Corporation Finance Law
Sample Exam 2 with Answers

1. Congratulations! You won the lottery! You (and your heirs or assigns) are entitled to payments of $200,000 per year for the next 250 years. You think the appropriate discount rate for this stream of payments is 5%. Please estimate the present value of the prize. (5 minutes)

2. Spatula City is considering selling zero coupon debt securities to the public. Pursuant to the terms of the deal, each security would be originally sold for $1,000, on November 23, 2017. Then Spatula City would pay each holder $3,000 per security on November 22, 2027, but nothing before that. What rate of return is Spatula City implicitly offering to its investors who bought these securities? (5 minutes)

3. Ladle City is considering financing a new factory so that it can better meet the growing worldwide demand for ladles. Ladle City expects to spend about $41 million up front building a facility and estimates the investment will return a net operating income $12 million a year for 4 years. Ladle City has $8 million of bonds outstanding. Bonds with similar characteristics are yielding 9.5%. Ladle City also has 1 million shares of common stock outstanding. The stock has a beta of 1.1 and currently sells for $20 a share. Currently, the risk-free rate is 2% and the equity market risk premium is 6%. Ladle City’s tax rate is 30%. Should Ladle City undertake the investment? (10 minutes)

4. Carma Corporation has issued convertible debentures at $1100 each. The debentures are convertible into 100 shares of Carma common shares, and are callable by the corporation at $1250 each. If interest rates have plummeted dramatically such that the present value of the debenture’s cash flow is $1300, yet the price of Carma common stock has recently and suddenly risen $14, what should the current market value of a Carma Corporation debenture be? What should you do if you’re Carma? What should you do if you’re a holder of a debenture? (5 minutes)

5. Fuel prices are highly volatile. In addition, they are one of the big expenses of shipping companies like U.P.S. Why wouldn’t shipping companies seek to hedge those fuel costs? In very general terms, what sort of hedging strategies might they be likely to engage in? (10 minutes)

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1 This is basically the exam I gave in Spring of 2017.
FACT PATTERN FOR QUESTIONS 6 THROUGH 8

Elon Tusk is the President, CEO, and largest shareholder of Spatula City, although he only owns 30% of the outstanding common stock. Spatula City, Inc. is a Delaware corporation. Tusk is discontent with Spatula City’s progress and has gathered his brain trust—including you—to consider various options. The options that are presented are as follows:

**Option 1: LBO.** Tusk has significant control of Spatula City but he wants more; he wants to consider taking Spatula City private through a leveraged buyout. Based on its current cash flows, he believes he could successfully structure the deal and offer common shareholders a 20% premium on their current market value. As is usual in an LBO, the takeover would ultimately be funded by high-yield bonds, with the highly leveraged equity stake going to Tusk and several of his buddies, most of whom are already either Spatula City directors or officers.

Tusk thinks that increased “operational efficiencies”—namely, firing most employees and replacing them with robots—as well as the introduction of a new line of solar-powered spatulas, will lead to a successful revamped company that he will then be able to take public again, cashing out his equity stake and augmenting his already sizeable fortune.

One of the challenges to Tusk’s LBO plan comes from Spatula City’s existing bondholders, whose existing bonds may be adversely affected the issuance of new high-yield bonds. Hearing rumors of an LBO in the offing, the existing bondholders have demanded that the high-yield bonds be expressly subordinated to the existing bonds, that the existing bonds be provided with substantial collateral in order to assure payment, or at a minimum that the existing bonds be redeemed per the terms of the indenture prior to the restructuring of Spatula City’s balance sheet. There is no express provision in their indenture documents requiring such treatment; in fact, the indenture expressly omits any restrictions on the creation of unsecured short-term or long-term debt Spatula City or its subsidiaries, and any restrictions on the payment of dividends by Spatula City. But the attorney to the bondholders has noted that Tusk repeatedly made public statements about how “tremendously, hugely credit-worthy” Spatula City is and how its bonds are “all investment-grade stuff, really great, phenomenal.” Also—while the public relations implications of this fact are beneath both you and Tusk—he has wondered if your analysis of this issue would be affected by the fact that while most of the bondholders are large banks, some of the potential bondholder plaintiffs are farmers, who frequent a country diner in the town where Tusk’s mother lives, and who placed most of their life savings in Tusk’s hands after he made a sales pitch to them one Thanksgiving over pumpkin pie. (They have only recently wised up and hired a sharp-dressing attorney out of the big city of Lexington, KY.)

Another challenge is that common shareholders may believe that the 20% premium isn’t enough; they may bring some sort of action to try to prevent the LBO or to recover damages after it takes place. Tusk thinks this is ridiculous: “I could give them no premium at all if I wanted to! Between me and my friends, the vote will go in my favor no matter what!” The transactional structure he imagines is a two-step merger, with a top-up option to make sure that step 2 is a short-form merger. He is not a patient man.

**Option 2: Sale of Assets—Spinoff of Legacy Assets.** Another option is to break the company up. Tusk believes that spatulas are the future, but Spatula City is a conglomerate. It has not just the up-and-coming spatula business but also several large “legacy” businesses, the largest of which are its line of whisks (branded “Whisk Me Away”) and its line of tongs (slogan: “Has It Been Too Long Since You Replaced Your Tong?”).
Tusk could do without these legacy businesses, which together make up approximately 55% of the book value of SC’s total assets.

Tusk’s idea is to transfer these legacy assets to a newly created company, and assign all of Spatula City’s existing bond debt to that subsidiary. The relevant clause in Spatula City’s existing bond indenture states as follows:

Nothing in this Indenture or any of the Debentures contained shall prevent ... any sale, lease, transfer or other disposition of all or substantially all of its property to any corporation lawfully entitled to acquire the same or prevent successive similar consolidations, mergers, sales, leases, transfers or other dispositions to which the Company [i.e., Spatula City] or its successors or assigns or any subsequent successors or assigns shall be a party; provided, however, and the Company covenants and agrees, that ... any such sale, lease, transfer or other disposition of all or substantially all of its property, shall be upon the condition that the due and punctual payment of the principal of, interest and premium, if any, on, all of the Debentures, according to their tenor, and the due and punctual performance and observance of all the terms, covenants and conditions of this Indenture to be kept or performed by the Company shall, by an indenture supplemental hereto, executed and delivered to the Trustee, be assumed by any corporation formed by or resulting from any such consolidation or merger, or to which all or substantially all of the property of the Company shall have been sold, leased, transferred or otherwise disposed of (such corporation being herein called the “successor corporation”), just as fully and effectively as if the successor corporation had been the original party of the first part hereto, and such supplemental indenture shall be construed as and shall constitute a novation thereby releasing the Company (unless its identity be merged into or consolidated with that of the successor corporation) from all liability upon, under or with respect to any of the covenants or agreements of this Indenture ....

Tusk has floated this idea with the bondholders are they are not keen on the idea.

Tusk—a non-lawyer, but that doesn’t stop him—says that if you don’t think a court will be convinced that this proposal suffices as a transfer of “all or substantially all” of the assets within the meaning of this clause, then we should try a different, “creative” solution: Transfer other pieces of the business to a new company first, including the prized spatula business that he is so interested in. He would obviously retain control of the new company. Then, after these transfers are done, he notes, the remaining legacy businesses really would be all or substantially all of the remaining assets. After waiting a couple of months, Spatula City could transfer the legacy businesses and assign the bond obligations per this clause. Mission accomplished!

**Option 3: Sale of Assets—Spinoff of Spatula Assets.** A different twist on the previous option is instead of spinning off the unwanted legacy assets, spin off the desired spatula business from the start, and simply leave the legacy assets behind and walk away.

From Tusk’s perspective, an advantage of this approach is that there are some legacy liabilities associated with these legacy assets; in particular, there is an intellectual property dispute over Spatula City’s right to use the phrase “Whisk Me Away,” which was coined by a clever consultant for Spatula City long ago who was never paid, and who has been threatening to sue. Spatula City’s intellectual property lawyers have noted that the damages from this claim are
potentially vast (punitive damages, etc.): These damages alone potentially amount to more than the entire market value of both the whisk and tong business combined (and that’s not even considering any existing bond debt).

Accordingly, Tusk’s idea is to leave both the legacy assets, the bond obligations, and the potential liabilities in the old entity, which he will then sell his stake in and then resign from the management of. “Then they’re not our problem anymore!” Tusk adds: “Screw that consultant! I would have thought of ‘Whisk Me Away’ soon, I’m sure! I will make sure that guy never collects on whatever judgment he gets some weak-minded jury to give him.”

To be specific, the plan would work like this: Create a new business, distribute its stock to existing Spatula City shareholders as a special dividend, and then transfer the spatula business assets to it. The new company will also either give a promissory note (on exceptionally favorable terms) or issue some amount new stock with which it will “buy” the spatula assets from Spatula City, in order to, as Tusk puts it, “make it look like we’re giving something in return for taking the good stuff out of Spatula City.”

_In considering the questions below, as always (and this should go without saying), focus on the law dealt with in this course (i.e., no need to get into any specifics of securities regulation or bankruptcy law beyond the scope of this course.)_
6. Consider Option 1 above. *(50 minutes)*
   a. In simple terms, what are the bondholders worried about, and why do the
      bondholders want each of their proposed remedies?
   b. In simple terms, why do shareholders expect premiums above market prices in
      this kind of situation?
   c. Overall, will this plan work? Why or why not? If not, are there workable
      modifications that could help it to be more likely to succeed?
7. Consider Option 2 above (ignore the additional information given in Option 3). Focusing on the bondholders’ likely objection to the application of the successor obligation clause, will this plan work? If not, are there workable modifications that could help it to be more likely to work? *(25 minutes)*
8. Consider Option 3 above. Focus only on the likely challenges from creditors including bondholders: In light of their challenges, will this plan work? If not, are there workable modifications that could help it to be more likely to work? *(25 minutes)*
9. Early on, Spatula City received some funding from Lazy Bank, a large financial institution. Part of the consideration for Lazy Bank’s financing was a number of warrants to purchase Spatula City stock at a considerable discount to the current market price (the warrants’ strike price is less than half the present value of the stocks). Although the bank hasn’t yet exercised the warrants, there is reason to think it may soon do so.

Tusk hates the idea of letting the bank reap a large profit at the current shareholders’ expense, and he realizes that one way to accomplish this would be to issue a 2-for-1 stock split, which would have the effect of maintaining current shareholders’ ownership percentages and values, but which would cut the market price of Spatula City’s shares in half, dilute the warrants, and dramatically cut the profits that Lazy Bank could receive.

Tusk’s prior lawyer (whom Tusk fired for telling him he couldn’t pursue one of his plans) examined the contract and told Tusk that there was no specific language prohibiting the stock split, although other similar methods of devaluing the warrants (including “capital reorganizations” and “reclassification of stock”) are expressly included and would trigger antidilutive adjustments to the warrant rights.

Tusk’s prior lawyer did note that Spatula City would be obliged to provide 14 days’ particularized notice of the intent to split the stock to Lazy Bank. This would of course provide sufficient time for Lazy Bank to exercise its warrants, and would thus ruin Tusk’s plans.

However, Tusk has looked closely at the stock warrant agreement, and he observed that the notice provision runs as follows:

Section 12. Notices.
(a) Effectiveness. Any notice or other communication in respect of this Agreement may be given in any manner set forth below to the address or in accordance with the electronic messaging system details provided in section (c) below, and will be deemed effective as indicated:
   (i) if sent by certified or registered mail (airmail, if overseas) or the equivalent (return receipt requested), on the date that mail is delivered or its delivery is attempted; or
   (ii) if sent by electronic messaging system, on the date that electronic message is received.
(b) Change of Addresses. Either party may by notice to the other change the address, telex or facsimile number or electronic messaging system details at which notices or other communications are to be given to it.
(c) Addresses. The addresses to which notice should be sent are as follows: [snail mail and e-mail addresses are then provided].

Tusk has realized that the “snail mail” address given in the agreement is likely outdated, and that it was never updated by the bank. The bank has moved its headquarters from the old address.

Tusk wants to know if he can simply send a certified letter providing notice of the intended stock split to the notice address provided in the agreement, wait 14 days, and then engage in the stock split— in relative safety, since it is very unlikely that Lazy Bank will have exercised its rights before it is too late.

Tusk admits that the notice email address likely would still work and reach the right people at Lazy Bank (which is precisely why he doesn’t want to use it).
Tusk notes (again citing his previous lawyer) that the contract expressly says that “the parties hereto shall have no duties to one another except those mandatory duties imposed by law,” which in this case means the implied duty of good faith and fair dealing.

One other relevant fact: Tusk reluctantly admits that he was recently called on the phone by Lazy Bank. They specifically asked him if he was planning “any big moves on the balance sheet” of Spatula City, if “we are safe waiting a bit longer on these warrants,” and if “there is anything they should be thinking about.” Tusk reassured them that “you have nothing to worry about” and said that “everything is same ol’ same ol’ around here these days.”

Tusk doesn’t think this conversation is a problem, because, again, he likes the contractual language, which states:

**Section 7.02. Warrant Holder’s Reliance.**

The Warrant Holder [i.e., Lazy Bank] acknowledges and affirms that the Issuer [i.e., Spatula City] shall not have, by reason of this Agreement or any other Transaction Document, a fiduciary relationship in respect of the Warrant Holder; and nothing in this Agreement or any other Transaction Document, expressed or implied, is intended or shall be so construed as to impose upon the Issuer any obligations in respect of this Agreement or any other Transaction Document except as expressly set forth herein.

Without limitation of the generality of the foregoing, (i) the Warrant Holder acknowledges, accepts, and consents that the Issuer expressly has made and will make no warranty or representation to the Warrant Holder for any statements, warranties or representations (whether written or oral) made in or in connection with any Transaction Document or any other instrument or document furnished pursuant hereto or in connection herewith, whether before or after the consummation of any transaction, except as shall be expressly agreed to in writing and executed as an express amendment to this Agreement or a Transaction Document related hereto; and (ii) the Warrant Holder acknowledges that any decision regarding the exercise of its rights under this Agreement or any Transaction Document shall be the sole and exclusive province and duty of the Warrant Holder and shall be made independently of any statement, representation, or warranty (whether written or oral) of the Issuer, aside from notices expressly made pursuant to the terms of this Agreement or any Transaction Document related hereto.

In light of all of this and of the materials dealt with in our course, please advise Tusk concerning both the stock split itself, and his proposed means of providing notice of it. *(45 minutes)*