

**FEBRUARY 1997 CALIFORNIA BAR EXAMINATION  
ESSAY QUESTIONS AND SELECTED ANSWERS**

*Corporations*

**QUESTION**

Graphic, Inc. (Graphic), is a California corporation that sells office copying equipment. Its Articles of Incorporation prohibit Graphic's sale of paper products. Graphic's common stock is registered for trading on a stock exchange. Frank, Graphic's president, recently signed a contract with Papco on behalf of Graphic to buy a paper mill owned by Papco. Frank intends to reveal the contract for the first time at a Board of Directors meeting next week.

Frank recently received a letter from Alice, who owns 9.2% of Graphic's common stock. Alice has asked to "look at a list of Graphic's shareholders and all contracts signed by Graphic in the past three months." Frank directed the corporate secretary to write to Alice denying her request, which was done.

Graphic's accountants advised Frank that Graphic will report a \$5 million loss for its current fiscal year, which will be the only loss in its twenty year history. Frank then sold 100,000 shares of his Graphic common stock through his broker for \$25 per share. The sale included 20,000 shares he had purchased two months ago by exercising a stock option at \$22 per share.

Frank called a press conference at which he stated that "Graphic has signed a major contract and will have other news to announce after its Board of Directors meeting." Alice heard about the press conference and purchased 5,000 additional shares of Graphic common stock at \$28 per share through her broker. When the news of Graphic's fiscal year loss became public, the price of Graphic stock declined to \$20 per share.

Alice wishes (1) to compel Graphic to make available for her inspection the shareholders' list and all contracts signed in the last three months, (2) to recover her loss on her recent stock purchase, (3) to force Frank to disgorge the profits on his stock sale, (4) and to have the Papco contract declared invalid.

What are Alice's rights and remedies, if any, with regard to (1) through (4) above?  
Discuss.

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**ANSWER A**

1. Whether Alice can compel Graphic to make available for her inspection the shareholders' list and all contracts signed in the last three months.

Generally, a shareholder has a right to examine corporate shareholder voting lists and general corporate information, so long as it is for a proper purpose and the inspection request is in writing, and the inspection will be in a reasonable place such as in the corporate headquarters. In this case, Alice wants to look at a list of shareholders and see all contracts Graphic signed in the last three months.

Alice should probably be allowed to look at the Graphic voting list. Alice wrote to the Graphic corporation regarding her request to look at the voting list; the facts do not indicate what her purpose for inspecting the voting list would be, but so long as it is for something proper a court will enforce this right, such as if she is soliciting proxy voting rights or some activity relating to the benefit of the corporation. Traditionally, some corporate laws required that a shareholder have at least a 5% interest in the corporation for the right to inspect voting lists, but the modern trends do not require a certain percent, just merely that the request is by a shareholder. Therefore, because Alice is a shareholder and if she is making a proper request to see the voting list, a court will require Graphic to let Alice, the shareholder, inspect the voting list.

Alice, however, will probably not get to inspect every Graphic contract signed in the last three months. This is not a reasonable right of shareholders to scrutinize the job of officers or directors. Hence, Alice cannot force the officers to report directly to her by forwarding all contracts they have entered into on behalf of Graphic for the purpose of satisfying a particular shareholders wishes. Officers answer to the directors, and directors to shareholders. As a result, Alice cannot get to look at all the contracts from the last three months, and this was probably properly denied by Frank.

2. Is Alice entitled to recover her loss on her recent stock purchase?

The federal act governing fraud in securities, section 10b5 may allow Alice to recover her loss if she can establish that her buying was a result of a material misstatement or omission by Frank at the news conference. A 10b5 action requires a plaintiff to have actually bought or sold stock in reliance on a party's material misstatement or omission. Here, Alice did purchase 5,000 shares of Graphic in response to Frank's major news; and the facts indicate "Alice heard about the press conference and purchased..." thus demonstrating the reliance factor necessary for a 10b5 action.

Another requirement for a 10b5 action is that there be some use of an interstate instrumentality to perpetuate the fraud. In this case, Frank's news conference which was assumingly broadcast out to possibly viewers in other states or FCC controlled instrumentalities would be sufficient to constitute an interstate factor to satisfy this requirement.

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On the other hand, Frank would argue that his statements at the news conference do not qualify as a material misstatement or omission subjecting him to liability under 10b5. Frank would assert that he merely indicated that he had signed the Papco contract and that he would be announcing other news later. This would most likely be the news of the Graphic report by the accountant's \$5 million loss for its current fiscal year.

Alice would probably prevail in showing that this "other news to announce" is a material omission; because the major loss is the first in the corporation's 20 years, and Frank sold 100,000 shares of his stock - indicating his loss of confidence in Graphic's value. Hence, Alice would point out the fact of Frank's selling and withholding material information he acted upon as constituting a material omission.

Therefore, Alice would most likely be entitled to recover in a 10b5 suit. Frank would be liable for his fraud to her and would repurchase her 5,000 shares at her purchase price of \$28. Thus, restoring her to her prepurchase position. Although she may elect to recover the damages of the lost value for the stock of \$8 price per share.

Also, Alice may be able to bring a common law action for fraud by Frank, a corporate officer, since she was in privity with him, and he had a fiduciary duty to shareholders. This would basically be the same as the above action except it does not require the federal instrumentality for the interstate commerce connection. The common law stock fraud action, however, does require the privity issue, and in this instance, because Alice was a Graphic holder already, she would fulfill the privity requirement with Frank, an officer of Graphic.

3. Whether Alice can force Frank to disgorge the profits on his stock sale.

Directors, officers, and 10% shareholders of corporations that are registered for trading on a stock exchange are subject to a short swing regulation of federal law under section 16(b) of the SEC act. Rule 16b is a strict liability type regulation that forces a director, officer, or 10% shareholder to disgorge profits from buying and selling stock within a six month period. This rule is strictly construed to apply so even if the sale came first and then the subsequent buy is within six months from the sale and the buy is at a lower rate the director, officer, or holder (10% previous to the buy) will be liable and have to return the difference between the sale price and the lower buy price.

The facts here indicate that Frank, an officer of the corporation purchased 20,000 shares within six months of the sale of his stock, so the short swing of buying and selling the 20,000 will make Frank liable to the corporation for the difference in the purchase and sale price. Frank bought at \$22 a share multiplied by the 20,000 and, then sold for \$25 a share; so the profit was \$3 a share multiplied by 20,000 shares yielding a total of \$60,000 profit Frank took from his short swing, 16b trading that he must disgorge to the corporation.

4. Whether Alice can have the Papco contract declared invalid.

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If a director or officer is acting contrary to a corporation's interest or objectives, a shareholder may bring suit to remedy the injury situation to the corporation. A shareholder can bring a derivative suit to enjoin a corporation from performing an ultra vires act. There are four requirements for bringing a derivative suit: the party must have owned stock at the time the cause of action arose on through the time of the suit; the shareholder must make a demand that the directors take action to remedy the activity injuring the corporation, unless that demand on the board would be futile or if after the demand on the board of directors, the board still refuses to bring the action, and the board is not just exercising a good faith business judgment in refusing to take action, then the holder may proceed with the derivative action. Also, the holder may be required to post a bond for any possible adverse consequences to the corporation from the derivative action, and the holder may be required to have the other holders vote to ratify or reject the action of the directors.

In this case, Graphic's Articles of Incorporation prohibit Graphic's sale of paper products. An ultra vires act is committed when Graphic directors or officers act outside of the Articles of Incorporation in doing business prohibited by the scope and purpose of the corporation and their authority. At common law an ultra vires act was void, but now it is voidable. If the corporation adopts or ratifies the ultra vires act then the corporation must perform the transaction, otherwise it is voidable, and they can avoid their obligation. If the corporation wants to amend its articles then the holders must do it by a majority vote and the directors cannot unilaterally modify the articles.

Alice would argue that Frank's entering the contract with Papco is contrary to the articles of the corporation and would be ultra vires because Papco is a paper company and Graphic is prohibited from selling paper products; thus, Frank should not have authority to enter Graphic into this transaction.

On the other hand, Frank would argue that Graphic's buying a mill does not constitute "the sale of paper products." Frank would claim that his contract for the mill is not ultra vires because Graphic may not "sell" paper products.

However, this argument will probably not succeed because a mill primarily produces paper for sale and profit. Hence, if the directors do not take action to set aside this contract, then Alice can bring derivative action on behalf of the corporation to set aside the contract as it is voidable on account of the ultra vires nature of the transaction. Additionally, Frank the officer that entered into this ultra vires action would be liable personally.

In conclusion, Alice will probably prevail in having the Papco contract declared invalid.

**ANSWER B**

1. Shareholder Inspection Rights – Shareholder's List & Contracts

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A shareholder of a corporation has a right to inspect the books and records of the corporation, provided the shareholder makes a written request for a proper purpose in its shareholder capacity. A proper purpose includes preparation for litigation. The shareholder can be a holder of even one share of stock.

Alice, a 9.2% holder of Graphic's common stock, has asked to look at Graphic's shareholder list and all contracts signed by Graphic in the past three months. Alice is entitled to review the shareholders' list, provided she gives a proper purpose. The facts do not indicate whether she has stated a purpose. However, Frank improperly denied such request.

With respect to the contracts, Alice probably has a right to inspect the contracts which are inserted in Graphic's minute book as attachments to Board and shareholder resolutions. Such contracts would probably be extraordinary contracts, outside of the ordinary course of business. However, Alice has requested to see all contracts. This probably is too broad. Shareholders cannot manage the corporation. Thus, Alice's right to inspect is probably limited to extraordinary contracts. Those outside of such scope were properly denied review by Frank because Alice's purpose was improper (shareholder management).

With respect to the improper denial to inspect the shareholder's list and contracts contained in Graphic's minute book, Alice can seek relief from the court. Under a court order, Alice or her representative may review such documents during reasonable business hours, as well as make or receive copies of such records.

The only way that Frank/Graphic can prevent such inspection is to argue that Alice seeks to inspect the documents for an improper purpose, such as for the benefit of an outside third party.

2. Recovery of Alice's Loss on her Recent Stock Purchase

In her capacity as a shareholder, Alice can sue Frank directly for breach of fiduciary duty and on the theory of 10b-5 liability (under federal and state law).

10b-5

A buyer or seller of publicly traded stock may recover losses incurred in connection with such purchase or sale where such loss results from a public misrepresentation.

Under 10b-5 of the Federal Securities Act of 1933 (and similar state law claims), Alice must prove the following:

Instrumentalities of In Interstate Commerce

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Here, the stock of Graphics is traded on a stock exchange. Also, Frank's statement was released probably by use of media. Thus, the fraud used instrumentalities of interstate commerce.

Possible Defendants

Alice may sue Frank, an insider of Graphics due to his service as president, and Graphics.

Possible Plaintiffs

Although the SEC may institute proceedings against Frank and Graphics, 10b-5 also permits private buyers and sellers to seek a private cause of action. Thus Alice is a proper plaintiff.

Bad Act

Frank holds a fiduciary relationship to the corporation as a result of his serving as president. When Frank made the public statement regarding Graphics major contract, he failed to disclose the fact that the company would also be posting a 85 million loss. The failure to disclose this material fact created the impression that Graphics was having a strong fiscal year. As a fiduciary to the corporation, Frank had a duty to disclose such information to prevent the public misrepresentation.

Scienter

Frank's misrepresentation to the public was done with the knowledge or reckless disregard that failure to disclose all of the material facts would mislead the public.

Of a Material Fact - Reasonable Investor

A reasonable investor probably would find that the \$5 million loss for Graphic's current fiscal year was a material fact. Failure to disclose such information created the impression that Graphics was financially successful and profitable in the current fiscal year.

Intent to Induce

Frank gave the press conference most likely with the intent to induce confidence in the company's operations.

In Connection with the Sale or Purchase of Equity

Alice bought her common stock

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Reliance

Reliance by Alice on Frank's press conference will be presumed because this case involves a public misrepresentation.

Damages

Alice may recover her lost profits of \$40,000 (8 x 5,000).

Fiduciary Duty

Alice might also be able to recover damages from Frank for his breach of fiduciary duty. Frank improperly refused Alice's request. She may have been able to avoid her loss if she had inspected the books.

3. Disgorge Frank's Profits - Section 16(b) and Breach of Duty of Loyalty and Care  
a. 16(b)

Under section 16(b), an insider must disgorge profits made on short-swing sales/purchases within six months. Frank's intent is irrelevant.

Recording Company

Graphics is probably a recording company under the Securities Exchange Act of 1934. Its stock is registered for trading on a stock exchange.

Insiders

As an officer of the corporation, Frank is an insider. To be liable, he must have been an officer at either the purchase or sale of the stock. The facts show that he was an officer when he sold the 100,000 shares of stock for \$25 per share. 20,000 of the shares were purchased two months ago for \$22/share.

Of an Equity Security

Frank sold his common stock.

Purchase and Sale within Six Months

20,000 shares were bought and sold within a two month period.

Disgorge Profits

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Thus, Frank must disgorge \$40,000 of the profits.

b.     10b-5

Alice may notify the SEC to pursue a 10b-5 claim against Frank for selling his shares without disclosing material inside information. Since Alice did not buy Frank's shares, she might not have a private cause of action. Assuming she can prove that she bought or sold securities during the time Frank sold his shares, or if the SEC seeks to pursue against Frank, Frank will be liable because (1) he used instrumentalities of interstate commerce (stock exchange), (2) he is an insider, (3) he failed to abstain from trading or disclose material information when he sold his stock, (4) he did so knowingly, (5) with the intent to induce, (6) reliance, and (7) caused damage/loss.

c.     Derivative Suit

Alice might pursue an action on behalf of the company for Frank's breach of duty of care and loyalty. Alice has standing because she owned common stock when the wrongdoing occurred and assuming she holds the stock through litigation. Alice must make a written demand on the corporation.

Breach of Duty of Care

An officer owes the company of due care. He must act as a reasonable person would with respect to his own affairs. Frank breached this when he used inside information and sold the stock.

Duty of Loyalty

Frank owes a duty of loyalty to Graphics. He must act as he reasonably believes is in the company's best interest. He probably breached this when he sold the stock prior to public disclosure of the company's loss.

4.     Papco Contract Invalid - Ultra Vires

The Articles of Incorporation expressly prohibit sale of paper products. The purchase contract is in direct conflict with this express limitation. This action would be ultra vires. The corporation is an entity created by law. It cannot exceed the authority created by law or its articles. Thus, the contract should be invalidated. The only defense would be if Papco relied on the contract to its detriment.