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)

STUDENT MODEL ANSWERS [both received full credit]

(1) This is an annuity because it is a fixed payment received over a fixed number of years. So, need to determine the PV of the annuity.

\[ PV = \frac{C_0}{r} \times \left[ 1 - \frac{1}{(1+r)^t} \right] \]

\[ C_0 = \text{periodic interest payments} \]
\[ r = \text{interest rate per period of compounding} \]
\[ ct = \text{current value} \]

\[ PV = \frac{200,000}{.05} \times \left[ 1 - \frac{1}{(1.05)^{250}} \right] \]
(I had calculator issues)

(2) Because the payments are so long, you would likely value it as a perpetuity-- which is simply the cash flow divided by the interest or discount rate.

\[ 200,000 / (.05) = 4,000,000 \]

PROFESSOR ANSWER AND COMMENTS

One way to approach this is as a perpetuity problem; in finance terms, 250 years might as well as be forever (see casebook pp. 27-28). You have an investment that is yielding $200,000, so that is your \( C_0 \). Your \( r \) is given as 5\%. So the answer is \( 200,000 / .05 = $4,000,000 \).

Alternatively, you could also value it as an annuity. \( 200,000 / .05 \times \left[ 1 - 1/(1.05)^{250} \right] \), and you would get something very close, approximately $3,999,979.83.

Either answer was fine.

The average score on this question was very high—4.19/5, meaning almost 84% of the available points were awarded.

As you can tell from answer (1) above, I didn’t mark anyone off for not completing the calculations. At the same time, doing the calculations should have been useful as a “gut check.” If you did your calculations and got an answer like “$198,900,” shouldn’t that clue you in that you did something wrong? The payments exceed that value in the very first year! Obviously, it’s worth much more than that. This was an example where common sense would help somewhat.

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1 This is basically the exam I gave in Spring of 2017.
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)

STUDENT MODEL ANSWER

Originally sold = $1,000
Payment in 10 yrs = $3,000

ROR?

\[ PV = \frac{FV}{(1+r)^t} \]
\[ $1000 = \frac{$3000}{(1+r)^{10}} \]
\[ 1000(1+r)^{10} = 3000 \]
\[ (1+r)^{10} = 3 \]
\[ 1+r = 3^{0.1} \]
\[ 1+r = 1.1161 \]
\[ r = 0.1161 \]

PROFESSOR ANSWER AND COMMENTS

This is problem 6 from the Haas problem set, virtually verbatim, with the numbers and names changed (but the number of years, which is the potentially tricky part, left intact).

Here is Haas’ calculation and explanation, with my numbers plugged in.

Given that it was literally straight from the problem set, I was surprised by the fact that only 44.6% of the points were awarded on this question.

\[ PV = \frac{FV}{(1+r)^t} \]
\[ $1,000 = \frac{$3,000}{(1+r)^{10}} \]
\[ $1,000(1+r)^{10} = $3,000 \]
\[ (1+r)^{10} = 3 \]
\[ 1+r = 3^{0.1} \]
\[ 1+r = 1.116 \]
\[ r = .116 \]

This question illustrates the present value of a lump sum compounded annually. It requires the student to calculate the rate of return “r” inherent in a present value calculation when she is given the present value, future value and time period. Here, the student must be able to determine that $1,000 is the price paid by investors for each security, and thus represents its present value. $3,000 is the amount that the investor will receive for each security at the end of the time period, and thus represents its future value. The time period “t” is 10 years. Based on the calculations above, the rate of return is 11.6%. For an explanation of zero coupon debt securities, see Nutshell Section 15.
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)

PROFESSOR ANSWER AND COMMENTS

There were a lot of struggles on this question, with only 45% of the available points awarded. No one received all the points awarded, and even those who got the most points made some significant calculation errors, so I haven’t given a student answer.

The big idea here is to find the present value of the future profits and then compare those to the present outflow required. Generally, if the PV of the future profits is higher than the outflow required up front, you should take the project.

The big math required is to figure out the appropriate discount rate for the relevant firm. Here, because the firm has both debt and equity, you need to use the WACC to figure that out. You’ve got everything you need for that, except the number for return on equity. So we start there:

First you have to figure out the return on equity using CAPM. That will be \( R_e = R_f + \beta_e (R_m - R_f) \), or here: \( .02 + 1.1(.08 - .02) = .086 = 8.6\% \). Although I gave partial credit for it, some people failed to note that “equity market risk premium” isn’t \( R_m \), it’s the additional amount (the “premium”) above \( R_f \), and thus the calculation should be as I’ve given it.

Then you plug this rate into the WACC formula. The amount of equity is $20,000,000; the amount of debt is $8,000,000. So the WACC is $20/28 [percentage of total financing that is equity] * .086 [cost of equity] + 8/28 [percentage of total financing that is debt] * .095 [cost of debt] * (1-.30 [tax benefit of debt]) = .0804 = 8.04\%. That’s the firm’s overall “discount rate”—that is, the rate that you use to calculate its overall cost of capital.

Once you have that, it’s a simple conversion of future values down to the present. You find the PV of the future cash flows as follows: \$12mm * (1-(1+.0804)^-4)/0.0804) = $39,710,160.12

Present cost of the project: $41 mm. Significantly higher than the PV of the expected cash flows. Thus, not worth it!

A number of folks got part of the analysis above correct, and I awarded partial credit as much as possible.

Again, I didn’t dock for not doing the math as long as you wrote the formulas, although I did dock if you didn’t take the math as far as possible using basic algebra.
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)

STUDENT MODEL ANSWER

The value of the conversion bond can be determined by looking at the conversion rights it carries. In this case, with the conversion rights entitling the holder to 100 shares which are currently valued at $14 in the market, we know the value is $1400. However, because it’s a callable bond, its market value is really capped at the call price of $1250. With current cash flow equal to $1300 and a convertible value in the current market of $1400; it is surprising the corporation has not called the debenture yet. The holder should immediately exercise their conversion rights so that they can reap the benefit of this opportunity before the corporation realizes it is sleeping on its right and decides to call the bond.

PROFESSOR ANSWER AND COMMENTS

Note that 3 questions are asked here: What should Carma do, what should the investor do, and what’s the market value? Not everyone tried to answer all three questions, which cost points. Nonetheless, the average score on this question was 81%.

In general, a convertible debenture with a call price has a “floor” value of its conversion value and a “ceiling” value of its call price. But... This is a crazy “room”! The “floor” ($1400) is higher than the market price ($1300) and the “ceiling” price ($1250).

Carma Corporation should call the debentures at $1250 immediately.

A holder should obviously try to convert before that happens, because that way they can lock in $1400 worth of stock!

What’s the market value? It’s really tough to say. People made good arguments for $1250 and for $1400, and for “in between.” I gave credit for any answer from $1250 to $1400.
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)

PROFESSOR ANSWER AND COMMENTS

There are plenty of good ways to answer this question. Since I only gave it 10 minutes, there was no need to give a complete answer to get most or all of the points. The average score was about 74%. Note that there are two questions: Why wouldn’t you hedge, and if you do hedge, what sort of strategies will you use?

The ideal answer described the basic hedging transaction and provided at least one or two compelling reasons that a shipper might not do it. Our discussion about the airline industry provides a good basis for this discussion.

a) What would the hedge look like?
Just as with airlines, shippers’ expenses will go up when fuel prices rise. When fuel prices go down, shippers’ expenses will decline. Sure, just as with airlines, they can pass these on to customers, but businesses prefer to keep prices “sticky” (rather than volatile), which customers prefer, and it also takes times to incorporate that information into prices (e.g., with airlines, which sell seats months in advance). Thus, a hedge could help manage this volatility.

The shippers will want to take a long position (i.e., that pays off when fuel prices rise) to hedge against their natural “short” position (since they benefit when fuel prices fall). They can relatively easily do this through the energy futures markets; or they can negotiate an over-the-counter derivative with a financial institution playing the role of “market-maker.” They could also just try to lock in long-term fuel contracts at some sort of “average” rate with their fuel suppliers, who will then be bearing some risk for them. Lots of good answers were given here.

b) Why wouldn’t they do this? Here are some possibilities:

• Lost upside. The hedger “gives up some of the potential upside” when prices move in her favor. This is because the hedging costs money, and when you aren’t using them, the hedges are just a dead loss for you.

• Relatedly: costs. There’s also the simple fact that there will be transaction costs in the form of a bid-ask spread that you pay to whomever is taking the risk for you.

• Credit risk of counterparty. Unless you go through a well-intermediated market like the futures exchanges, where a clearinghouse bears the credit risk, you will be taking on some risk that your counterparty won’t pay up on the hedges when they are supposed to.

• “Natural hedge” is already in place. This is subtle and no students mentioned it: As referenced in the airlines discussions/readings, there is a “natural hedge” in that fuel prices are likely to be high when the economy is humming along and business is good—giving companies a bit of extra leeway to absorb higher costs.

• Pass on price increases to customers. Some people made the interesting argument that hedging might not be worth it because you could simply pass prices on to customers. This is a logical argument, and I gave a lot of credit for it (although of course it might hurt you if the other people in your industry have hedged and can therefore undercut you on price, and you can’t necessarily raise prices immediately if people have already paid for services several months out, as is common in some industries).
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 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?

STUDENT MODEL ANSWER

A: The bondholders are worried in this situation because the company will be extremely leveraged after this deal. Before an LBO, the bondholders see that there is probably a higher level of equity than debt. But when the deal goes through, the amount of debt will greatly exceed the amount of equity. These previously existing bondholders have an increase in risk without a corresponding increase in return. This means that if something goes wrong and the company ends up in bankruptcy, there will be more mouths to feed with the same amount of food.

The bondholders want these remedies in order to make sure that if the company does enter bankruptcy, the bondholders will be paid first. Essentially, these provisions are an attempt to move the bondholders up in the automatic (read: absolute) priority rule. If the high-yield bonds are subordinated to the current bonds, the current bondholders will have a shot at being paid back before the new bondholders do. If the bondholders get collateral, they will have at least some security interest that will aid in protecting their investment. Their final request of having their bonds redeemed will simply allow them to walk away before the risk of things going south becomes apparent. All of these provisions are essentially attempts to gain more protection.

B: Shareholders expect to receive premiums above market prices in situations like this because the acquirer will be obtaining control of the company. These premiums are commonly called "control premiums" for that reason. Since SHs will lose any voting/negotiating power that they may have, the acquirer must compensate them for that loss through a premium price than they would otherwise achieve on the market.

C: Directors do not owe fiduciary duties to creditors. MetLife v. Nabisco. If the bondholders desire any protection, they must bargain for specific terms in the contract. The relationship is directly governed by the terms contained within the contract. In this contract, the indenture agreement expressly omits any restrictions on the creation of debt. It is unlikely that the bondholders will have any negotiating power in attempting to alter the contract to require subordination of the high-yield debt, etc. because they did not originally bargain for that.

This situation is on point with the situation in MetLife. In that case, the plaintiffs were bondholders who alleged that an LBO impaired the value of their bonds. The court looked at the agreement between the parties and found that they did not bargain for any debt limitations. The court stated that if the bondholders wanted this protection, they should have bargained for it in the beginning.

This argument holds true for most of the bondholders in Tusk's LBO case. The bondholders should have bargained for the contract to include debt limitations. The directors do not have to "be nice" and renegotiate with the bondholders. There may be one catch, though: the farmers.

In MetLife, the court noted that the parties were sophisticated so they had the power to negotiate for the desired protections. In Tusk's case, there may be a question of whether the
farmers that he pitched to over Thanksgiving were sophisticated enough to be able to negotiate. They were unrepresented at the time of the negotiations. In MetLife, the court said that the indentures were not secret and that the plaintiffs knew their rights under the contract since they were well aware of the terms and had reviewed them carefully before they lent the massive amount of money. A court may find that the farmer bondholders were not in this position and were not aware of the potential risks associated with it.

Even though no fiduciary duties are owed to creditors, there is still an implied duty of good faith and fair dealing. According to MetLife, this is only applied by courts when it is consistent with other mutually agreed upon terms of the contract. The court will never impose an obligation which would be inconsistent with the contract. It is only breached when one party seeks to prevent the contract's performance or withhold its benefits from the other party.

Here, Tusk's public statements may cause a problem. In BA we learned something about disclosures and 10b-5 or something but I don't remember. I feel like that is implicated here but really don't remember. Anyway. These public statements that the company is doing amazing and everything may come back to bite Tusk. A court may find that a public statement such as this malevolently induced the bondholders to think that nothing was going on and that there would not be an LBO in the future. This actually seems a little bit like Paracor where the investors were telling the bond purchasers that everything was great. There, they did not have any duty to disclose though because the financer and investors had no prior relationship or contact throughout the transaction. Here, Tusk clearly has a relationship with the bondholders. He may be held to a different standard than Paracor financers were because of the relationship that he has with them.

If he does the two-step process, he would try to squeeze out the remaining shareholders since he owns a large chunk of it. If he did this before he obtained 90% ownership, he would be subject to either the BJR or the entire fairness test. Since he is conflicted he is likely to be judged on the intrinsic fairness standard instead of the BJR. This means that there has to be fair process and fair price. It is likely that a court would find that it is fair to the SHs to have a control premium considering that they are giving up some of their rights.

Something about freeze outs maybe but don't have enough time ugh

If so, if he is a controlling SH but does not have 90%, he would need to get a special committee to approve the purchases and then get a majority of minority SHs to approve it. If he does not get these two reqs, subject to the entire fairness test. If he is able to get 90%, he can do a short-form merger and the only rights that other SHs will have is an appraisal remedy.

Top ups are cool, need to make sure that the board determines a form and manner of payment Olson v. EV3

PROFESSOR ANSWER AND COMMENTS

On (a) and (b), all I was looking for was a “plain English” explanation of what was going on—the incentives and dynamics of the situation. Then, (c) required most of the analytical work. The average score on this question was about 70%.

a. There are two sub-questions here, which I will address in turn. The student model answer did a good job of dealing with both of these questions very briefly and efficiently, as did many of the other answers to this part of the question.

i. What are the bondholders worried about? Higher risk, lower value. The bondholders are worried that their likelihood of repayment is going to be lowered by the
issuance of other bonds on equal level of liquidation priority as they are. (The question doesn’t explicitly state that the junk bonds would be on the same level as the existing bonds, but it’s implied because they’re asking for subordination, which you don’t need if something is already subordinated to you.) The old bonds aren’t going **down** in the capital structure (nothing is being imposed senior to them, as far as we can tell), but their level of the capital structure is getting much bigger, while the equity level beneath them is getting much thinner. Thus, there’s less of an equity cushion beneath them to absorb losses. Because the value of bonds is tied to their riskiness, this rise in risk will lower the value of the existing bonds.

ii. Why do the bondholders want these remedies? **To lower risk, maintain/raise value.** These mechanisms have the effect of making the existing bonds less risky and thus more valuable, by either cashing them out or moving them up the capital structure. Getting a security interest leaves them in a “senior” position as to the particular collateral. Being expressly subordinated ensures that they are higher on the capital structure. Getting cashed out at their pre-LBO price will give them something like the fair market value of their investment prior to the proposed degradation of it due to this dilution.

b. Why pay shareholders a premium over market price? **Control.** The market price of stocks reflects only the value of one share on its own, which amounts to its dividend value. When purchased in mass, including in an LBO for the entire company, the additional value of control (voting rights, most obviously) adds to their value. Thus, as was tested in Self-Assessment 1, the premium above market price paid to exiting shareholders in a change-of-control transaction (such as a going-private transaction) is often called the “control premium.” Most people got this correct.

c. I will break my analysis up into two parts, one dealing with bondholders and the other with shareholders.

**Bondholders**

• Is there any problem with the proposed treatment of the bondholders? I will leave aside the farmer bondholders for a moment. As to the bank bondholders, this would seem to be a fairly straightforward application of the Metlife case. There, the court found that in the absence of an affirmative prohibition of the issuance of such debt, the court would not read one into the contract. Nor would the court consider various pieces of parol evidence (analogous to Tusk’s statements here) that supposedly supported the idea that the issuer had implicitly covenanted not to issue non-investment-grade securities like junk bonds. The court expressly held that the IDGFFD would not intervene to help the bondholders in such a situation.

• As to the farmers in particular, which merits some additional discussion. As we discussed in class, an individual might have made a better plaintiff in the MetLife case, because MetLife’s own internal documents and course of dealing made crystal clear that it had **not** been hoodwinked; the same might not apply to an individual. At numerous places in the MetLife decision, the court highlights the sophistication of MetLife, possibly thereby implying that an opposite result might be warranted with respect to a different bondholders. So I think the farmers’ claims would like be a closer call to a court, because they can more plausibly claim to have been misled by a reasonable reliance on Tusk’s misstatements. However, in the absence of more specific misrepresentations, and given the clarity of a contract, I think the court would probably still side with Tusk. Because it was a close call, I was willing to award most or all points here to those who argued the opposite side well.
• If you are worried about his chances, is there something you could do to help these bondholders out, short of just giving them what they are asking for?
  o I don’t see anything particularly obvious but I gave credit for all sorts of reasonably good ideas.
  o One thing you could try would be an exchange offer with an exit consent: Offer them a small premium (less than they’re asking for) to be bought out, and on the way out the door get them to pass an exit consent amendment making crystal clear that issuing junk bonds is permitted under the indenture. There might be problems with this (are you conceding that without the amendment, bondholders have a good case that the bonds aren’t allowed?), but it is one strategy.
  o If you’re worried just about the farmers, you could also offer them some sort of premium that you don’t offer the institutional bondholders. This might or might not work, but it’s a good idea. (Any problems with it are beyond the scope of this course.)

Shareholders
• Tusk is wrong. He and his buddies cannot simply ram this vote through, because there’s (obviously) a massive conflict of interest (he is essentially the controller of both the seller and the purchaser; he has an incentive to set a low purchase price at the expense of the other current shareholders). A lot of people missed this.
• As specified in the Haas readings and my slides for that day, because this is almost certainly a controlling shareholder transaction, Tusk and his group will have to either (a) meet the entire/intrinsic fairness test, while bearing the burden of proof; (b) both (i) get the approval of a truly independent special board committee empowered to negotiate for the shareholders, and (ii) receive a majority vote of the minority (i.e., independent, non-Tusk) shareholders in favor of the merger; or (c) do either (i) or (ii) above and then count on the challenging shareholders not being able to carry their burden of showing the transactions wasn’t “intrinsically/entirely fair” (in other words, if Tusk does (i) or (ii), the burden on fairness shifts to the plaintiffs).
• Just to be super-clear, the top-up offer therefore won’t work, because the first step (a tender offer) will be challenged, successfully unless the standards just discussed are met.
• Note that DGCL 251(h), which is the statutory implementation of “top-up” offers, won’t apply because it doesn’t protect you when the acquirer is an “interested” party, which Tusk certainly is.
• Again, many people missed the crucial fact that this was a transaction with a conflict of interest, so I gave a lot of partial credit to people who otherwise gave a good discussion of shareholder issues.

Some people also mentioned need to give WARN Act notification before Tusk fires all the workers and replaces them with robots. I gave some partial credit for this (although it’s really about what happens after the transaction rather than the transaction itself).
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)

STUDENT MODEL ANSWERS

(Answer 1—This received all available points)

Tusk is attempting to do exactly what happened in Sharon Steel: sell assets over time, then sell remaining asset with the liabilities. Intuitively, at the end of the line, it seems as though the company would be selling all or substantially all of its assets because the remaining asset is all that is left in the company. Sharon Steel held to the contrary, though. The bondholders argued that the buyer did not purchase "all or substantially all" of the seller's assets since the seller had previously sold off some subsidiaries. The court held that the sale of the remaining asset to the seller did not involve substantially all of the seller's assets since it had previously liquidated the majority of its company to another party.

Therefore, the successor obligor clauses were not applicable, and the seller defaulted on the bonds. The language here is identical to that of the indenture in Sharon Steel. This is boilerplate language, which means it must be given consistent, uniform interpretation. Any rights that the parties may have must be laid out in the contract--no fiduciary duties exist to bondholders (except in special circumstances involving bankruptcy/insolvency). Here, similar to Sharon Steel, since Tusk would essentially be retaining control and everything, the first "transfers" would not really be sales. Successor obligor language exists in part to protect lenders from a discontinuity of assets. Since the final transfer here would only represent about 55% of the company's book value, it is likely that it is not "substantially all" of the businesses assets. Sharon Steel's final transfer was worth about 51% of the book value.

Although in a different context, Hollinger also addressed the question of what constitutes "all or substantially all" of a corporation's assets. In that case, the company wanted to sell one of its specific newspapers. The SHs sought an injunction, arguing that the particular newspaper constituted all or substantially all of its assets. The court held that to be substantially all of its assets, the assets must either (1) be quantitatively vital to the operation of the company, or (2) substantially affect the heart of the existence/purpose of the company. The court looked at the newspaper's profitability, notoriety, and more, and ultimately determine that the newspaper only represented 55% of the company's assets and was not the "heart of existence" of the company since it had other magazine/newspaper lines that would still thrive without the particular newspaper.

Here, the "legacy" businesses that Tusk references account for 55% of the book value of the company. Quantitatively, it does not seem as though the legacies are vital to the operation of the company. The newspaper in question in Hollinger accounted for approximately half of the assets in that company and the court held that this was not enough to surpass the test. Therefore, they do not meet the first test's requirement. As to the second test, Spatula City has three existing product lines that seem to act independently of one another--none of them seem to rely on the other to thrive. It is unlikely that it would meet the second test's requirements.

If it is not substantially all of the assets, Spatula City would therefore default on the bonds, making them due and payable. Tusk’s plan will probably not work and he should be wary that if he attempts it, the bonds may become due and payable.
(Answer 2—This received a bit less than full credit, but I include it to show an analysis that is on point but that is shorter than the one above can still get almost all of the available points.)

Will plan 2 work? If not, what mods will make it work?
Bust up conglomerate (55% is non-spatula); "all or substantially all"?
-under Hollinger, substantially all does not simply mean more than 50% - presumably the opposite is true
Sharon Steel - lenders are assured a degree of continuity of assets - borrowers are permitted to sell, liquidate, etc. - protections for borrowers as well as for lenders may be fairly inferred from the nature of successor obligor clauses
-want to sacrifice the interests of both sides as little as possible
However, boilerplate successor obligor clauses do not permit assignment of debt to another party in the course of liquidation unless "all or substantially all" of the assets of the company at the time the plan of liquidation is determined are transferred to a single purchaser - in other words, a company cannot conduct a piecemeal sale of assets and then liquidate
So it is unlikely that this technique will work. Unclear what could make it work beyond a more transparent dealing with the bhhs.

PROFESSOR ANSWER AND COMMENTS

There are two plans contained within this option, and it is important to deal with both of them (even if very briefly, as in the second model answer above). The average percentage of points awarded on this question was 70%.
The first plan, a straightforward spinoff with the assignment of the bonds along with the assets, will plainly not work, under the Sharon Steel case. The language given in the exam is practically identical to the language in the Sharon Steel case, and I don’t see any reasons the results would not be the same. This is not a sale of all or substantially all the assets. In fact this first scenario is simpler than Sharon Steel, because the court doesn’t have to collapse several transactions in order to analyze the question.
The second plan is more sneaky. Here, Tusk proposes basically engaging in a sham initial transaction, sending most or all of the 45% of non-“legacy” assets to a newly created company, thus rendering the “substantially all” claim more plausible, in hopes that the second transaction—the spinoff + assignment—will then pass muster.
This second scenario is actually in some ways even closer to Sharon Steel. In Sharon Steel, the transfer that was being challenged was the last in a line of transactions subsumed under one “Plan of Liquidation” that had been approved by shareholders. In part, what the court said was, look, we’re going to view this Plan as a whole and not let you just focus on the last step in it.
Here, there’s not a formal “Plan” that has been publicly announced, but these transactions certainly seem to form part of a uniform scheme, and I think it’s for that reason that the bondholders are likely to prevail. It doesn’t change the result, but note that in Sharon Steel, the earlier transfers of assets were for monetary consideration; here, it is not clear if the first transfer will actually involve the exchange of any consideration. If there is proper consideration, then the case looks very much like Sharon Steel, where the court held that the transactions in the
sequence all had to be viewed at once; if not, then the sequence of transfers looks truly like a sham and will be even more suspicious for that reason.

Some people offered Hollinger as a helpful parallel, and got credit for that too, although for reasons stated above, Sharon Steel was more directly on point.

A lot of people also discussed potential fraudulent/voidable transfer liability. While I was intending that to be asked in the next problem (and, in this question, explicitly excluded consideration of the additional liabilities discussed in Option 3), this made a lot of sense. I gave significant partial credit for these discussions.

A lot of people also spent a lot of time talking about the successor liability stuff in the USX case and other related case. I didn’t totally know what to think about that. Unlike those cases, the explicit goal here is to transfer the liabilities to the new corporation, and since Tusk and his cohort will have control, there shouldn’t be any problems getting the new corporation to “accept” those liabilities. The issue here is whether the bondholders can maintain their existing recourse against Spatula City given the plan, or whether the clause that is provided will allow Tusk to get rid of the bondholders. That is more a Sharon Steel situation than a USX situation. Anyway, I gave some partial credit where the analysis made sense to me based on the question presented here and where it was at least clear that the answer understood what the proposals were, and what they were trying to do.

Some other answers spent a lot of time talking about shareholder voting requirements. But I’m also not sure how relevant this was, given that the prompt instructed, “focusing on the bondholders’ likely objection,” which seems to exclude shareholder challenges. I gave a little partial credit for this where it seemed to make sense.
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)

STUDENT MODEL ANSWER

[Note that this answer isn’t directly on point with all of my analysis below, but I give it to illustrate that there can be a bit of variation while a lot of credit is still awarded.]

Finally, Musk proposes the reverse of Option 2; he wants to spin off the Spatula Group and leave the Legacy Group behind and walk away. The Legacy Group is facing some potentially severe damages from an ongoing IP litigation and may have other yet-unknown liabilities. Musk wants to leave the legacy assets, bond obligations, and potential liabilities in the old entity and sell his shares and resign from management. This plan also faces serious problems.

As with Option 2, the sale of the spatula assets to a new entity may also transfer the liabilities and debt obligations Musk wants to leave behind. Under the transfer of liabilities test as laid out in Franklin v. USX the court laid out four situations where liabilities will transfer with assets: (1) if the purchaser expressly or impliedly agrees to assume them; (2) if the transaction amount to a consolidation or a merger of two corporations; (3) if the purchasing corporation is merely a continuation of the selling corporation; and (4) if the transaction is entered into fraudulently to escape liabilities.

Just as in Option 2, it seems likely a court would find this a mere continuation and even if not, it is simply a fraud transfer to escape liabilities. Even though the Musk believes his plan will make it look like the new company is giving something to the old company for the "good stuff" a court would likely see through this sham transaction and find a mere continuation.

Another problem with this option is the possibility that it will be rescinded under the voidable or fraudulent transfer rule. This Uniform Voidable Transfer Act allows a court to rescind a transaction if the debtor engaged in it with the actual intent to hinder, delay, or defraud any creditor. Under these facts, it is very possible a court would determine that was Musk’s actual intent with this transaction.

Additionally, the transaction could be rescinded under the UVTA if it left an unreasonably small amount of remaining assets to the debtor. It seems less likely a court would find that occurred here because the Legacy Group assets represented 55% of the company, and that is not an unreasonably small amount of remaining assets, but it is possible the court could apply this test as well. Finally, the UVTA allows a transfer to be rescinded if a reasonably equivalent value was not received in exchange.

This issue arose under the transfer of liabilities test in Franklin and just as there, it is possible a court would see through Musk’s "sham transaction" to make it appear as though they are paying for the prized assets of Spatula City, when they really are not. Just as in Jevic the court may collapse the transaction and look at what it really amounts to. In this case that would likely reveal that Musk was not paying an equivalent value for the Spatula Group. Jevic also discusses the test for determining if a reasonably equivalent value is received. It tells us to look at the totality of circumstances and consider the fair market benefit of the transfer, the existence of an arm's length transaction, and that the transferee exhibits good faith. We don’t have enough information to determine the fair market value of the transfer benefit and whether it was paid,
but the fact that Musk is essentially on both sides of the transaction weighs against a finding that it was arm's length or that good faith was exhibited. Given this precedent and the provisions in the UVTA, it seems highly likely that this deal would be rescindable if the bondholders sued, which they likely would.

PROFESSOR ANSWER AND COMMENTS

This was primarily a UVTA question. Again, some answers spent a lot of time on successor liabilities, but as with the previous question, I’m not sure how relevant that was—the assumption here is that the new sub will gladly (controlled at least at formation by Tusk) accept the liabilities contractually. (If you noted that he would want to make sure the liabilities were expressly included in the transfer, that is a fine point and would get you some partial credit, but it doesn’t seem that controversial to me.) The biggest issue is whether a court will allow that sort of shenanigan to screw creditors over. So the only successor liability issue is whether the court will find that the original company, where the liabilities originated, will be liable. Again, where people at least seemed to understand that basis dynamic, I gave points. But I think the more important and controversial stuff, which I tried to signal with the various nefarious statements he makes in the fact pattern, is the stuff discussed below. The average on this question was about 71.5%.

Avoidable Transfer. The biggest problem here is that the transfer of these valuable assets out of Spatula City, in light of Spatula City’s significant amount of debt (both bond debt and apparent tort liability), may be an avoidable transfer (see our materials for Chapter 25). This seems likely under two different lines of law:

○ Actual Intent.
    ○ A transfer intentionally made to hinder, delay, or defraud creditors is avoidable pursuant to what used to be called “fraudulent transfer” law but is now called “avoidable transfer” law. UVTA section 4(a)(1).
    ○ As Tusk’s comments make clear, part of his goal here is to secret these assets away so that they will be out of the reach of Spatula City’s creditors. That seems likely to open him up to liability under this section. The intent is definitely there.
    ○ You may ask, well, is there really liability here, if the tort claim hasn’t yet been embodied in a judgment? That is a good question, and I gave credit if you weren’t sure whether this counted or not. Under governing law, as long as it’s sufficiently identifiable and certain, then it does count; I think the fact pattern leaves this ambiguous.

○ Constructive Avoidable Transfer.
    ○ In addition, regardless of intention, if a transfer for less than “reasonably equivalent value” is made while the transferor is insolvent, that transaction is avoidable as a “constructive” fraudulent/avoidable transfer. See UVTA section 4(a)(2), section (5).
    ○ Here, it certainly looks like this transaction will be at risk. The company left behind may well be insolvent, and it’s not at all clear that the new company will be giving “reasonably equivalent value” in return—in fact Tusk’s comments seem to suggest he will give as little as possible, just a “fig leaf.” This is a classic case of when you’d expect constructive avoidable transfer law to apply.
Again the issue of the uncertainty of the tort claim is relevant, and that will be a fact issue for the court or jury to examine.

Remedy. Under either of the types of claim above, the remedy can be rescission of the transaction. UVTA section 7. There might be other equitable or damages remedies too.

Other challenges. There are potential other challenges here, although we really don’t have enough information to develop them (and thus they aren’t really worth much time or space in an exam answer). For instance, there might be a bond covenant dealing with the transfer of high-value assets out of the company, or there might be a debt/equity covenant that would be busted by this proposal. But I don’t think any of these other potential issues are triggered by the facts as given.

Modifications. People made various suggestions on what to do to “save” the transaction, but obviously, the major one is to give reasonably equivalent value—which of course Tusk probably doesn’t want to do. I have points for whatever creative and reasonable answers people gave here.
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)

STUDENT MODEL ANSWER

Stock Split

In general terms, a warrant is an instrument that grants the warrantherder an option to purchase shares of stock at a fixed price. Warrants are generally offered by the issuer as consideration for some larger deal--such as is the case here, where Lazy Bank (“LB”) received warrants from Spatula City (“SC”) and Tusk as part of a loan transaction. As such, warrants are essentially contracts between the issuer (here, SC and Tusk) and the warrantheader (LB). Because of their nature as contracts, general rules of contract interpretation prevail.
It is likely that Tusk's proposed stock split would not trigger the antidilutive provisions of the warrants. First, the contract between LB and SC has no specific language prohibiting a stock split. Further, Tusk is only subject to the terms that are expressly included in the contract between LB and SC. A warrantholder is not owed fiduciary duties by a company. A warrant represents a contract; not until the warrant is exercised and the holder owns common stock does SC or Tusk owe LB any duties beyond those set out in the contract.

It follows that LB's only avenue of success would be to find a way that the stock split breaches the contract. This will prove difficult. The contract only mentions "capital reorganizations" and "reclassification of stock." LB can argue that these terms encompass a stock split, however as discussed in the Lohnes v. EV3 case, neither term is ambiguous and each has an independent legal meaning that does not include a stock split. A capital reorganization encompasses a substantial change in a corporation's capital structure, while a reclassification of stock entails alterations of the character of existing securities. A stock split is unlikely to be found within the parameters of either definition.

A number of rules of contract interpretation also weigh in Tusk and SC's favor. First, is the maxim that when parties specifically include like items in a document, any item not listed is considered excluded. This would likely apply here. The contract specifically provides for antidilution provisions, but does not mention stock splits. Thus, it would be difficult for LB to argue that Tusk would be in breach of the contract by pursuing the stock split.

Method of Notice

Tusk's proposed method of granting notice to LB could prove more troublesome for Tusk. This is in spite of the fact that Tusk's proposed plan does not appear to be in violation of the express terms of the contract. Section 12 expressly allows for any notice or other communication to be given in any manner set forth below... which includes "snail mail" or e-mail. In addition section (b) puts the burden on the party who changes their address to notify the other party. Tusk has no burden to keep up with LB and always make sure he is sending notifications to the correct address. Rather, he is supposed to send correspondence to the address in the contract, or whatever new address LB notifies him of. Thus, Tusk's proposed form of notice is not in breach of the express terms of the contract. LB may, however, have an argument that Tusk will have violated the implied covenant of good faith and fair dealing if he goes along with his notice plan. The implied covenant is read into every contract and its general goal is to ensure that the reasonable expectation of the parties under the contract are fulfilled. According to the majority of courts, a party is in breach of the implied covenant if they took unreasonable actions that had the effect of destroying or injuring the rights of the other party to receive the fruits of their bargain.

Based on this language, the first question then is what did LB expect to be the fruits of this contract with Tusk? The warrants were consideration for a loan, and the facts suggest that the strike price was intended to be considerably lower than the market price. If this is true, then LB expected the fruits of the bargain to be to purchase SC stock at a considerable discount. Conversely, however, it is possible that SC issued the warrants with a strike price that reflected a minor discount and then the SC stock went up. Thus, LB would essentially be getting a windfall by buying shares at half price. Under this analysis, the stock split would probably not ruin LB's reasonable expectations.

If we follow the assumption that LB and SC expected the warrants strike price to be at a considerable discount to the market price for common shares, the next question is whether SC's
actions served to destroy LB's rights to the fruits of its bargain—the huge discount on the stock. LB will argue that Tusk's stock split and subsequent failure (or inability) to give actual notice constitutes a breach. LB has a good argument that the notice provision is in there to do what the anti-dilutive provision does not—that is, protect LB in this exact scenario. LB would expect to get notice in adequate time to exercise its warrant and therefore reap the benefits of its bargain.

The issue with all of LB's arguments is that it stretches the implied covenant farther than many courts have been willing to. Courts are wholly unwilling to use the implied covenant to write new terms into the deal. The express terms of the deal do not (1) prohibit a stock split, or (2) require either party to give the other actual notice. Finding Tusk in violation of the implied covenant would go against current precedent because it would write a new term into the deal, essentially requiring Tusk to ensure that LB received actual notice of the stock split.

**Phone Conversation**

Finally, Tusk should have nothing to worry about stemming from his phone conversation with LB despite the fact that a prudent attorney should counsel him against it in the future. The conversation should not be a problem, because as Tusk says, the language of the contract appears clear. The contract specifically states that the issuer makes no warranty or representation to the Holder for any statements, except those expressly agreed to in writing and duly executed. The phone conversation was neither. Furthermore, the contract states that the exercise of the warrant should be the sole duty of the warrant holder and not based on statement of the issuer.

Tusk owes LB no fiduciary duties as a warrant holder. Thus, LB should focus more on the words of the contract rather than Tusk's. In addition, based upon the language in Section 7.02, SC made no warranty and will make no warranty as to any statements. Thus, this case would not be similar to a case such as Ziff-Davis, where the court found that part of the deal was that the party relied on the counterparty's promise and warranties. Here, there were no such warranties.

**PROFESSOR ANSWER AND COMMENTS**

People did well on this question generally, winning almost 85% of the available points.

**1. The Stock Split.**

Let's leave aside the notice provision for a minute. Is there a duty to make sure that Lazy Bank is aware of the stock split and given the chance to protect its rights? And does the contract protect against this course of action?

Our most direct case on this is Lohnes v. Level 3 Communications, from which the phrases “capital reorganizations” and “reclassification of stock” are drawn. There Judge Selya says that a stock split isn’t either one of these things that would entitle the warrant-holder to any anti-dilutive protections. The court notes that the principle of expressio unius weighs against the warrant-holder.

The court also holds that the implied duty of good faith and fair dealing weighs against the warrant-split.

True, that case isn’t exactly like this one—there was clear language saying the warrant holder had no rights as stockholder until the warrant was exercised, and there was at least a generalized press release provided there, which Tusk doesn’t seem inclined to provide. On the other hand, the fact pattern tells us that there is no duty except IDGFFD.
Overall the case is so close to Lohnes that I think that case would very likely govern.

2. The Notice Scheme.

As I read the notice provision on its plain text (which a good answer should do, even if briefly), Tusk’s proposal complies with it: you don’t have to give BOTH email and snail mail notice, just one or the other. And if you just provide it by mail, all you need to do is show that “its delivery is attempted.” Finally, it seems to me that the burden is on the party to be noticed to change its address, which Lazy Bank didn’t do. So as a matter of contract interpretation, I think that’s pretty decisive.

But what about the implied covenant of good faith and fair dealing? My understanding of the law on that, as announced in numerous of our cases, is that the ICGFFD only applies where a contract is silent as to a matter and yet clearly indicates what the parties would do if they did contract on that matter. If a contract deals with a matter, that is that, and the ICGFFD will not lead to an obligation to the contrary. Here, it seems to me that the two sophisticated parties explicitly dealt with how they wanted the notice provisions to work, and they permit Tusk’s conduct.

On the other hand, the idea is plainly to provide notice, and clearly Lazy Bank bargained for the benefit of getting notice prior to the split. Tusk is knowingly undermining that, and it would literally take only some keystrokes (an email) to provide actual notice. Several people aptly brought up the Lehman case here.

What’s the holding? I’ve been torn back and forth about this question. I find the conduct morally and ethically reprehensible, and I don’t think I would continue working for someone who would do something like this. Ultimately, although it will depend on the court, I think it’s more likely than not that Tusk would win. Obviously I would give you most or all points if you disagreed on that conclusion but gave a solid analysis.

By the way, you may think, “This is a terrible notice provision! Why would anyone agree to such a provision! Get real, Professor Bradley!” But I am being real. This is actually drawn (in slightly modified form) from the 1992 form ISDA Master Agreement; in other words, this is one of the most widely used notice provisions in the world, used among the very most sophisticated parties. The world is an odd place sometimes.

Also, some people raised the clever point that maybe the bank has given notice, for instance in stationery that it has sent notices on. This was worth some points (although I think the problem mostly forecloses that problem by saying the address “was never updated by the bank”). An even more clever point was to advise Tusk to go ahead and give notice both at the bank’s old snail mail address and at the current snail mail address, because the truth is, banks aren’t always super quick about opening and dealing with their mail. It made me laugh and garnered some consideration in points but again, it doesn’t really get to the heart of the problem.

3. Tusk’s Phone Conversation.

Will Tusk’s statements expose Spatula City to risk? Although it’s not as explicit as it could be, these are arguably misrepresentations.

On the other hand, there is an express waiver of reliance, just like there was in the Unicredito case (from which this language is essentially drawn); in that case, the court held that J.P. Morgan’s alleged misstatements to the other banks in the syndicate lending to Enron were not actionable (the one issue on which the court found for the plaintiffs isn’t relevant here, since
it involved actually aiding and abetting Enron’s fall, not making specific misstatements to these plaintiffs, which is the allegation we’re concerned with here).

The disclaimer here seems to me to explicitly cover this situation, on its plain terms. As in Unicredito, the contract expressly bars any reliance by Lazy Bank on Tusk’s/Spatula City’s misstatements. Is there a reason not to enforce it? If a court follows Unicredito, it looks to me like Tusk has to win on this.

Finally, just as in Unicredito, the IDGFFD seems to be no help either, since the contract expressly covers this matter. Spatula City likely prevails on this too.

All of this may lead you to wonder: Do the bad guys always win? No. But sometimes they do.