its articles as a result of the merger, as set forth in the plan of merger in this problem. Thus, fewer than all of the four conditions of MBCA § 11.04(h) are met with respect to Nuts, meaning that its shareholders must approve the merger before the merger may occur. NOTE: The amendment to Nuts's articles of incorporation in this problem is not one of the "minor" amendments for which shareholder approval is not required under MBCA § 10.05.

Question 6-25: The correct answer is B. Nuts's shareholders do not have dissenters' rights with respect to the merger. Under MBCA § 13.02(a)(1), a shareholder has dissenters' rights with respect to a merger if the shareholder has the right to vote on the merger, "except that appraisal rights shall not be available to any shareholder ... with respect to shares ... that remain outstanding after ... the merger." Nuts's shareholders would not have dissenters' rights because their shares will remain outstanding after the merger. Thus, Answers A and D are wrong. The shareholders of Bolts would not have dissenters' rights, either. While MBCA § 13.02(a)(1) would initially grant them dissenters' rights because they have the right to vote on the merger and their shares are "going away," subsection (b)(1)(i) would take away their dissenters' rights because Bolts stock is traded on Nasdaq. Subsection (b)(3) would *not* restore Bolts's shareholders' dissenters' rights because they will receive Nuts stock in the merger, and Nuts stock is publicly traded. Subsection (b)(3) only restores dissenters' rights if the target company's shareholders would receive something *other than* cash or stock that is publicly traded (or that will be publicly traded as of the effective time of the merger).

Question 6-26: The correct answer is A. As stated above, under MBCA § 11.04(b), the shareholders of each corporation involved in a merger must approve the merger, except as provided in subsection (h). Subsection (h) provides that the shareholders need not approve the merger if (1) the corporation will survive the merger, (2) its articles of incorporation will not be changed (except for the minor amendments permitted by section 10.05), (3) each shareholder of the corporation whose shares were outstanding immediately before the merger "will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the" merger, and (4) "the issuance in the merger of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f)." Here, Hand will not survive the merger, so its shareholders must approve the merger. This eliminates Answers B and C. Glove's shareholders must also approve the merger. While Glove will survive the merger, there will be no amendments to its articles as a result of the merger, and the currently outstanding shares of Glove stock will not change, Glove will need to issue 3 million new shares of Glove common stock to the soon-to-be-former shareholders of Hand. Thus, the number of shares of Glove common stock will increase from 6 million to 9 million, which is a 50% increase, far above the 20% limit set by MBCA § 11.04(h)(4) and MBCA § 6.21(f). (Note also that Glove is issuing these shares in exchange for something other than cash or cash equivalents. Glove will basically be getting Hand in exchange for these new shares.)

Question 6-27: The correct answer is A. Under MBCA § 13.02(a)(1), a shareholder has dissenters' rights with respect to a merger if the shareholder has the right to vote on the merger, "except that appraisal rights shall not be available to any shareholder ... with respect to shares ... that remain outstanding after ... the merger." However, subsection (b)(1) "takes away" a shareholder's dissenters' rights if his stock is publicly traded within the meaning of that section. Subsection (b)(3) would "restore" dissenters' rights that had been taken away by subsection (b)(1), but only if the Target shareholders would be receiving something *other than* cash or other publicly traded stock in the merger. In Merger 1, Target's shareholders have dissenters' rights because they have the right to vote on the merger and their shares are "going away" (that is, merged out of existence). Subsection (b)(1) does not take away Target's shareholders' dissenters' rights in Merger 1 because Target stock is not publicly traded. In Merger 2, however, Target stock is publicly traded, which means that subsection (b)(1) takes away its shareholders' dissenters' rights. Moreover, subsection (b)(3) does not "restore" their dissenters' rights in Merger 2 because they will be receiving cash. The same reasoning applies in Merger 4, with the result that Target's shareholders do not have dissenters' rights in Merger 4 either. In Merger 3, Target stock is publicly traded, which means that subsection (b)(1) takes away its shareholders' dissenters' rights; subsection (b)(3) does not "restore" their dissenters' rights because they will receive other publicly traded stock in Merger 3 (because Acquirer is publicly traded in Merger 3).

Question 6-28: The correct answer is A. As stated above, MBCA § 12.02 provides that even if an asset sale is outside the corporation's usual and regular course of business (as this sale would be), shareholder approval would *not* be necessary if the seller retains a "significant continuing business activity" following the sale. MBCA § 12.02 then sets forth a "25 and (25 or 25)" safe harbor, under which the seller would *conclusively* be deemed to have retained a significant continuing business activity. Here, following the sale of Seller's assets, Parent would retain 75% of its consolidated assets and 30% of its consolidated revenues, so it clearly meets the safe-harbor test. (The fact that it will only retain assets that generated 5% of its pre-tax income is not dispositive.) This makes Answer A correct. Answer B is incorrect because if you meet the safe-harbor test, you are *conclusively* deemed to have retained a significant continuing business activity; there is no need for Parent to "show" that it did. Answer C is incorrect because MBCA § 12.02 evaluates assets, revenues, and pre-tax income on a "consolidated" basis, meaning that it includes a parent corporation's subsidiaries. Answer D is obviously wrong for the reasons discussed above; focus on what is being *retained*, not what is being sold.

Question 6-29: The correct answer is D. As discussed in Chapter 8, a quorum at a shareholders' meeting consists of a majority of the shares entitled to vote, unless the articles provide a different number. See MBCA § 7.25(a). Here, a majority of 3,000 shares would be 1,501, so that eliminates Answers A and C. Next, if a bare minimum number of shares are present to have a quorum and no shares abstain from voting, we will need a majority of the 1,501 shares to vote to approve the transaction, which would be 751. See MBCA § 7.25(c).

Question 6-30: The correct answer is D. Answer A is incorrect because either the *surviving* corporation in a "short form" merger (that is, a parent-subsidiary merger under MBCA § 11.05) does not need shareholder approval. In fact, approval of the subsidiary's shareholders wouldn't be needed to merge the subsidiary into the parent. Answer B is incorrect because the mere fact that a corporation is *buying* assets does not require shareholder approval (unless the buying corporation would issue another 20% or more of its shares to the seller; see MBCA § 6.21(f)). The same logic applies to Answer C. As for Answer D, while MBCA § 10.05(4)(b) does allow the board to "increase the number of authorized shares of [a] class [of stock] to the extent necessary to permit the issuance of shares as a share dividend," other amendments to the articles to increase the number of authorized shares would require shareholder approval. See MBCA § 10.03(b).

Question 6-31: The correct answer is A. Remember that this question is asking which answer is wrong. Answer A is incorrect because a tender offer must be held open for at least twenty business days, regardless of how successful it is. The remaining answers are all correct under the SEC's tender offer rules, as discussed in Chapter 14. Note with respect to Answer D that the facts state that the tender offer only sought 51% of the shares. A tender offeror is not obligated to buy more shares than it was seeking to buy in the tender offer.

Question 6-32: The correct answer is B. Because Solar Corp. stock is publicly traded, whenever a person—or group—acquires more than 5% of its outstanding stock, the person or group must file a Schedule 13D with the SEC within ten days. Here, Coal Corp. and Mr. Lump are clearly acting as a group. Thus, the total shares held by each of them (400,000) should be considered as owned by the group. Because there are 10 million shares of Solar Corp. stock outstanding, this means if Mr. Lump and/or Coal Corp. acquire another 100,001 shares, they will own *more than* 5% of Solar Corp. and will be required to file a Schedule 13D.

Question 6-33: The correct answer is B. Option I is not legal because a tender offer must remain open for at least twenty business days (unless it is terminated without purchasing *any* shares). Thus, Answer A can be eliminated because it hasn't been 20 business days yet. As for Option II, it is now October 20. If a material amendment is made to the terms of the tender offer, then SEC Rule 14e-1(b) would require that the tender offer stay open for at least another ten business days. November 8 would be enough time. Option III would not work because the highest price paid in the tender offer to any shareholder must be paid to all shareholders. See SEC Rule 14d-10(a)(2).

Question 6-34: The correct answer is E. *Revlon* duties apply if the corporation agrees to a transaction that will result in a "change of control" or a "break-up" of the company. As discussed in the textbook, one of the primary cases discussing when *Revlon* duties apply is *Arnold v. Society for Savings Bancorp*, 650 A.2d 1270 (Del. 1994), in which the Delaware Supreme Court held that *Revlon* duties do not apply in a stock-for-stock merger (i.e., a merger in which the Target shareholders will receive shares of the acquirer's stock)—*if there is no change in control*, that is, if the merger won't result in a single entity (or group) controlling the surviving corporation. But if the surviving corporation's stock will be owned by a "fluid aggregation of unaffiliated stockholders" after the merger, then a change in control of the Target would not occur and *Revlon* duties would not apply. However, if the merger is a *cash merger*, then a change in control has occurred and *Revlon* duties apply. Here, Transaction I (which is a "cash merger") will result in a change of control of Page Corp.; after the transaction Book Corp. will control what remains of Page Corp. However, Transaction II will not result in a change of control of Page Corp. because no one will have "control" of the combined company after the merger. Transaction III will result in a change of control of Page Corp. because Mr. Ink will have "control" of the combined company after the merger.

Question 6-35: The correct answer is E. None of these actions would be legal. As for Option I, there are two problems. First, the tender offer must remain open for at least 20 business days, which would be Monday, August 29. Second, any material amendment to a tender offer requires that it remain open for at least 10 business days afterward. As for

Option II, SEC Rule 14d-10(a)(1) requires that the tender offer be open to all holders of the class of securities that is the subject of the tender offer (including Ms. Widget). Option III is not legal for the same reasons that Option I is not legal.

PART 7

Answer Key to Part 7:

7-1: B
7-2: D
7-3: C
7-4: B
7-5: C
7-6: C
7-7: A
7-8: A
7-9: D
7-10: C
7-11: D
7-12: C
7-13: D
7-14: E
7-15: C
7-16: C
7-17: A
7-18: C
7-19: B
7-20: D
7-21: D
7-22: D
7-23: D
7-24: B
7-25: B
7-26: A
7-27: C
7-28: A
7-29: D
7-30: D
7-31: C
7-32: A
7-33: D
7-34: A
7-35: A
7-36: C
7-37: A
7-38: A
7-39: D
7-40: B

Explanations:

Question 7-1: The correct answer is B. Answer A is wrong because this investment opportunity involves more than just land. Answer C is wrong because whether the transactions take place solely in one state is irrelevant to whether the transactions amount to a "security." Answer D is wrong because there is no indication in the facts that a limited partnership has actually been formed. (See Chapters 1 and 6.) Applying the *Howey* test to determine whether this transaction might be an "investment contract," we can see that the fourth element ("solely from the efforts of others") will fail because the investors will need to do a lot of work farming the land.

***Question 7-2*:** The correct answer is D. In other words, all of the prior three answers are correct reasons why an issuer might want to use Rule 504 instead of Rule 506. With respect to Answer A, note that Rule 506 has a limit of 35 non-accredited investors but Rule 504 has no limit on the number of investors (whether accredited or non-accredited). Similiary, Answers B and C are correct statements of differences between Rule 504 and Rule 506, in light of the 2017 and 2021 amendments to Rule 504 discussed in the textbook supplement.

Question 7-3: The correct answer is C. Answer A is wrong because you cannot offer securities to residents of more than one state under the intrastate exemption (Rule 147 is a "safe harbor" to Section 3(a)(11) of the Securities Act). Answer B is wrong because publicly traded companies are prohibited from using Rule 504. Note also that an unlimited amount of money may be raised in a Rule 506 offering; thus, Answer C is correct because it would be permissible to raise $20 million in this offering.

***Question 7-4*:** The correct answer is B. The issue here is whether the discretionary trading account is an "investment contract" (as no other type of "security" would seem to be present). Under the *Howey* test, an investment contract is an investment of money in a common enterprise with the expectation of profits solely from the efforts of others. Under the "vertical" formulation of the common-enterprise element, there must be a link between the fortunes of the investors and the promoter of the enterprise or a third party. The "horizontal" formulation of the common-enterprise element requires multiple investors who are similarly situated. Thus, Answer A would be incorrect here. Answer B is correct because all of the elements of *Howey* are met in this example. Answer C is wrong because the "family resemblance" test determines whether a "note" is a security. That test is irrelevant to whether something is an "investment contract."

***Question 7-5*:** The correct answer is C. Answers A and B are incorrect because *Ralston Purina* specifically rejected a numerical limit on the number of offerees (or, for that matter, purchasers) in a private offering under Section 4(a)(2) of the Securities Act, although the more offerees there are, the more likely it is that one or more of them will not be appropriately qualified. Answers D and E concern factors that were not considered important (or even discussed) by the *Ralston Purina* Court.

Question 7-6: The correct answer is C. Answer A is incorrect because it does not matter under the intrastate exemption of Section 3(a)(11) and Rule 147 where the company's *current* shareholders reside; what is important is whether the *offerees and purchasers* reside. Answer B is incorrect because there is no dollar limitation on offerings under the intrastate exemption of Section 3(a)(11) and Rule 147. Answer D is incorrect because any type of issuer may use Rule 506 (provided it doesn't run afoul of the "bad actor" disqualification provisions in subsection (d) of that rule).

Question 7-7: The correct answer is A. Under Section 4(a)(2), all offerees must be able to "fend for themselves" which has translated in case law as requiring a showing that they are either associated with the issuer or otherwise "sophisticated" in investing matters. Clearly, Mr. Lucky is not "sophisticated." However, the fact that he is a millionaire will suffice to make him an accredited investor for purpose of Regulation D and Rule 506 does not require a showing that accredited (as opposed to non-accredited) investors are sophisticated.

Question 7-8: The correct answer is A. Looking at the options that Corporation has, option I (Section 4(a)(2)) looks possible because the offering would be made only to "wealthy and financial sophisticated" persons. Option II (Section 3(a)(11)) is also possible because Corporation is incorporated in Michigan, clearly "does business" in Michigan, and could restrict the offering to Michigan residents. Option III (Rule 504) would also work because it has a $10 million limit in a twelve-month period (as Rule 504 was amended in 2021). Finally, option IV (Rule 506) would also work under these facts. Thus, Answer A is the correct answer.

Question 7-9: The correct answer is D. Changing the dollar amount to $12 million will eliminate Rule 504 as a possibility. However, Section 3(a)(11) remains viable, as does Rule 506. Thus, the correct answer is Answer D.

Question 7-10: The correct answer is C. Given that Cloning Corp. wants to raise $35 million, we can quickly eliminate option III (Rule 504), which has a $10 million limit. Option I (Section 3(a)(11)) seems viable, as Closing Corp. is incorporated in California, is "doing business" in California, and could restrict the offering to California residents. Section 4(a)(2) also seems viable, if all of the offerees are "sophisticated" businesspersons. Option IV (Rule 506) woud also work because there is no dollar limit in a Rule 506 offering and all of the offerees would likely either be accredited investors or "sohisticated" non-accredited investors. Thus, on these facts, Answer C is correct.

Question 7-11: The correct answer is D. Answer A is wrong because an immediate sale to *out-of-state* purchasers will ruin the intrastate exemption; the securities must "come to rest" before they may be resold outside the state. Answer B is true, as is Answer C, which makes Answer D the best answer. In Answer B, reselling to other in-state residents is permissible, even immediately after the offering. In Answer C, one year is sufficient for the securities to "come to rest" in the state.

Question 7-12: The correct answer is C. Answer A is incorrect because all offerees (not just purchasers) must be properly qualified under Section 4(a)(2). Answer B is incorrect because there is no specific numerical limit on the number of purchasers in a Section 4(a)(2) offering. Answer D is wrong because there is no dollar limit in a Section 4(a)(2) offering.

Question 7-13: The correct answer is D. Clearly, this was a very bad way to go about doing a stock offering! Answer A is incorrect because whether the investors received all of the information they *asked for* is irrelevant to whether there was a valid exemption from registration. Answer B is clearly incorrect—the company sent 1,000 letters to potential investors and the facts specifically state that none of these persons were sophisticated investors, as would be required under Section 4(a)(2). Answer C is clearly wrong. Under Rule 506 there is a limit of 35 non-accredited investors (but no limit on the number of accredited investors). None of the 100 investors were "wealthy" which likely means that none of them were accredited.

Question 7-14: The correct answer is E. Under the "family resemblance" test adopted by the Supreme Court in *Reves v. Ernst & Young*, notes (or at least those with a term of more than nine months) are presumed to be "securities." However, this presumption could be rebutted by (1) showing that the note at issue bears a strong resemblance (i.e., a "family resemblance") to other types of notes that have previously been found not to be "securities" or (2) creating a new class of notes that are not "securities." If the second option is used, the Court listed four factors to examine (the parties' motivations in entering into the transaction; the plan of distribution; the reasonable expectations of the investors; and whether there are other factors which reduce the risk of the investment). Here, option I is clearly wrong; if anything, a term longer than nine months makes it *more* likely that the note will be considered a security. Option II is incorrect because the *Reves* Court pointed out that if "the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" Whether the investors had a preexisting relationship with the issuer is irrelevant, which makes option III incorrect as well.

Question 7-15: The correct answer is C. As discussed in the textbook, Rule 147 is a safe harbor to the Section 3(a)(11) intrastate exemption. In other words, if you comply with Rule 147, then you definitely have a valid intrastate exemption, but compliance with Rule 147 is not the only way to have a valid intrastate exemption. Of course, because Restaurant is incorporated in Michigan, it would not be permitted to sell to any Florida residents under Rule 147, which means that it cannot comply with Rule 147 and that Answer C is correct. The other answers are incorrect for what should be obvious reasons, given the foregoing discussion. Also, note that Answer D is really a description of Section 4(a)(2) (the "private offering" exemption), not the intrastate exemption.

Question 7-16: The correct answer is C. Because SEI did not register its shares before engaging in this stock offering, it must rely on an exemption from the registration requirement. The facts of this problem closely resemble the facts of the *Ralston Purina* case in Chapter 15, which clearly means that SEI was engaged in a "public" offering and that Section 4(a)(2) is not a valid exemption for this offering. None of the exemptions in Regulation D will work either—Rule 504 will not work because SEI sold more than $10 million in a year, and Rule 506 will not work because it appears that SEI sold securities to more than 35 non-accredited investors. Answer D is incorrect because SEI stock is not an investment contract. (Although investment contracts *are* a type of security to which the Securities Act applies, *stock* is also a security.)

Question 7-17: The correct answer is A. Boiling down the facts, Jersey Fashion Corp. wants to sell $9.9 million of stock to (1) four multi-millionaires who would be considered accredited investors within the meaning of Regulation D and (2) nine non-accredited and "unsophisticated" investors. Rule 504 should work because $9.9 million is below the $10 million offering limit, and Rule 504 does not contain any restrictions on the wealth or "sophistication" of offerees and purchasers. Rule 506 won't work because it requires that each non-accredited investor must have "such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description." See Rule 506(b)(2)(ii). Similarly, Section 4(a)(2) requires that investors be "sophisticated" (able to "fend for themselves" in the language of the *Ralson-Purina* case).

Question 7-18: The correct answer is C. Arguably, the bad news from the FDA was no longer nonpublic information when Elvis sold his shares. Note how the bad news was already driving the price of the stock down. As such, one of the requirements of a potential Rule 10b-5 violation was missing (the other three requirements being material information, the purchase or sale of a security, and the use of jurisdictional means). However, Elvis's sale took place within six months after his purchase of shares, and the sales price was higher than the purchase price. Therefore, Section 16(b) would be applicable.

Question 7-19: The correct answer is B. Bill did not "tip" Tom because he was unaware that Tom was listening to him. Thus, even though Bill had a *Cady, Roberts* duty to Large Corp., he did not receive any sort of "personal benefit" when Tom heard him. However, in *Dirks* the Supreme Court stated that a gift of material nonpublic information to a friend or relative who trades on the basis of the information confers a personal benefit on the *tipper*. Here, Bill gave a gift of the information to Angie. Answer C is a red herring, as there is no indication that Bill was a "Section 16 person" with respect to Large Corp., or any information about his previous purchases and sales of Large Corp. stock. Answer D is wrong because one *can* violate Rule 10b-5 by being a tipper.

Question 7-20: The correct answer is D. Answer A is incorrect because there is nothing in the facts that indicates that Angie had a duty of trust and confidence to Bill for purposes of the misappropriation theory of insider trading; they are just friends. See Rule 10b5-2.

Answer B is incorrect because the facts do not indicate that Angie was an "insider" that owed *Cady, Roberts* duties to Large Corp. As for Answer C, it is true that Angie did *not* owe a duty of trust and confidence to Large Corp.; however, the facts indicate that she was a tippee. As discussed in the prior explanation, Bill was a tipper. Given the facts, it seems clear that Angie knew or should have known that she was receiving an improper tip. Given these two conditions, that makes Angie a tippee under the rule from the *Dirks* case.

Question 7-21: The correct answer is D. Tom was a bystander who overheard material nonpublic information from Bill. However, in the facts, Tom does not owe any duties to Bill or Large Corp. that would support a "classic" insider trading or a misappropriation theory argument; he is just a guy who happened to be at the same party as Bill. Thus, Tom did not violate Rule 10b-5 even though he traded a security on the basis of material nonpublic information.

Question 7-22: The correct answer is D. Answer A is wrong because a Schedule 13D would not be required until Nacho owned more than 5% of PCC's stock. Answer B is wrong because it is not a Rule 10b-5 violation to buy stock before launching a tender offer; Nacho's *own* intentions do not constitute material nonpublic information when *Nacho* is doing the buying. Answer C is wrong for similar reasons; Rule 14e-3 does not prohibit the *tender offeror* from buying stock in a target company before launching a tender offer for it (although it would prohibit other people who know about the upcoming tender offer from doing so, regardless of how they learned the information). Answer E is wrong because the SEC does in fact regulate many kinds of stock purchases that do not violate Rule 10b-5. In other words, Rule 10b-5 is not the only rule "in the book."

Question 7-23: The correct answer is D. Answer A is wrong because Carrie does not appear to have tipped Chuck. While she did tell him material nonpublic information, she did so because she was upset about possibly losing her job and does not appear to have intended that Chuck buy PCC stock. (Similarly, she told him that it was "top secret" information and that he couldn't tell anyone about it.) Answer B is wrong because Carrie did not trade on the basis of the information nor did she tip anyone (although it is true that she owed a duty of trust and confidence to PCC). Answer C is nonsensical; just because your spouse violated the law does not mean that you did.

Question 7-24: The correct answer is B. As discussed above, Chuck was not "tipped" by Carrie; therefore, Answer A is wrong. Answer C is wrong because one does not owe a *Cady, Roberts* duty to a company simply because one's spouse works there. Answer D is wrong because Chuck likely did misappropriate material nonpublic information from *Carrie*. Rule 10b5-2 provides in part that one owes a duty of trust or confidence for purposes of the misappropriation theory "[w]henever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling." Thus, Chuck has misappropriated information from Carrie unless he can:

> demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information. [Rule 10b5-2.]

Given Carrie's admonition that the information was "top secret," it seems unlikely Chuck can do this.

Question 7-25: The correct answer is B. Given his employment agreement, particularly the confidentiality clause, Cletus owed a duty of trust and confidence to Cleaning Crew. See Rule 10b5-2. He violated this duty by secretly using material nonpublic information that he learned from this source to purchase securities. He would not have been in a position to have learned the information were it not for his job with Cleaning Crew.

Question 7-26: The correct answer is A. First, because Y Corporation stock is traded on the Nasdaq Stock Market, it is registered pursuant to Section 12 of the Securities Exchange Act, which means that Section 16(b) applies. (In other words, Y Corporation is publicly traded.) As an officer of Y Corporation, Harold is subject to Section 16(b). Therefore, any "matched" purchases and sales that occur within six months of each other and that produce a profit will subject Harold to liability, regardless of his intent. (As stated in the textbook, it is completely irrelevant under Section 16(b) whether the person who was engaged in the securities trades possessed material nonpublic information at the time. Instead, Section 16(b) is largely "mechanical"; if a fact pattern runs afoul of its prohibitions, then there will be liability. There are virtually no defenses that may be asserted to a Section 16(b) lawsuit.) Thus, Harold must disgorge his $15,000 of profits in this fact pattern, which eliminates Answers B and C. However, because it does not appear that Harold was in possession of any material nonpublic information when he purchased and sold the Y Corporation shares, he did not violate Rule 10b-5. This eliminates Answer D.

Question 7-27: The correct answer is C. A Rule 10b-5 violation requires material information, nonpublic information, the purchase or sale of a security, and the use of "jurisdictional" means. The information here seems material (information that a reasonable investor would consider important, as described in *Texas Gulf Sulphur*) because the press release reported very favorable information (and led to a big jump in MSI's stock price). At the time of Don's purchase, the information was nonpublic. MSI stock is obviously a security. Finally, without going into any detail here, it would be virtually impossible for anyone to buy stock without using jurisdictional means. Thus, all of the prerequisites are met. There are three types of Rule 10b-5 insider trading violations: (1) "classic," (2) misappropriation, and (3) tipper-tippee. The first theory is where an "insider" (someone who owes *Cady, Roberts* duties to a company, i.e., a person who has access to information about that company only meant for its purposes), buys or sells securities of that company on the basis of material nonpublic information. Under the second theory, a person who owes a duty of trust and confidence (see Rule 10b5-2 for some examples) to the source of information secretly (i.e., without disclosing his intent) uses material, nonpublic information from that source to buy or sell any security (not necessarily securities of that source). Finally, a "tipper" is someone who owes *Cady, Roberts* to a company—or owes a duty of trust and confidence to a source under the misappropriation theory—and passes along material, nonpublic information to another person and gains a "personal benefit" (see *Dirks* for a discussion of what a "personal benefit" is) by doing so, assuming that the other person trades a security on the basis of that information. A "tippee" first requires a "tipper" and also that the tippee knew or should have known that he was receiving an improper tip.

Although Don was not an employee of MSI, a footnote to the *Dirks* case provides that

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

Here, Don was a lawyer, which obviously brings with it duties of confidentiality to clients. As such, he is likely a "temporary insider" of MSI which means that when he purchased MSI stock on the basis of this material, nonpublic information, he violated Rule 10b-5. Don could also be considered a misappropriator, because lawyers clearly owe a duty of trust and confidence to their clients and Don secretly used information that he learned from MSI to buy or sell a security.

Question 7-28: The correct answer is A. Fred does not owe any duties to Yellow Corp. or Mr. Yellow on these facts. Answer B is incorrect because the information was material. Answers C and D are wrong because Fred does not owe a duty of trust and confidence to either Yellow Corp. or Mr. Yellow. Fred is simply a spectator at a basketball game who got lucky.

Question 7-29: The correct answer is D. As the president of Yellow Corp., Mr. Yellow clearly owes fiduciary duties to Yellow Corp. He violated these duties by trading in Yellow Corp. stock on the basis of material nonpublic information. Under Delaware law, this would be considered a *Brophy* claim. As discussed in *Kahn v. Kohlberg Kravis*

Roberts & Co., L.P. beginning on page 772 of the textbook, to assert a *Brophy* claim, the plaintiff must show that: "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information." Even though *Brophy* claims would be brought as derivative lawsuits, *Kahn* held that actual harm to the corporation is not a required element of a *Brophy* claim. All of this makes Answer D the best answer.

Question 7-30: The correct answer is D. Although Mr. Orange does not owe *Cady, Roberts* duties to Yellow Corp. because he is not an "insider" of *Yellow Corp*., he does owe a duty of trust and confidence to *Orange Corp*. He thus violated Rule 10b-5 under the misappropriation theory because he used material nonpublic information that he learned from a source (Orange Corp.) to which he owed a duty of trust and confidence to purchase securities, and did not disclose his intentions to the source beforehand.

Question 7-31: The correct answer is C. Answer A is incorrect as the "insiders" who owe *Cady, Roberts* to a corporation for purposes of Rule 10b-5 can include more than just the officers and directors of a corporation. See footnote 14 of the *Dirks* case for other examples; see also page 751 of the textbook. Answer B seems plausible; after all, Quinn's employment agreement merely provided that he could not *disclose* the information, which he did not do. The *Cuban* case discussed on pages 752-753 of the textbook seems to lend some support to this argument, but note that the appellate court reversed that part of the lower court's opinion in *Cuban* (see the footnote on page 753) and that Rule 10b-2(b)(1) does provide that, for purposes of the misappropriation theory, "a 'duty of trust or confidence' exists in the following circumstances, among others: (1) Whenever a person agrees to maintain information in confidence; …." Answer D is factually correct, but irrelevant because the misappropriation theory focuses on whether you owe a duty of trust or confidence to the *source* of the information, not necessarily the company whose securities you trade. All of this makes Answer C the best answer; Quinn was a misappropriator because he owed a duty of trust and confidence to his employer's clients and secretly used information that he learned from Target (a client) to buy or sell a security.

Question 7-32: The correct answer is A. Before discussing why Joe is both a misappropriator and a tipper, let's make sure that all of the prerequisites would be met in this situation. A Rule 10b-5 violation requires: material information, nonpublic information, the purchase or sale of a security, and the use of "jurisdictional" means. The information that Joe has is material under the *Texas Gulf Sulphur* standard because the proposed tender offer price is 50% higher than the current market price of Target stock. The information was nonpublic because the tender offer had not been publicly announced at the time of Joe's purchase and Frank's purchase. Both Joe and Frank purchased a security (the Target stock). Finally, as discussed above, it is virtually impossible to buy stock without using jurisdictional means. Next, let's decide what type of insider trading this might be. It is important to note that Joe's firm's client is *Acquirer* but that Joe is considering buying *Target* stock. Because of this, this would not be an example of "classic" insider trading because, although Joe may owe *Cady, Roberts* duties to Acquirer as a "temporary insider" of Acquirer, no one bought *Acquirer* stock. However, as an attorney, Joe clearly owes a duty of trust and confidence to his firm and his firm's clients within the meaning of the misappropriation theory elucidated in the *O'Hagan* case and Rule 10b5-2. Thus, if Joe were (without disclosing his intentions to the source(s) to which he owes a duty of trust and confidence) to purchase *any* security on the basis of material, nonpublic information that he learned from these source(s), he would be violating Rule 10b-5 under the misappropriation theory. Further, as discussed on page 751 of the textbook, misappropriators can become tippers under the rules from the *Dirks* case (even though *Dirks* itself involved an alleged tipper who was a "classic" insider, as opposed to a misappropriator.) Thus, if Joe gets a "personal benefit" by making this tip, he would be a tipper. The Supreme Court in *Dirks* specifically said that making a gift of information to a friend or relative gives one a personal benefit. Thus, once Frank purchased Target stock, the requirements to show Joe's liability as a tipper were all present.

Question 7-33: The correct answer is D. As discussed on pages 760-762 of the textbook, Section 16(b) applies to securities that are registered under Section 12 of the Securities Exchange Act, that is, publicly traded securities. Here, Banana stock is listed on Nasdaq, so that requirement is met. Second, Section 16(b) only applies to the persons who are either officers, directors or ten-percent shareholders of such companies. (Technically, Section 16 applies to persons who own *more* than ten percent of the equity securities of a publicly traded company.) Here, Steve is the president of Banana, which makes him an officer of Banana. Third, Section 16(b) applies where one of these persons buys and then sells, or sells and then buys, the securities and the transactions are within six months of each other. If two transactions occur more than six months apart, they cannot be "matched" for purposes of Section 16(b). Here, Steve's trades occurred less than a month apart, so that requirement is met. Fourth, Section 16(b) only applies where two (or more) "matched" transactions (that is, transactions that occur within six months of each other) produce a "profit." Here, that requirement is met, because the $20 sale price was higher than the $18 purchase price. However, because he only bought 5,000 shares, we can only "match" that purchase with 5,000 shares that were sold. This results in a $10,000 profit that Steve must disgorge (5,000 shares multiplied by ($20 minus $18)). Answer A is incorrect because the temporal order of the transactions does not matter under Section 16(b). Answer B is incorrect because Steve doesn't have to be an officer, director, *and* 10% shareholder, he need only be *one* of these types of people for Section 16(b) to apply to him. Answers C and E are mathematically incorrect.

Question 7-34: The correct answer is A. The April 2016 sale cannot be "matched" with the September 2015 purchase because it was more than six months later. But we can match the November 2015 purchase with the April 2016 sale. The profit per share is $1 ($22 minus $21) and we can match 5,000 shares. Thus, the answer is $5,000.

Question 7-35: The correct answer is A. Note that because Mr. Crier is not an officer or director of Baby Food Corp., he may only be subject to Section 16(b) if he owns more than 10% of its outstanding stock. However, for a transaction to "match" for Section 16(b) purposes for someone who is only a shareholder, the person must have been a ten-percent shareholder immediately before the transaction. Thus, the July 1 purchase does not "count," because Mr. Crier did not own more than 10% of Baby Food Corp.'s stock immediately beforehand. However, the August 17 purchase counts, as does the September 30 sale and the October 31 sale. Because the sales price in both sales was the same ($22), it does not really matter which one we use to match with the August 17 purchase. Matching the August 17 purchase with the September 30 sale results in matching 50,000 shares at a $1 per-share profit, for a total recoverable profit of $50,000.

Question 7-36: The correct answer is C. Note that there is only one sale in this series of transactions (August 10). Because the January 23 purchase took place more than six months before this sale, we can ignore that purchase. Remember that Section 16(b) makes "any" profit recoverable; thus, if given a choice, we should choose the "match" that results in the greatest profit. Here, we should first match the August 10 sale with the December 10 purchase because that purchase price ($9) was lower than the May 3 purchase price ($11). From these transactions, 1,000 shares can be matched at a $5 per-share profit, for a liability of $5,000. However, we still have 1,000 shares "left over" from the August 10 sale to match with the May 3 purchase. From these transactions, 1,000 shares can be matched at a $3 per-share profit, for a liability of $3,000. Total liability is thus $8,000.

Question 7-37: The correct answer is A. Note that matching the April 13 purchase with the July 8 sale would produce a loss because the purchase price ($10) was higher than the sale price ($8). However, we can match the July 8 sale with the October 28 purchase. From these transactions, 1,000 shares can be matched at a $1 per-share profit, for total liability of $1,000.

Question 7-38: The correct answer is A. Note that because Mr. Dull is not an officer or director of Sharp Corp., he may only be subject to Section 16(b) if he owns more than 10% of its outstanding stock. However, for a transaction to "match" for Section 16(b) purposes for someone who is only a shareholder, the person must have been a ten-percent shareholder immediately before the transaction. Thus, the March 13 purchase, which put him *over* the 10% threshold, does not count. By contrast, the April 13 purchase and the August 7 sale can be matched. From these transactions, 2,000 shares can be matched at a $1 per-share profit, for total liability of $2,000.

Question 7-39: The correct answer is D. Note that the May 7 purchase cannot be matched with the December 3 sale because they are more than six months apart. Thus, we can only match the May 7 purchase with the October 10 sale. However, this results in a loss because the sales price ($15) was lower than the purchase price ($17). Hence, there was no "profit" that is recoverable under Section 16(b).

Question 7-40: The correct answer is B. If the purchases were made in February and the sales were made in October, they would be more than six months apart, and Mr. Slate would not have any liability under Section 16(b) for them. Answer A is incorrect because there are virtually no defenses to a claim that you violated Section 16(b). Answer C is incorrect because, as an officer of Quarry, Mr. Slate is subject to Section 16(b) when he buys and sells Quarry stock, regardless of how many shares he owns at the time. Finally, Answer D is incorrect because Section 16(b) (unlike Rule 10b-5) does not require that you were in possession of material nonpublic information at the time of the transactions.

PART 8

Answer Key to Part 8:

8-1: A
8-2: A
8-3: B
8-4: C
8-5: B
8-6: B
8-7: E
8-8: B
8-9: C
8-10: A
8-11: C
8-12: B
8-13: B
8-14: A
8-15: D
8-16: A
8-17: D
8-18: A
8-19: C
8-20: B
8-21: D
8-22: D
8-23: C

Explanations:

Question 8-1: The correct answer is A. Remember, the call of the question was "[w]hich of the following is not an accurate statement …." A close reading of the statute, which is set forth in the textbook, indicates that each of Answers B, C, and D is correct. Therefore, Answer A is the only answer that is not accurate.

Question 8-2: The correct answer is A. Note that RCC ended up with only 287 record holders of its common stock. Therefore, it will not be required to register its common stock under Section 12(g), which makes Answer C incorrect. Moreover, its stock is not listed on a national securities exchange, which makes Answer D incorrect. Section 15(d) provides in part that the "duty to file under this subsection shall also be automatically suspended as to any fiscal year, *other than the fiscal year within which such registration statement became effective*, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons." Thus, RCC can discontinue making Exchange Act filings with respect to years after 2016, which makes Answer B incorrect.

Question 8-3: The correct answer is B. This question should be self-explanatory given the discussion of Forms 10-Q in the textbook.

Question 8-4: The correct answer is C. Public companies are not *required* to solicit proxies (but if they do, they must comply with the proxy rules). A company that has a majority shareholder may not need to actually solicit proxies from shareholders, if the majority shareholder will attend the meeting in person. (But see Section 14(c).) Answer A is incorrect because the correct figures under Rule 14a-8 are $2,000, not $1,000 and one year, not six months. Answer B is clearly incorrect given the many cases that appear in the text that concern private litigation under Rule 14-9. Answer D is incorrect because the *Virginia Bankshares* case held that, under certain circumstances at least, statements of opinion can violate Rule 14a-9. See also the discussion of the *Omnicare* case beginning on page 832.

Question 8-5: The correct answer is B. Remember, the call of the question was "[w]hich of the following is <u>not</u> an accurate statement …." Nothing would prohibit exchanges from adopted rules that are "tougher" than SEC rules and in some cases they have done so.

Question 8-6: The correct answer is B. This is known as the "500 going up and 300 coming down" rule. See page 788 of the textbook. Answer A is incorrect because 300 is the floor for deregistering the class. Answer C is incorrect because, although some banking and insurance companies may be exempt from Section 12(g), pharmaceutical companies are not automatically exempt. Answer D is wrong because Section 12(g) does not "care" whether the securities are listed on a national securities exchange; instead, if they are so listed, the correct subsection of Section 12 would be subsection (b), not subsection (g).

Question 8-7: The correct answer is E. Unfortunately, from the perspective of shareholder "activists," none of Answers A, B, C, or D is correct under current law.

Question 8-8: The correct answer is B, as discussed in the text. Answer A is incorrect because SOX did not require *all* Section 12 companies to have an independent audit company; it merely required the SEC to pass a rule (Rule 10A-3) that prevents a national securities exchange from listing the securities of issuers that do not have independent audit committees. Answer C is incorrect; insiders may buy securities of the company and nothing in SOX prohibits them from doing so under all circumstances. Answer D is incorrect because SOX does not actually *require* a code of ethics; it merely directed the SEC to adopt rules requiring public companies to *disclose* whether they have a code of ethics for certain senior officers (and, if not, why they do not have such a code).

Question 8-9: The correct answer is C. Option I is correct, as discussed in the text, as is Option III. Option II is clearly wrong; being public doesn't somehow give a company better access to information about its competitors. Option IV is also wrong because market activity consists largely of *resales*, not issuances of securities by the company.

Question 8-10: The correct answer is A. Answer B is incorrect because the SEC has never, to my knowledge, pressured companies to de-stagger their boards; instead, as the text discusses, this pressure has come from shareholders. Answer C is incorrect because many majority systems would allow, in some circumstances, "defeated" directors to continue serving on the board, such as where the board refuses to accept a resignation, as discussed in the text. Finally, Answer D is incorrect because the "say on pay" vote is only an *advisory* vote by the shareholders, which means that it is not binding on the company.

Question 8-11: The correct answer is C. As discussed in the textbook, following the JOBS Act, issuers (other than banks and bank holding companies), must register a class of equity securities under Section 12(g) if the issuer has more than $10 million in assets, the issuer is engaged in interstate commerce, and the class of securities is held of record by either (1) 2,000 persons or (2) 500 persons who are not accredited investors (as defined by the SEC). Here, because Corporation had 600 record shareholders of its common stock and meets the other requirements of Section 12(g), it must register its common stock under Section 12(g) within 120 days after the end of 2016.

Question 8-12: The correct answer is B. This is a complex problem, so bear with me. First, Rule 14a-1(*l*) gives us the basic definition, providing in part that the terms "solicit" and "solicitation" include:

> (i) Any request for a proxy whether or not accompanied by or included in a form of proxy:
>
> (ii) Any request to execute or not to execute, or to revoke, a proxy; or
>
> (iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

Under this broad definition, Joe's request that Ted sign a proxy card would seem to be a "solicitation" of a proxy, particularly since Joe would be acting as the proxy. Rule 14a-1(*l*)(2)(iv), however, excludes some things from the definition of a "solicitation," including:

> A communication by a security holder *who does not otherwise engage in a proxy solicitation (other than a solicitation exempt under Rule 14a-2)* stating how the security holder intends to vote and the reasons therefor, provided that the communication:

> (A) Is made by means of speeches in public forums, press releases, published or broadcast opinions, statements, or advertisements appearing in a broadcast media, or newspaper, magazine or other bona fide publication disseminated on a regular basis,
>
> (B) Is directed to persons to whom the security holder owes a fiduciary duty in connection with the voting of securities of a registrant held by the security holder, or
>
> (C) Is made in response to unsolicited requests for additional information with respect to a prior communication by the security holder made pursuant to this paragraph (l)(2)(iv).

(Emphasis added.) While Joe does owe fiduciary duties to Ted as his guardian (see subsection (B)), he actually did ask Ted to sign a proxy. He went beyond saying how he intended to vote and his reasons. This would mean that Joe is engaged in a "solicitation." (Note that while Joe's solicitation of Ted's proxy would be exempt from *most* of the proxy rules under Rule 14a-2(b)(2) ("Any solicitations made otherwise than on behalf of the registrant where the total number of persons solicited is not more than ten")), it is still a "solicitation" within the meaning of Rule 14a-1(*l*). This means that Joe doesn't need to provide Ted with a Schedule 14A proxy statement, but would be liable under Rule 14a-9 if he made materially false or misleading statements to Ted in connection with the solicitation). As for the speech, however, Joe was simply stating how he intended to vote his shares. Further, because the communication was made publicly, it would seem to fit within Rule 14a-1(*l*)(2)(iv)(A) quoted above, and thus would not be a "solicitation."

Question 8-13: The correct answer is B. Answer A is incorrect because it is possible that the shareholders could have a valid cause of action under Rule 14a-9 with respect to the statement of the directors' opinion that the price was a fair price. As discussed in *Virginia Bankshares*, statements of opinion can give rise to Rule 14a-9 liability in some circumstances. Further, in the *Omnicare* case, the Court stated that:

> That still leaves some room for [Section] 11's false-statement provision to apply to expressions of opinion. As even Omnicare acknowledges, every such statement explicitly affirms one fact: that the speaker actually holds the stated belief. [Citations omitted.] For that reason, the CEO's statement about product quality ("I believe our TVs have the highest resolution available on the market") would be an untrue statement of fact—namely, the fact of her own belief—if she knew that her company's TVs only placed second. And so too the statement about legal compliance ("I believe our marketing practices are lawful") would falsely describe her own state of mind if she thought her company was breaking the law. In such cases, [Section] 11's first part would subject the issuer to liability (assuming the misrepresentation were material).

Thus, if the directors did not honestly believe that the price was a fair price, Rule 14a-9 liability would be possible. Answer C is factually incorrect; if the corporation did not receive a fair price, then the corporation was harmed, and the shareholders would have been indirectly harmed. Moreover, causation was present here; because shareholder approval ofthe sale was required under state law, the allegedly false and misleading proxy would have been an "essential link" in the transaction. As the Court stated in *Mills*: "Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the [Rule 14a-9] violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." Answer D is factually incorrect. For example, note that the plaintiff in *Virginia Bankshares* sued after the transaction had been completed.

Question 8-14: The correct answer is A. As discussed in the explanation for Question 8-13 above, causation is present if the proxy solicitation was an "essential link" to the completion of the transaction, that is, shareholder approval was required for the transaction to occur. But if shareholder approval was not needed, note in that *Virginia Bankshares* the Court held a Rule 14a-9 cause of action would generally not be available. However, the Court did say that: "This case does not, however, require us to decide whether §14(a) provides a cause of action for lost state remedies, since there is no indication in the law or facts before us that the proxy solicitation resulted in any such loss." In other words, *Virginia Bankshares* reserved the question of whether shareholders would have a valid Section 14(a) cause of action if they lost state-law remedies such as appraisal rights as a result of a misleading proxy statement. Although many lower federal courts have said that they would, there do not appear to have been any lost state-law remedies in this question. The shareholders did not have dissenters' rights that they waived by voting in favor of the sale on the basis of the allegedly false and misleading proxy statement. Moreover, if the shareholders truly believe that the board did a bad job in negotiating the price of the assets, they could sue the directors for a breach of the duty of care (see Chapter 9); the fact that the shareholders approved the sale would not insulate the directors from liability if the proxy statement *had* been materially false and misleading; as the Court stated in *Virginia Bankshares*:

> Assuming the soundness of respondents' characterization of the proxy statement as materially misleading, the very terms of the Virginia statute indicate that a favorable minority vote induced by the solicitation would not suffice to render the merger invulnerable to later attack on the ground of the conflict. The statute bars a shareholder from seeking to avoid a transaction tainted by a director's conflict if, *inter alia*, the minority shareholders ratified the transaction following disclosure of the material facts of the transaction and the conflict. Va. Code Ann. § 13.1-691(A)(2) (1989). Assuming that the material facts about the merger and Beddow's interests were not accurately disclosed, the minority votes were inadequate to ratify the merger under state law, and there was no loss of state remedy

> to connect the proxy solicitation with harm to minority shareholders irredressable under state law. Nor is there a claim here that the statement misled respondents into entertaining a false belief that they had no chance to upset the merger until the time for bringing suit had run out.

Because Answer A is correct, we can eliminate Answer B. Answers C and D are incorrect for the reasons discussed in the explanation of Question 8-13 above.

Question 8-15: The correct answer is D. Section 15(d) of the Securities Exchange Act provides in part that the "duty to file [periodic reports] under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class … to which the registration statement relates are held of record by less than 300 persons, or, in the case of bank or a bank holding company, … 1,200 persons." Because Corporation is still above 300 record shareholders, it is stuck continuing to comply with the periodic reporting requirements.

Question 8-16: The correct answer is A. Unfortunately for Joe, noting in the proxy rules requires the corporation to reimburse him for his expenses here.

Question 8-17: The correct answer is D. Answers A and B are incorrect because Rule 14a-8 requires the shareholder to have owned at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year. Stop the Violence meets these requirements. Answer C is incorrect because Stop the Violence's Proposal is phrased as a recommendation and, as stated in the note to Rule 14a-8(i)(1), "[i]n [the SEC's] experience, most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. Accordingly, [the SEC] will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise." Thus, SMC's best bet to exclude the Proposal would be to argue that it relates to SMC's ordinary business operations. Whether this argument would work is not entirely clear, however. In *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015), the court held that a *somewhat* similar proposal could be excluded by Wal-Mart under Rule 14a-8(i)(7). As the court stated, "[s]tripped to its essence, Trinity's proposal—although styled as promoting improved governance—goes to the heart of Wal-Mart's business: what it sells on its shelves. … [W]e hold that it is excludable under Rule 14a-8(i)(7) …." For the SEC's view of this case, see Securities and Exchange Commission Division of Corporation Finance, *Shareholder Proposals: Staff Legal Bulletin No. 14H (CF)*, Oct. 22, 2015, *available at* https://www.sec.gov/interps/legal/cfslb14h.htm.

Question 8-18: The correct answer is A. As discussed in the textbook, although there are many variations of the majority-voting theme that various public companies have adopted, in a "true majority" system the actual requirement to be elected as a director in an uncontested election is a majority vote by the shareholders. In contrast, a "plurality plus" system typically means that plurality voting is still used as the standard for election to the board, but such systems typically require directors who receive more "withhold" votes than "yes" votes to submit a resignation (which could then be rejected by the board). The textbook also notes:

> As the careful reader will have noticed, due to the board's ability to fill vacancies with persons it chooses, none of the systems described above always prevent a director who received more "against" or "withhold" votes than "for" votes from serving on the board. At this point, it seems unlikely that many companies will adopt a majority voting standard that would prohibit a candidate who does not receive majority shareholder support from serving on the board *in all cases*.

Answer A is correct for the reasons discussed above, and also because it correctly describes how plurality voting works, which you learned about in Chapter 8. Answer B is incorrect because "true majority" systems do not require that a director receive "for" votes from a majority of the *outstanding* shares to be elected to the board; instead, they typically require "for" votes from a majority of the shares *that vote*. The second sentence of Answer B also incorrectly describes "plurality plus" systems. Answer C is incorrect because, based on the discussion above, it is possible in *both* systems that a director who received more "withhold" votes than "for" votes could end up serving on the board. Answer D is incorrect because both types of systems have been adopted through board-approved bylaw amendments or other corporate policies that did not require shareholder approval.

Question 8-19: The correct answer is C. As discussed on page 796, Regulation FD provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain persons such as securities market professionals, it must make public disclosure of that information. The public disclosure must be made simultaneously if the information was intentionally disclosed to the enumerated persons; if the private disclosure was unintentional, the public disclosure must be made promptly. Here, the information seems material, and was disclosed to Wall Street analysts. While the facts are not clear whether this disclosure was intentional or unintentional (such as in response to an unexpected question), the best answer is Answer C. Answer A is clearly wrong, as waiting until the Form 10-Q is due on April 14 is far too long from when the disclosure occurred. Answer B is wrong because there is no such form as a Form 14A. (Although there is a Schedule 14A, that is for proxy statements, not current reports, which are made on Form 8-K.) Answer D is factually incorrect; this information is a pretty "big deal" and would likely be considered material under federal securities laws such as Regulation FD. It is also nonpublic (at least until the Form 8-K is filed, that is).

Question 8-20: The correct answer is B. As discussed in the textbook, following the JOBS Act, issuers (other than banks and bank holding companies), must register a class of equity securities under Section 12(g) if the issuer has more than $10 million in assets, the issuer is engaged in interstate commerce, and the class of securities is held of record by either (1) 2,000 persons or (2) 500 persons who are not accredited investors (as defined by the SEC). Here, Corporation does not have either 2,000 record shareholders of its common stock or 500 non-accredited record holders. Thus, it isn't currently required to register under Section 12(g), which makes Answer B the best answer. Answer A is incorrect because it is not relevant under Section 12(g) whether the securities are listed on a national securities exchange; instead, that is a matter for Section 12(b). Answers C and D are incorrect for the reasons discussed above.

Question 8-21: The correct answer is D. As explained in the textbook, there are three types of filers in terms of deadlines for when their Forms 10-K and 10-Q are due: (1) large accelerated filers (those whose securities have a market value of $700 million or more, excluding shares held by certain affiliates, and have been subject to the Securities Exchange Act's reporting requirements for at least one year); (2) accelerated filers (these typically have a market value of $75 million or more, calculated in the same manner, and have also been reporting companies for at least one year); and (3) non-accelerated filers. Large accelerated filers have only 60 days in which to file Forms 10-K; accelerated filers have 75 days to file Forms 10-K; and non-accelerated filers have 90 days to file their Forms 10-K. Here, Corporation A is a large accelerated filer, which means its Form 10-K will be due within 60 days after the end of the year, or March 1. Corporation B is a non-accelerated filer, which means its Form 10-K will be due within 90 days after the end of the year, or March 31.

Question 8-22: The correct answer is D. None of Answers A, B, or C are correct, for the reasons discussed on pages 799-801 of the textbook.

Question 8-23: The correct answer is C. One of the requirements of Rule 14a-4 is that, with respect to matters other than the election of directors, the proxy card must provide a means whereby the shareholder "is afforded an opportunity to specify by boxes a choice between approval or disapproval of, or abstention". Answer A is incorrect because nothing in Rule 14a-4 prohibits the proxy card from stating the board's recommendation. Answer B is incorrect because most companies elect directors through plurality voting; in such a system, a shareholder's choices for each candidate are either "for" or "withhold." Answer D is incorrect because Answer C was correct.

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