Business Organizations

Final Examination

Spring 2022

Professor J. Harvey,

Instructions:

There are 2 questions in the examination.

You will be given 3 hours to complete the examination.

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KCCL 343B Business Organizations II
Spring 2022 Final Exam

Question 1

Randy is a recent graduate of the Kern County College of Law. Along with two of his classmates, Matt and Perry, he decides to use his legal training in a nontraditional way and start up an online business that provides study aids and other materials for undergraduate students considering law school. They drafted a short business plan that outlined some of their goals and expectations and then immediately set to work.

They outlined their relative responsibilities as follows. Matt, the most charming of the three, would set to work developing strategic relationships with advertisers and serve as the main public face of the company. Perry, the most diligent of the three, would be responsible for preparing the study aids and other materials they intended to sell. Randy, the leader of their study group from law school, would handle essentially anything else that came up and float as needed to make sure that everyone's workload was reasonably balanced. They also agreed to share equally in any profits.

Aside from the short business plan they drafted, the three never took any steps to formally document the terms of their relationship.

Initial sales were encouraging, but all three perceived room for growth. As often happens with successful startups, however, they were quickly approached by Kapbri, the largest existing company in the industry, with a proposal: Kapbri would form a subsidiary corporation; appoint Randy, Matt, and Perry as the initial officers and directors; and allow each of them to purchase a 10% interest in the subsidiary corporation for the pre-established price of $1.00 on condition they remained in those positions for at least two years. In exchange, Kapbri would acquire ownership rights to all of the materials developed by the trio.

Matt wanted to jump on the opportunity, but Randy was concerned with giving up too much autonomy. Perry struggled to make up his mind, and each of the others expended considerable energy trying (without success) to convince Perry to take their side.

Frustrated with the others, Matt contacts Kapbri on his own. He explains, "I think you've presented a great opportunity, but I just can't seem to get the others to see it. But maybe you'll be interested in a counterproposal: an exclusive two-year license to incorporate any of our study aids and other materials into your own products and services in exchange for 15% of your profits from any sales of products incorporating our materials."

Kapbri agrees to the proposal.

1. **Suppose that Randy and Perry had no knowledge of Matt's proposal to Kapbri and, upon learning of it, do not want to move forward with the deal Matt made. None of the study aids or other materials the trio developed are ever provided to Kapbri, which threatens to bring a claim for breach of contract. Does Kapbri have a colorable**

claim? Who might be liable? Explain your analysis. (You can assume that the elements of offer, acceptance, and consideration are present. You do not need to analyze whether a contract was formed—only who [if anyone] would be bound by it and why.)

2. **Does your analysis change if Randy and Perry knew of Matt's intended proposal and specifically told him not to contact Kapbri to discuss it? Explain why or why not. Assume that Matt ignored their directive and that all other facts are the same as before.**

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Question 2

Jack and Kyle are the CEO and CFO, respectively, of Two Kings, Inc. ("TKI"). TKI is a publicly traded corporation that provides project management services for large-scale infrastructure projects, with 100,000 shares issued and outstanding.

One day, Jack is approached by Lee—a wealthy entrepreneur who, after making his fortune in solar energy development, has now decided to try his hand at public infrastructure. His first successful bid, to comprehensively renovate City Hall in downtown Bakersfield, has just been accepted by the city manager. Lee asks Jack if TKI will provide management services for the project in exchange for a fee equal to 10% of the total cost of construction.

Jack discusses Lee's offer with Kyle, and the two agree to accept. After calling Lee to let him know they are on board, Jack and Kyle get to work.

The project proved highly successful for TKI, which saw its stock price increase in response to $130.00 per share—more than double what TKI stock was trading at before Lee first contacted them. Lee, for his part, was so impressed with TKI's work and executive team that he purchased a full 40% of the outstanding stock of the company, making him the single largest individual shareholder. In response to Lee's purchase, public hype begins to pick up around TKI stock and the price surges again to $160.00 per share.

About three months later, however, Jack calls a private meeting with Lee while Kyle is on a four-week vacation in Idaho. Jack alerts Lee to a number of brewing interpersonal tensions between Jack and Kyle, and suggests that TKI would probably be better off if Lee used his position as plurality stockholder to implement changes on the board of directors that will ultimately allow them to eject Kyle from the company. Not wanting to embroil himself in what suddenly seems a much messier investment than anticipated, Lee sells off all but 1,000 shares of his TKI stock that afternoon for $160.00 per share. The sale causes the hype train to crash and the price of TKI stock drops to $90.00 in response.

Distressed by the drop, Jack—who only owns 50 shares of TKI, despite being CEO—immediately sells his 50 shares at their new market price of $90.00 per share.

When Kyle returns from vacation, Jack calls a meeting and explains what happened. He apologizes, and the two reconcile. With their bond renewed, they contact Lee to let him know

the good news. Lee is ecstatic to hear it, and immediately purchases back all of the shares he sold off at a price of $95.00 per share. At the same time, Jack and Kyle each buy 100 shares of TKI stock for the same price. A few weeks later, Lee is offered and accepts a position on the board of directors, as well as a position as the company's Director of Development.

1. Does Jack have any potential liability under Rule 10b-5? Why or why not?
2. Does Jack have any potential liability under Rule 16b? Why or why not?
3. Does Kyle have any potential liability under Rule 10b-5? Why or why not?
4. Does Kyle have any potential liability under Rule 16b? Why or why not?
5. Does Lee have any potential liability under Rule 10b-5? Why or why not?
6. Does Lee have any potential liability under Rule 16b? Why or why not?

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ANSWERS

Question 1

Two main issues to spot.

One: The three students' enterprise appears to fit all the criteria for a de facto partnership. They are carrying on as co-owners a business for profit with an explicit agreement to at least share profits, and by both implication and legal default, losses.

- Since the three students are partners in a de facto partnership, they will have personal liability on any contracts the partnership enters into. Accordingly, Kapbri has a colorable claim against the partnership *and* each partner if the partnership is bound to the contract. Whether the partnership is bound turns on agency principles, i.e., Matt's authority to bind the partnership.
- (Bonus) Depending on jurisdiction, Kapbri may have to satisfy exhaustion requirements as against the partnership before pursuing claims against the individual partners. This can be accomplished by demonstrating that the partnership is insolvent, for example, because it has filed for bankruptcy or because a writ of execution on a judgment against the partnership has been returned unsatisfied.

Two: Matt is the one who entered the agreement, but he did so expressly in the name of the group, i.e., the de facto partnership.

- As a partner, Matt is an agent of the partnership and the partnership is the principal.
- Whether the partnership is bound will depend on whether Matt had actual or apparent authority to enter into the contract on the partnership's behalf.
- Matt's position, both as a partner generally and as the public face of the partnership specifically, suggests actual authority to enter into contracts like the Kapbri contract.
    - As a general default rule, partners in a partnership have general discretionary authority to bind the partnership in matters within the scope of its business.
    - Some question can be raised as to whether *licensing* their materials is strictly within the scope of the partnership, which was formed to *sell* study materials directly, but scope issues are not likely to ultimately impact Matt's authority here

in light of the ill-defined nature of de facto partnerships generally and the bare-bones nature of the trio's business plan.

 - Some question can be raised as to whether Matt reasonably believed himself to have actual authority to enter the contract, in light of the state of disagreement within the group. But that degree of dissention is probably not enough to overcome the general authority of a partner, particularly where the transaction Matt agreed to was materially different than the one that was the subject of the students' internal disagreement.

- Even if Matt lacked actual authority, the partnership is still bound as long as he had apparent authority, i.e., as long as a reasonable person in Kapbri's position would *believe* he had actual authority, based on objective manifestations of the principal.
  - Objective manifestations of the principal include acts of the agent within the scope of the agent's actual authority. So, if Matt had actual authority, it would not take much more than him holding himself out as having authority to support a finding of apparent authority. See above re: whether he had actual authority.
  - Matt is the public face of the enterprise. A reasonable member of the public would likely believe his discretionary authority very broad, if not unlimited.
  - BUT: Matt's explanation to Kapbri is vague in a way that impacts this question. Arguably, Kapbri should have made some further inquiry as to whether the other partners were on board with Matt's counterproposal or if Matt was functionally acting alone. On the other hand, Matt's statement that he couldn't get the others on board with *Kapbri's* offer does not necessarily imply that the trio did not jointly endorse the *counterproposal*. (It doesn't necessarily matter what students conclude, and they should ideally point out the gray area and identify why it is a gray area.)

1. **Does your analysis change if Randy and Perry knew of Matt's intended proposal and specifically told him not to contact Kapbri to discuss it? Explain why or why not. Assume that Matt ignored their directive and that all other facts are the same as before.**

The main significance of this change in the facts is how it impacts Matt's actual authority, and by extension, his apparent authority to the extent Kapbri is relying on Matt's own representations of authority as a basis for *believing* he has authority. (Rule above re: objective manifestations of the principal as a basis for apparent authority.)

On these facts, it is unlikely Matt had actual authority to enter the Kapbri contract.

- As before, some arguable gray area because the disagreement was over *Kapbri's* offer. "Don't contact Kapbri to discuss it" is not specific as to whether "it" is the specific offer *from* Kapbri or, more broadly, the notion of making any deal *with* Kapbri. But it seems a hard sell for Matt here.

- (Bonus) Since the partnership is ill-defined to begin with, Matt could take the position that negotiations with third parties are within his sphere of authority per the business plan and the others don't have the power to overrule him in any event. But the lack of clear definition cuts both directions: Matt can point to nothing explicit that says he has unilateral discretion to overrule the others. The legal default in a partnership—one partner, one vote—should control here.

If Matt lacked actual authority, then he cannot have apparent authority, as to Kapbri, based on anything that *Matt* said or did. The only other relevant fact is the partnership holding Matt out in general as the face of the enterprise, which is arguably sufficient alone to support a finding of apparent authority for the reasons discussed above.

Remainder of analysis unchanged.

Question 2

RULE 10B-5

Rule 10b-5 has two separate elements tests: one for securities fraud and one for insider trading.

10b-5: Securities fraud

Liability for securities fraud arises under Rule 10b-5 when a person (i) makes a fraudulent statement or omission of material fact (ii) in connection with the purchase or sale of a security, (iii) with intent to deceive or reckless disregard for the truth or falsity of a statement, thereby (iv) causing loss.

Fraudulent statement or omission of material fact. A fact is material if a reasonable person would consider it important in deciding whether to purchase or sell a security.

Here, the fact pattern does not indicate that anyone made any affirmative statements of relevance to this element. Liability for omission only arises where disclosure would be necessary to make whatever statements *were* made *not* misleading.

As to Jack and Kyle, there is simply nothing here to meet this element. Neither of them made any affirmative statements or obvious omissions of any relevance to their stock transactions.

As to Lee, the most relevant fact is that he sold off his shares at $160.00 per share while in possession of what appears to be inside information: the internal dissention between the TKI executives. Lee certainly considered it material enough that it motivated him to sell. A reasonable buyer would likely have considered it material. But as stated, omissions are not actionable unless they render some other, affirmative statement misleading. Because the facts do not indicate Lee made any affirmative statements in connection with any of his stock transactions, his omission is likely not actionable.

It does not appear that *any* of the three had a duty of disclosure here to satisfy this element.

Connection with securities transaction. Nothing to suggest this element is met re: Jack or Kyle. Lee's omission was in connection with his sale of stock for $160.00. But as noted above, while the omission appears to be material, it does not appear to be actionable under the elements test for securities fraud.

Intent to deceive. Nothing to suggest this element is met re: Jack or Kyle. In Lee's case, intent to deceive is unclear. He made a material omission but no facts regarding his specific intent are given. Given his wealth and evident sophistication, however, it is not likely he will have an easy time selling that it simply didn't occur to him to make the disclosure. A reasonable person would arguably believe Lee likely appreciated the benefit of the inside information he had available to him. The worst fact for Lee is that the board dissention was *his* subjective motivation for *selling*, so it presumably occurred to him that any buyer would want to know. His nondisclosure seems intentional.

<u>Causing loss</u>. Nothing to suggest this element is met re: Jack or Kyle. This element will be met, as to any purchaser of Lee's TKI stock, unless they managed to offload it at the same price they paid before the stock plummeted from $160.00 to $90.00.

In some circumstances, the plaintiff must also prove his reliance on the fraudulent statement or omission, but an exception applies under a "fraud on the market" theory when the shares are publicly traded; that is, traders of publicly traded securities generally presume and rely on the integrity of the market price when they trade. Here, TKI shares are publicly traded so a plaintiff would not need to prove reliance.

Finally, the plaintiff must prove that the defendant made use of the mails or some other instrumentality of interstate commerce to perpetuate the fraud, unless the securities are publicly traded. Here, the securities are publicly traded so this element is met.

For purposes of rule 10b-5 securities fraud, it is likely that no one has liability. Lee comes the closest, but the absence of any affirmative statements by him will likely preclude any liability on the basis of his omission under the elements test for securities fraud.

<u>10b-5: Insider trading</u>

Under rule 10b-5, insiders—like directors, officers, employees, and controlling shareholders—have a duty to refrain from trading on the basis of material information not disclosed to the public.

Nothing in the facts *really* suggests that Jack or Kyle might have liability for insider trading under Rule 10b-5. As officers, they are insiders, so that element is met. But it does not appear that any of their stock transactions implicate any undisclosed material information. An overzealous prosecutor *could* argue that the purchase of 100 shares each by Jack and Kyle at the end of the fact pattern was based on undisclosed knowledge of Lee's impending board appointment, but (i) the materiality of that information is debatable, and (ii) the facts never clearly state that Jack or Kyle even knew at the time.

As to Lee, however, even if he would not be liable for a fraudulent omission under rule 10b-5, his sale of TKI stock does appear to constitute prohibited insider trading.

Lee's initial purchase of TKI stock was for a controlling stake of 40,000 shares. At that point, he became an insider and remained one for purposes of the later transaction in which he sold off 39,000 of those shares. So, Lee was prohibited from trading on the basis of his knowledge of Jack's plan to oust Kyle *if* a reasonable investor would consider the information important in deciding whether to buy TKI stock—which, if not quite indisputable, seems at least reasonably likely. The fact that it subjectively motivated Lee to sell off almost his entire stake does not help him at all.

<u>Rule 16b: Short Swing Trading</u>

Under rule 16b, directors, officers, and persons owning more than 10% of a publicly traded company's stock are prohibited from earning a profit on short-swing transactions. A short-swing transaction is defined as any purchase and sale, or sale and purchase, of an individual company's securities within a six-month period. The profits element includes losses avoided, not just affirmative profits, i.e., in the case where shares are sold at one price then repurchased for a lower price. Although the policy goal of the rule is to prevent insider trading, we do not ask or care if inside information was known or used. Rule 16b is a strict liability elements test.

TKI is a publicly traded corporation, so that element is met as to all stock transactions described in the fact pattern.

At all relevant times, Jack and Kyle were officers. They are subject to Rule 16b in connection with all stock transactions by them.

Jack engaged in two transactions within the fact pattern: a sale of 50 shares at $90.00 per share, and a subsequent purchase of 100 shares at $95.00 per share. The two transactions were within six months of each other, so Jack violated Rule 16b if he profited or avoided losses by the pair of transactions. Here, Jack actually *incurred* losses he would have avoided by *holding* so there is no violation of Rule 16b. The profits element is unmet.

Impliedly, Jack must have engaged in a third transaction since he came into the fact pattern already owning 50 shares. But nothing in the facts suggests that he acquired them within six months of the transaction in which he sold those 50 shares, and no information is given as to the price he paid. It does not appear Jack has any potential liability under Rule 16b.

Kyle engaged in only one stock transaction in the fact pattern, and thus cannot meet the purchase and sale / sale and purchase element. Kyle has no potential liability under Rule 16b.

Lee, at the time he acquired his initial 40,000 shares, was not a covered individual. He was not a director or officer, and the transaction by which someone *becomes* a controlling shareholder is not a covered transaction for purposes of Rule 16b. Lee's initial purchase of 40,000 shares was thus not a covered transaction under Rule 16b. His subsequent sale of 39,000 shares *was* a covered transaction but divested him of most of his interest to the point that he fell below the 10% threshold for controlling shareholder status. If Lee were a director or officer, his subsequent repurchase within six months would be subject to a lookback rule and would constitute a covered transaction, but the lookback rule only applies for directors and officers. Accordingly, Lee's repurchase of 39,000 shares, even though within six months of selling them, was not a covered transaction. The repurchase was for a lower price than the sale, so the profit element would have been met in the form of losses avoided if the repurchase were a covered transaction, but it was not.

It does not appear anyone has potential liability under Rule 16b.

1)

Fact Pattern - 1

Question 1.

Whether Kapbri has a colorable claim for breach of contract

Under RUPA, a Partnership is formed when two or more people take on the typical tasks of co-owning a business for profit, have mutual control over the operation of the business, and share in the profits and losses equally. A partnership can form without an express oral or written agreement between the partners if the necessary conditions are met. The intent to form a partnership, while a factor in the analysis is not dispositive and partnership may be formed if the partners intend to do the things that constitute a partnership.

In a partnership all partners are joint and severally liable for all debts and obligations of the partnership. Each partner in a partnership has the right to participation, however, a simply majority of the partners is all that is needed to make decisions that are in the normal course of business. Amending a partnership agreement or selling a partners stake in a partnership requires unanimous consent.

Despite a simple a majority being required to make decisions, under RUPA if a partner enters into any contracts that are within the normal scope of business for the partnership the partnership will be bound to the contract because each partner acts as an agent for the partnership. When there is not written agreement limiting or modifying the scope of actual authority of an individual partner then the default rules this provides each partner with almost limitless actual authority to enter into contracts on behalf of the partnership. When a partner acting within the scope of their actual authority as an agent within the partnership enters into a contract the partnership, and by extension, the partners are bound to the contract.

In this case, a court will likely find that Kapbri does have a colorable claim for breach of contract against the partnership. Although Matt did not first consult his other two partners about his proposal to Kapbri as a partner Matt had the actual authority to enter into contracts within the regular scope of business of the partnership. Even though the partners did not have a written agreement formally declaring their intent to form a partnership, their intent will be implied from their actions.

The three intended to co-own a business for profit, the had an oral agreement that they would share losses and profits, and they created a business plan that divided up the day-to-day management of the business. Further, they implemented their plan and began to do the things that a business for profit would typically do. Since the three had a formed a partnership that did not have a written or oral agreement limiting the scope of actual authority of any individual partner, under RUPA each partner had the actual authority to bind the partnership to a contract. Since Matt made an offer to Kapbir that accepted, he bound the partnership to the agreement.

Perry and Randy may attempt to argue that they should be bound to the agreement because they had no knowledge of Matt's offer to Kapbri and Matt acknowledged during his contact with Kapbri that neither Randy nor Perry could see the great opportunity Kapbri had presented them. However, since Matt had the actual authority as a partner to enter into contracts on behalf of the partnership the fact that Randy and Perry had no knowledge of his offer to Kapbri will not be sufficient to free them from their obligation to Kaprbi.

Who Might Have Liability for the Contract

Given that Matt had the actual authority under RUPA to bind the partnership to the agreement all three partner will be joint and severally liable if Kapbri brings a claim for breach of contract. However, before Kapbri can go after each individual partner it would first need to obtain a judgment against the partnership. Partnership ships operate within a gray space between aggregate and entity status. For the purposes of the agreement, the partnership will be treated as a separate legally entity. If the partnership does not have enough capital or assets to satisfy a judgment against it then Kapbri may go after any or all of the partner to collect their judgment.

If the judgment is satisfied individually by one or more of the partners then the partnership will have to indemnify each partner for any share of the judgment that was paid beyond their share 1/3 share of the partnership. When the partnership indemnifies the individual or individuals that has satisfied the judgment the partnership the remaining partners will have an obligation to the partnership to compensate it for such indemnity.

Question 2.

Whether Randy and Perry would have liability if they knew of Matt's proposal and expressly told him no.

As stated above, a simple majority is all that is required for a partnership to make a decision that is within the regular scope of business for a partnership. However, even if Randy and Perry knew of

Matt's proposal and expressly told him not to make it, they would still be bound under the agreement because Matt still had apparent authority to enter into the agreement.

Apparent authority exists when a third party reasonably believes that a person is an agent of the principal acting with the scope of their authority. Whether it is reasonable for the third party to believe that a person has the actual authority to enter into a contract will depend upon the power of the agent's position and how the agent presents their authority as an agent of the principal.

In this case, it is likely that a court would find that it was reasonable for Kapbri to believe that Matt had the actual authority to enter into the agreement. While Matt did say that he could not get Randy and Perry to see that great opportunity that Kapbri had offered them that alone would not be enough to make it unreasonable for Kapbri to believe that Matt had the actual authority to make his counteroffer. Matt's comment was direct only at the offer Kapbri made to the partnership. His comments refer specifically to that offer, and not his counteroffer. Since Matt is a partner and partners have actual authority to bind a partnership to agreements on behalf of the partnership Kapbri would be reasonably justified in believing that an agent with the actual authority to make the offer had done so. Kapbri would, and given the available facts could not, know that Randy and Perry had told Matt not to make the counter offer to Kapbri. As a partner, Matt would have been acting with him actual authority to make the offer had Perry and Randy not direct him not to. Since Kapbri likely was unaware of any directives given to Matt from Randy and Perry it would not be unreasonable for them to believe Matt had the actual authority to make there.

Therefore, whether Randy and Perry had knowledge of Matt's desire to make a counteroffer would not fundamentally change their liability related to the offer by Matt and acceptance by Kapbri. The partnership will likely be found by the offer.

Matt's liability to the partnership

Despite the partnership being liable for Matt's offer, that alone would not sever or free Matt from liability to the partnership for acting outside of his actual authority. When an agent causes a principal to be bound to an agreement when they did not have the actual authority to do, the agent is the liable to the principal for that obligation. Therefore, as an agent acting outside the scope of his authority, Matt would be liable to the partnership for binding them to the agreement with Kapbri.

2)

Jack - 10b-5

Rule 10b-5 regulates securities fraud, insider trading, tippers, tippees, and misappropriation.

Securities Fraud

Under securities fraud, liability occurs if someone (i) made a fraudulent statement or omission of material fact (ii) in connection with the purchase or sale of a security (iii) with the intent to deceive or reckless disregard for the truth or falsity of the statement (iv) causing loss. Generally, the plaintiff must also prove their reliance on the fraudulent statement or omission of material fact. However, if a public exchange is involved, then analysis of this element is not required. Further, usually the plaintiff will also have to prove that the defendant used the mails or another instrumentality of interstate commerce. However, just like reliance, if it is a public exchange then this element is presumed as well.

Here, securities fraud does not apply to Jack. Jack did not make a fraudulent statement or omission of material facts. In fact, as the facts indicate, Jack disclosed to Lee his plan to eject Kyle from the company. Jack did not intend this to affect the stocks because even Jack was distressed at the drop.

Thus, Jack will not be held liable under securities fraud.

Insider Trading

An insider has a duty to refrain from trading on material information that is not disclosed to the public.

Jack is the CEO of TKI and that makes him an insider. Jack became distressed by the sudden drop in TKI stock and decided to sell his shares. However, it is likely that Jack realized Lee sold his stock because of Jack wanting to remove Kyle. Further, the sell of Lee's stock causes the hype train to crash and the price of TKI stock to drop. Later, Jack and Kyle reconciled and Jack decided to call Lee to tell him the good news. It was likely that Jack knew this material information would lead to Lee purchasing back his stock and Lee's re-purchase would cause the price to sky rocket again. At the same time Lee purchased the stock, Jack purchased 100 shares for the same price.

Thus, Jack may be held liable under insider trading.

Tipper/Tippee

A tipper is an insider who gives a tip of information to someone that is not disclosed to the public. The person receiving the information is the tippee. The tipper may be held liable when the tippee trades on the basis of the information and the tipper gave the tip for an improper purpose. A tippee had a fiduciary duty of trust and confidence to the tipper. The tippee breaches this duty if the tippee trades on the information given to them by the tipper and the tippee knows or should have known that the information was improperly disclosed.

Here, Jack is an insider since he is the CEO of TKI. He gave Lee significant information that him and Kyle reconciled. Jack likely gave this information for an improper purpose, that is for his benefit. Jack likely knew he would benefit by telling Lee the news because he knew if he told Lee the news, Lee would purchase stock again and the price in TKI stock would sky rocket again due to the past pattern discussed above.

Thus, Jack may potentially be held liable as a tipper. However, if it is found that Lee is not a tippee, then Jack cannot be held liable as a tipper. Whether or not Lee is a tippee will be discussed below under Lee.

Misappropriation

Misappropriation occurs when somebody trades on the basis of information received by someone to whom they owed a duty of trust and confidence. A duty of trust and confidence for misappropriation is owed under 3 circumstances: (i) the parties have expressly agreed that they owe a duty of trust and confidence to one another; (ii) the parties have a history of trust and confidence that would warrant such a duty to be implied; or (iii) the parties possess a familial relationship (parent, sibling, or spouse). A spouse may rebut the familial relationship duty of trust and confidence by claiming they had no knowledge of the improperness of the disclosure.

Jack has not received any information, thus misappropriation does not apply.

Jack - 16(b)

Rule 16(b) allows for the return of the wrongful selling and buying of shares back to the corporation. This rule prohibits the profit by a director, officer, or shareholder owning more than 10% of outstanding shares of the corporation from selling and purchasing or purchasing and selling the shares within a period of six months. This is applied to corporations on the national exchange, or

corporations containing 2,000 shareholders (or 500 shareholders that are not accredited) and $10 million in assets. A shareholder whose purchase puts them over 10% is not subject to rule 16(b).

TKI is a publicly traded corporation, thus this corporation suffices as a national exchange. Further, Jack is an officer of the TKI since the facts state that he is the CEO. Jack only owns 50 shares of TKI. The facts state that Jack sells these shares at $90.00 per share. After Kyle's vacation for four-weeks in Idaho, Jack meets with him and they reconcile. Soon thereafter, Jack buys 100 shares of TKI stock for $95.00 per share. Jack bought and sold these shares within 6 months given that Kyle's vacation lasted four-weeks.

Thus, Jack may be liable under 16(b) pending the analysis below.

Short-swing profit

This looks at the profits and the losses avoided. The highest sale price is matched against the lowest purchase price within a period of 6 months.

The highest sale price for Jack was $90.00 of 50 shares. His lowest purchase price was $95.00 for 100 shares. Given that Jack sold 50 shares for $90.00 and bought 100 shares for $95.00, he did not profit.

Since Jack did not profit, he will likely use that a defense and not have to return the shares.

Kyle - 10b-5

Rule 10b-5 regulates securities fraud, insider trading, tippers, tippees, and misappropriation.

Securities Fraud

Under securities fraud, liability occurs if someone (i) made a fraudulent statement or omission of material fact (ii) in connection with the purchase or sale of a security (iii) with the intent to deceive or reckless disregard for the truth or falsity of the statement (iv) causing loss. Generally, the plaintiff must also prove their reliance on the fraudulent statement or omission of material fact. However, if a public exchange is involved, then analysis of this element is not required. Further, usually the plaintiff will also have to prove that the defendant used the mails or another instrumentality of interstate commerce. However, just like reliance, if it is a public exchange then this element is presumed as well.

The facts do not indicate any sort of fraudulent behavior on Kyle's part. Kyle has been the innocent party and went on a vacation.

Thus, it is likely that Kyle will not be held liable for securities fraud.

Insider Trading

An insider has a duty to refrain from trading on material information that is not disclosed to the public.

Kyle is the CFO of TKI, so Kyle is an insider. Jack's news of the reconcile between Kyle and Jack appears to be private information. If it is proven that Kyle knew that Jack's telling the news of them reconciling to Lee would make the stock price sky rocket because Lee would buy back all of his shares, then Kyle may be held liable under insider trading because the bought 100 shares at the same time Lee heard the news and bought his shares back.

Tipper/Tippee

A tipper is an insider who gives a tip of information to someone that is not disclosed to the public. The person receiving the information is the tippee. The tipper may be held liable when the tippee trades on the basis of the information and the tipper gave the tip for an improper purpose. A tippee had a fiduciary duty of trust and confidence to the tipper. The tippee breaches this duty if the tippee trades on the information given to them by the tipper and the tippee knows or should have known that the information was improperly disclosed.

Kyle has not given information to anyone, neither has he received information. Thus, Kyle is not liable under tipper/tippee.

Misappropriation

Misappropriation occurs when somebody trades on the basis of information received by someone to whom they owed a duty of trust and confidence. A duty of trust and confidence for misappropriation is owed under 3 circumstances: (i) the parties have expressly agreed that they owe a duty of trust and confidence to one another; (ii) the parties have a history of trust and confidence that would warrant such a duty to be implied; or (iii) the parties possess a familial relationship (parent, sibling, or spouse). A spouse may rebut the familial relationship duty of trust and confidence by claiming they had no knowledge of the improperness of the disclosure.

Kyle has not received any information from anyone, thus he is not liable for misappropriation.

Kyle - 16(b)

Rule 16(b) allows for the return of the wrongful selling and buying of shares back to the corporation. This rule prohibits the profit by a director, officer, or shareholder owning more than 10% of outstanding shares of the corporation from selling and purchasing or purchasing and selling the shares within a period of six months. This is applied to corporations on the national exchange, or corporations containing 2,000 shareholders (or 500 shareholders that are not accredited) and $10 million in assets. A shareholder whose purchase puts them over 10% is not subject to rule 16(b).

The corporation has already been established as a publicly traded corporation and is thus national. Kyle is the CFO, so he is an officer. Although Kyle did buy shares, he never sold shares. Thus, Kyle did not buy and sell and is not subject to rule 16(b).

Lee 10b-5

Rule 10b-5 regulates securities fraud, insider trading, tippers, tippees, and misappropriation.

Securities Fraud

Under securities fraud, liability occurs if someone (i) made a fraudulent statement or omission of material fact (ii) in connection with the purchase or sale of a security (iii) with the intent to deceive or reckless disregard for the truth or falsity of the statement (iv) causing loss. Generally, the plaintiff must also prove their reliance on the fraudulent statement or omission of material fact. However, if a public exchange is involved, then analysis of this element is not required. Further, usually the plaintiff will also have to prove that the defendant used the mails or another instrumentality of interstate commerce. However, just like reliance, if it is a public exchange then this element is presumed as well.

Nowhere in the facts does it indicate that Lee participated in a type of fraud.

Thus, securities fraud does not apply to Lee.

Insider Trading

An insider has a duty to refrain from trading on material information that is not disclosed to the public.

Lee traded on his own accordance and is not an officer or director.

Thus, Lee is not liable insider trading.

Tipper/Tippee

A tipper is an insider who gives a tip of information to someone that is not disclosed to the public. The person receiving the information is the tippee. The tipper may be held liable when the tippee trades on the basis of the information and the tipper gave the tip for an improper purpose. A tippee had a fiduciary duty of trust and confidence to the tipper. The tippee breaches this duty if the tippee trades on the information given to them by the tipper and the tippee knows or should have known that the information was improperly disclosed.

As established above, Jack tipped Lee. Thus, this analysis will be for Lee as a tippee. Lee has a duty of trust and confidence to the tipper. If Lee were to trade on information knowing it was improperly disclosed by Jack, he would be liable as a tippee. However, Lee purely learned of Jack and Kyle's reconcile through Jack. Due to their reconcile, Lee decided to trade. It is reasonable that Lee had no clue of any sort of improper disclosure. Disclosing that Jack and Kyle reconciled is fine and should not be subject to being a tippee.

Thus, it is likely that Lee may not be held liable as a tippee.

Misappropriation

Misappropriation occurs when somebody trades on the basis of information received by someone to whom they owed a duty of trust and confidence. A duty of trust and confidence for misappropriation is owed under 3 circumstances: (i) the parties have expressly agreed that they owe a duty of trust and confidence to one another; (ii) the parties have a history of trust and confidence that would warrant such a duty to be implied; or (iii) the parties possess a familial relationship (parent, sibling, or spouse). A spouse may rebut the familial relationship duty of trust and confidence by claiming they had no knowledge of the improperness of the disclosure.

Since Lee is not liable as a tippee, the next step is to see if he is liable under misappropriation. Lee decided to trade on his own accordance. Learning of the reconciliation, he gained trust back into the company and decided it would be a good idea to purchase back his stocks. Although Lee may owe a duty of trust and confidence to Jack through their history has business partners and it may be argue that thus Lee is liable under Misappropriation. Lee was purely trading on his own accordance and thus should not be subject to it.

Lee - 16(b)

Rule 16(b) allows for the return of the wrongful selling and buying of shares back to the corporation. This rule prohibits the profit by a director, officer, or shareholder owning more than 10% of outstanding shares of the corporation from selling and purchasing or purchasing and selling the shares within a period of six months. This is applied to corporations on the national exchange, or corporations containing 2,000 shareholders (or 500 shareholders that are not accredited) and $10 million in assets. A shareholder whose purchase puts them over 10% is not subject to rule 16(b) for that purchase.

As already discussed, the corporation is publicly traded on the national exchange. Lee became impressed with TKI's work and purchased 40% of the outstanding stock of the company. This purchase makes him a shareholder and put him above the 10% threshold but this purchase is not subject to 16(b). 40% of 100,000 outstanding shares of TKI is 40,000 shares. Lee does qualify as a shareholder now since he meets the 10% threshold. After that purchase, Lee sold all of his stock except for 1,000 shares, which is 39,000 shares sold for $160.000 per share. Lee then buys all of those shares back at $95.00 per share. Lee sold and bought the shares within 6 months since Kyle's vacation was only 4 weeks.

Thus, Lee may be liable under 16(b).

Short-swing profit

This looks at the profits and the losses avoided. The highest sale price is matched against the lowest purchase price within a period of 6 months.

Lee's highest sales price was $160.00. He sold 39,000 shares at $160.00. Lee's lowest purchase price was $95.00 where he bought back the 39,000 shares. Since Lee bought the shares back for lower than he sold them, he profited through a short-swing trade.

Since Lee profited, he is liable under rule 16(b).

END OF EXAM