Sample Exam 1
Corporation Finance Law

1. A share of preferred stock is convertible into common at a 1:1 rate. The conversion right is equivalent to: (5 minutes)
   A) A call option with a strike price equal to the market price of the preferred stock
   B) A put option with respect to the preferred stock at its market price
   C) Both A and B
   D) None of the above

   A describes it pretty well from the common stock side. B describes it pretty well from the preferred stock side. C is the best answer.

2. A “poison pill” with a “flip-in” feature is effective because it has what sort of effect? (5 minutes)
   A) Convertible
   B) Dilutive
   C) Derivative
   D) Disciplining

   B. It permits the purchase of significant numbers of new outstanding shares at less than market price, which will dilute any shares that don’t have such rights.

3. Karma Corporation has issued convertible bonds at $1000 each. The bonds are convertible into 100 shares of Karma common shares, and are callable by the corporation at $1150 each. If interest rates have not changed since issuance, and the price of Karma common stock is $11, what should be the value of a Karma Corporation bond? (5 minutes)
   A) $1000
   B) $1100
   C) $1150
   D) Some other number

   In general, a convertible bond (or debenture) with a call price has a “floor” value of its conversion value and a “ceiling” value of its call price. The price of the bond when issued was $1000, but now the “floor” has risen to $1100, but we have not reached the $1150 “ceiling.” B is the best answer.

4. One reason that Modigliani & Miller’s “dividend irrelevance” theorem is open to challenge is: (5 minutes)
   A) Arbitrage will prevent profiting from dividend transactions
   B) The tax rate on dividends and capital gains is usually identical
   C) Dividend policy affects company policy
   D) A rational investor will not pay directors to do what she could do herself

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1 Various of these exam questions were originally given in (very) modified form by Professors Campbell and Michael, among others. These answers and comments are mine alone and should not be viewed as relevant to their classes or to their exams in general.
A, B and D are all arguments which support the theorem. C is an important challenge and is the correct answer.

5. Briefly explain what the “omnipresent specter” is when boards implement and/or maintain takeover protections. (5 minutes)

The “omnipresent specter” is that boards will be implementing takeover protections not to protect the company’s shareholders’ best interests but rather to preserve their own privileges and positions with the company.

6. Please complete this sentence: When interest rates go up, existing bond prices go _____, because ______. (5 minutes)

Down because bonds with comparable risk profiles will now pay higher interest than the existing bonds; therefore for existing bonds to have the same effective yield (and thus to be desirable to investors), their purchase price will have to go down.

Please consider the following financial information and then answer the question below:
Continental Corporation, incorporated in Delaware, is a local manufacturer with a current share price of $50. This is the company’s most recent balance sheet.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 600,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>200,000</td>
</tr>
<tr>
<td>Fixed assets, net of depreciation of $50,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Intangible assets, net of amortization of $100,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Total</td>
<td>$ 1,500,000</td>
</tr>
</tbody>
</table>

| Accounts payable                            | $ 100,000              |
| Current portion of long-term debt           | 200,000                |
| Remaining portion of long-term debt         | 700,000                |
| Common stock, $1 par value, 100,000 shares authorized, 50,000 shares outstanding | 50,000 |
| Contributed capital in excess of par        | 200,000                |
| Retained earnings                           | 250,000                |
| Total                                       | $ 1,500,000            |

Other financial information:

Income (after allowance for depreciation and interest charges) for the last 5 years has been as follows:

- 2012 ............... $ 50,000
- 2013 ............... 100,000
- 2014 ............... 275,000
- 2015 ............... 140,000
- 2016 ............... 330,000

7. What is the market capitalization of the company? (5 minutes)

This is essentially a trick question. The market capitalization is simply the current share price ($50) times the outstanding shares (50,000); in other words, the market capitalization is $2,500,000.
8. Why are “takeover defenses” permitted at all? Why not just let shareholders vote on whether they want to take whatever cash is being offered to them, for instance in a tender offer (particularly since federal law has already intervened to make tender offers less coercive and more “fair” in various respects)? (10 minutes)

There are lots of potential answers to this. Since I gave only “10 minutes,” that is an indication that the answer does not need to be overwhelmingly detailed.

One conventional reason is that the board might have better information than either the market, the shareholders, or the would-be acquirer as to what the company is really worth. For instance, the board might be aware of a huge new mineral discovery or invention, which hasn't been publicly announced. Without takeover strategies, the 20 days that a tender offer has to be open under federal law might not be long enough to reveal the important details.

More commonly, the board simply has a different—and in its view better—long-term vision for the company, which it believes will raise the shareholder value beyond what the offeror is currently offering. Also commonly, the takeover defenses simply let the board have room to negotiate an offer higher before the vote goes forward, since, very often, the vote does indeed turn out in favor of the merger.

Another point you might raise: Even with the tender offer protections of federal law, if a takeover initiator tenders for less than all offered shares (meaning they have a ceiling for a number of shares they want or amount of consideration they will pay), the remaining shareholders (who may have tried to tender but not ended up being allowed to, because of the limits of the offer), may be significantly worse off, e.g., in an LBO situation where the surviving company is more leveraged than before. Thus there can be “lottery” effects that the target’s board might be trying to prevent. (This is a fine answer to this question, although for various reasons beyond the scope of this course, it's not actually that common.)

There are some slightly more controversial reasons, which include that highly leveraged takeover initiators may speedily extract short-term gain without regard to any damage they may inflict on the reputation of the target company, the employees of the target company, or the community in which the target company operates. Not all boards may think of such factors, or be willing to admit that they have, but it can be a factor.

9. Lubben makes a deposit of $60,000 into a high yield savings account. The deposit is to earn interest at the rate of 12% per annum compounded monthly for 2 years. How much will Lubben have in the account at the end of 2 years? How much less would she earn if interest were compounded only annually? (15 minutes)

Step One: Determine the future value of $60,000 in 2 years at an 12% annual rate of return, compounded monthly:

\[ FV = C_0(1 + r)^t \]
\[ = 60,000*(1+.01)^{24} \]
\[ = 76,184.08 \]

Step Two: Determine the future value of $60,000 in 2 years at an 12% annual rate of return, compounded annually:

\[ FV = C_0(1 + r)^t \]
\[=60,000 \times (1 + 0.12)^2\]
\[=75,264\]

**Step Three: Subtract the answer in Step Two from the answer in Step One:**
\[=920.08\]

This question explores the mathematical difference between annual compounding and quarterly compounding.

In step one, the student must calculate the future value of $60,000 in 2 years at a 12% annual rate of return, compounded quarterly. The annual interest rate is 12%, but we are compounding monthly, so we divide that by 12 and get 1%. The number of time periods “t” is now 24 (2 years divided into months). Based on the calculations in step one above, the future value of $60,000 in 2 years at a 12% annual rate of return, compounded monthly, is $76,184.08. In step two, the student must calculate the future value of $60,000 in 2 years at a 12% annual rate of return, compounded annually. Thus, the interest rate “r” is 12%. The number of years “t” is 2. Based on the calculations in step two above, the future value of $60,000 in 2 years at a 12% annual rate of return, compounded annually, is $75,264. Step three requires the student to subtract the amount determined using annual compounding in Step Two ($75,264) from the amount determined using quarterly compounding in Step One ($76,184.08), which equals $920.08.

10. Please consider the following clauses from a hypothetical shareholder rights plan:

   "**Acquiring Person**" shall mean any person who is or becomes the beneficial owner of 15% or more of the outstanding shares of common stock at any time.

   "**Flip-in Date**" shall mean the Stock Acquisition Date or such later date and time as the Board of Directors may from time to time fix by resolution adopted prior to the Flip-in Date that would otherwise have occurred.

   "**Stock Acquisition Date**" shall mean the earlier of (i) the first date on which there shall be a public announcement by the Company (by any means) that a person has become an Acquiring Person, which announcement makes express reference to such status as an Acquiring Person pursuant to this Agreement, or (ii) the date on which any person becomes the beneficial owner of more than 30% of the outstanding shares of common stock.

   In the event that a Flip-in Date shall occur, each Right shall constitute the right to purchase from the Company, upon exercise thereof in accordance with the terms hereof, that number of shares of common stock having an aggregate Market Price on the Stock Acquisition Date that gave rise to the Flip-in Date equal to three times the Exercise Price for an amount in cash equal to the Exercise Price, paid within 90 days of the Flip-In Date.

   (b) Notwithstanding the foregoing, any Rights that are beneficially owned on the Stock Acquisition Date by an Acquiring Person or an Affiliate thereof shall become null and void.
Evil Raider, Inc. acquires 31% of the outstanding shares of Common Stock on January 4, 2017. The Market Price of each share of Common Stock is $300 on that date. The Exercise Price is $9000. The Board of Directors has not made any relevant resolutions. It is now January 14.

Your client (who, incidentally, was in your office in the first place because they are currently going through some financial trouble and considering bankruptcy) has a Right within the meaning of this contract, and was not an Acquiring Person or an Affiliate thereof on the Stock Acquisition Date.

What (if anything) does your client have the right to do, and do you advise them to do it? Please be as specific as possible. (20 minutes)

Your client has a right to acquire, upon payment of $9,000, shares having a value equal to $27,000 as of January 4, 2014—in other words, 90 shares (27,000/300). She should definitely take this deal (if for no other reason than she will be extremely diluted if she doesn’t).

The problem suggests that she might not have the cash to take advantage of this purchase right. This problem shouldn’t be hard to surmount. Immediately upon the occurrence of the Flip-In Date, her Right will have become very valuable, and she should be able to either finance the $9,000 investment, or simply sell her right for a significant profit.

11. Marty Sloane and Amanda Host are both name partners in the August firm of Sloane, Host and McCoy. Because today is your first day as an associate at the firm, they thought it would be a nice gesture to take you out for a few drinks after work. Marty is a trusts and estates lawyer, while Amanda is an environmental lawyer. You are the firm’s first corporate associate, and will be working for Stephen McCoy, a prominent corporate lawyer and name partner in the firm. Stephen was unable to join you for drinks because he spent all of the preceding night working through draft after draft after draft of deal documents.

Marty and Amanda get into a heated debate about the rights of preferred stockholders. Marty, on the one hand, thinks preferred stockholders are the same as bondholders, and thus a corporation’s board of directors owes them no fiduciary duties. Amanda, on the other hand, believes that a board of directors owes the preferred stockholders the exact same fiduciary duties as are owed to common stockholders. Since you’re the “expert,” they ask you to settle the debate. With your embryonic career hanging in the balance, and both Marty and Amanda starting to slur their words, you better be diplomatic about your answer. (25 minutes)

They are both correct to a certain degree. Under the Jedwab decision, the Delaware court noted that a preferred stockholder’s “preferential” rights, such as her dividend and liquidation preference over common stockholders, are contractual in nature. Thus, with respect to preferential rights, a preferred stockholder is, indeed, like a bondholder—she only receives the rights to which she contractually agreed, no more, no less. However, a preferred stockholder also has extra-contractual rights that she shares with the common stockholders. The court held that a corporation’s board of directors does owe fiduciary obligations to a preferred stockholder with respect to those extra-contractual rights.
12. Please pick one case from the course where, in your view, the court *incorrectly* applied the current governing law with respect to the **implied covenant of good faith and fair dealing**. If you don’t like that prompt, or you think that the courts applied the current test *correctly* in all cases, then you may either (a) explain how you think the test should be modified so that it reaches better results in one or more cases that we read this semester, or (b) explain why the test is perfect just as it is, illustrating it with one or more cases. In favor of whatever you argue, you may adduce any legal or policy argument within the scope of the materials dealt with in this course (i.e., don’t make constitutional law arguments or something like that, but feel free to range over our entire course as you would like). *(40 minutes)*

*Lots of potential answers here, obviously. I would give points for clarity of writing, for answering the question (which is very specific, and requires an understanding of the current state of the law), and for accurate descriptions of the current governing standard and the cases in which we have seen it applied. The key on this kind of question is to show an accurate and fluid understanding of the doctrine, in addition to giving a sufficient number of examples. I hope you realize this, but obviously, being “right” or “wrong” in your conclusions has nothing to do with it; I just want to see your thorough engagement with the legal arguments. (As it happens, I don’t even know what I would consider “right” or “wrong” with respect to this very difficult doctrine.)*

13. Your clients are considering buying some bonds. They have asked you to draft a provision to insert into the governing documents that will prevent the issuer from using "exit consents" like those approved in the *Katz v. Oak Indus.* case (which your clients consider to be coercive). Assume your clients are bond buyers with a lot of negotiating power (although they want the deal to go forward, so they have asked you to be “as aggressive as you need to be, but no more.”). You may, if you wish, include explanatory language for what your drafting is intended to accomplish. *(35 minutes)*

*Again, lots of potential answers here. This question is not a particularly easy one. I would give points for clarity of writing, for a demonstrated understanding of what exit consents do and how they do it (based primarily on the case), for effectiveness in barring this scurrilous exit consent strategy, and for not drafting too broad of an answer (i.e., not prohibiting too much, which would likely blow up the deal).*