MONTEREY COLLEGE OF LAW

BUSINESS ORGANIZATIONS

Final Examination

Spring 2019

Prof. D. Lamb

INSTRUCTIONS:

There are three (3) questions in this examination.

You will be given three (3) hours to complete the examination.

Professor's Answer Outline - NOT AVAILABLE

QUESTION 1

Soon after California's referendum legalizing the sale and use of marijuana for recreational purposes became law, Denise Dizzy contacted her second ex-husband, Steve Strait, and proposed that he finance a new business to sell marijuana in the City of Seaside, California. Steve still carried a torch for Denise, and he knew that she was a very experienced drug dealer. So he agreed to Denise's proposal.

They agreed that they would prepare a written partnership agreement with these and other basic terms at some point in the future. They agreed that Steve would put up the money to get the store open and operating, including purchasing the inventory. Denise would manage the store and keep 40% of the profits. Steve would keep the other 60%. Cautious from long experience with his ex, Steve asked Denise to seek his prior consent before committing the business to any contracts exceeding $25,000.

The very next day Denise contacted her first ex-husband, who was a lawyer, and with his help she formed Central Coast Bud Boutique, L.P., a limited partnership, and filed all required forms with the State Corporations Commission. The filings contained no defects. Denise listed herself as the general partner and listed Strait as the sole limited partner.

Denise then contacted Ag Country Marijuana Growers, Inc., which was run by several old friends and past suppliers. She placed an order for a starter inventory package of THC and CBD products for a total price of $50,000, but payable in monthly payments of $10,000. She signed the supply agreement as "General Partner, Central Coast Bud Boutique, L.P."

Proud of her resourcefulness, Denise invited Strait for champagne and oysters at the Mission Ranch that evening. Needless to say, Steve was flabbergasted when he heard about Denise's order from Ag Country. He put his head in his hands and said, "I thought you agreed that you wouldn't make any financial commitments of that size without discussing it with me. You are exposing my investment to risk I can't control. Sorry Sweetie, but you'll have to find someone else to back your boutique.

Denise immediately called her friends at Ag Country and asked them to cancel the inventory order. When they asked why, she explained that her investor had backed out. "Hmmm, that's tough," her friend sympathized. "I'll try to sell the pot elsewhere, but we're in an oversupply position in this market right now, and I may have to take a pretty heavy loss. You and Steve will owe me any money I lose on the deal."

a. Describe the liabilities, if any, among Denise, Steve and Ag Company for the loss on the sale of the marijuana Denise ordered.

b. Can Central Coast Bud Boutique, L.P., continue in business given Strait's refusal to fund?

QUESTION 2

(Questions 2 & 3 are based on the same set of facts)

Bob Ketchum and Randy Cheatham, two refugees from the collapse of international megafirm Browbeat, Phlog & Harassem, opened their own practice, Ketchum & Cheatham, LLP, a duly registered and licensed California limited liability partnership with Bob and Randy as its managing general partners. Their written agreement contained an indemnity clause as permitted by statute. The clause provided the firm was required to indemnify either partner for legal expenses incurred in a successful defense of any claim connected with the partnership.

Things went very well for the new firm. It specialized in representing tech start-up companies and venture capitalists. Randy handled the transactional work and Bob did the litigation. Before long they both had more work than they could possibly handle. They decided to expand, and placed ads online for experienced associates. One day while Randy was interviewing a fourth-year intellectual property lawyer from a Palo Alto firm, the interviewee began extolling his experience in handling various patent disputes. Before Randy could stop him, the young lawyer told Randy about a deal he had been working on just that morning for a seed company named Sprout, Inc. Randy moved him off the topic, but not before the lawyer revealed that Sprout, which was publicly traded, was just days away from launching a genetically engineered corn seed that was resistant to the European Corn Borer, a pest that annually costs corn growers hundreds of millions of dollars.

Randy wrestled with his decision over a sleepless night, and the next morning he logged onto ETrade and purchased 10,000 shares of Sprout stock in his own name. It was trading at $8.00, and Randy borrowed $80,000 from his 401K to make the purchase. After the product announcement hit the wires, the price of Sprout shares rose steadily until it leveled off at $35 a share about one month later. Randy sold his 10,000 shares two months after he had bought them and made a tidy profit of $270,000. After he repaid the loan from his 401K, Randy immediately went to a jewelry store he passed on the way home every day and purchased an Audemars Piguet wrist watch that he had long admired, paying full retail of $52,348.

One month later, Randy was sitting in his office admiring his new wristwatch, when a letter from the Analysis and Detection Center of the Market Abuse Unit of the U.S. Securities and Exchange Commission was hand-delivered. The letter asked Randy to stop by the SEC offices in San Francisco for a chat about Randy's trades in Sprout, Inc. stock, and to bring with him his telephone records for the past six months. When he arrived for the meeting, he was ushered into a conference room and introduced to two lawyers in the Enforcement Branch of the SEC, who started the meeting off by informing him of his right to remain silent and his right to an attorney.

Discuss whether Randy's purchase and sale of Sprout, Inc., shares violated Section 10B of the Securities Exchange Act of 1934 and SEC Rule 10B-5. What defenses can Randy raise?

QUESTION 3

One of the benefits of representing start-up companies was that Bob and Randy were sometimes offered the opportunity to purchase shares in the start-ups, either as investments or in lieu of cash compensation for their services. These shares were not yet publicly traded so they represented an opportunity for a substantial return if the company was successful or went public. Since opening Ketchum & Cheatham, the two partners had made 15 such purchases. The stock was always purchased with firm revenues and held in the name of the firm, Ketchum & Cheatham L.L.P. rather than in the name of the individual partners.

After Randy left the meeting at the SEC Offices described in Question 2, he made a beeline to his partner Bob's office to fill him in on this new development. Bob listened carefully to Randy's tale until Randy stopped talking and put his head in his hands.

"Are you done?" Bob asked. "Is that it?"

Randy looked up hopefully. "Yes. What do you think?"

Bob sighed. "Randy," he said, "I'm just a trial lawyer. I have no clue whether you've broken any securities laws. But what I do know is that the Sprout stock you bought? That was an opportunity that belonged to this law firm. When you bought those shares in your own name without offering them to the firm first, you stole a business opportunity and breached your fiduciary duties to me and to our firm."

Randy sat dumbfounded while Bob reached into his desk drawer, pulled out a single sheet of paper and handed it to Randy along with a ballpoint pen.

"That's a tolling agreement. It tolls the statute of limitations on any claim the firm has against you until the resolution of the SEC action."

Randy shrugged and signed the document. "I guess this means I'm screwed either way. If I beat the SEC, then the firm will come after me next."

Bob grinned. "Sounds about right," he said. Then glancing at Randy's wrist, Bob said, "Nice watch you got there, partner."

Assume that Randy decides to go to trial and is acquitted of any 10B and 10B-5 charges by a jury. Discuss whether Bob and Ketchum & Cheatham LLP have a valid claim against Randy for breach of fiduciary duty in the theft of a business opportunity.

Assume that instead of going to trial, the SEC agrees to dismiss all charges against Randy in exchange for disgorgement of Randy's profits from the Sprout trade. Does Ketchum & Cheatham have an obligation to indemnify Randy for his legal fees in defending the SEC action? Why or why not?

1)

Limited Partnership

Based on the facts, there was a valid limited partnership agreement formed and Denise was properly listed as a general partner who is involved with managing the store and keeping 40% of the profits and Steve was listed as the sole limited partner and has put up money to get the store open and operating as well as purchasing the inventory.

a. To determine the liabilities of Denise, Steve and Ag Company for the loss on the sale of the marijuana Denise ordered, we must first determine Denise and Steve's respective roles and conduct as general and limited partners.

Is Steve liable?

To determine if Steve is liable for the loss, it must first be determined if he is truly acting as a limited partner or if he role has expanded to that of a general partner. In a limited partnership, the role of a limited partner is typically passive - the person has no management or control, no personal liability for the debts and obligations of the partnership and does not owe the partnership any fiduciary duties. Here, given Steve's past experience with Denise, he asked Denise to seek is his prior consent before committing the business to any contracts exceeding $25,000, which is an indication that he wants to actively participate in making financial decisions for the company. When Denise told Steve that she had placed an order from Ag Country, he responded by saying "I thought you agreed that you wouldn't make any financial commitments of that size without discussing it with me.You are exposing my investment to risk that I can't control." Given Steve's concerns over his exposure to risk and his interests in protecting himself from liability, this would clearly indicate that he is acting as a general partner

instead of a passive investor. The courts would find that given Steve's words and conduct, he intended to be more than just a limited partner.

Therefore, Steve, as a general partner would be liable to Ag Country up to the amount of his investment/ownership into the partnership.

Is Denise liable?

In a limited partnership, a general partner is fully liable for the debts and obligations of the partnership. Here, Denise is acting in the role of a general partner, and also acting as a agent. When she placed an order with Ag Country, she was acting as an agent, which is binding and makes the partnership liable for the transaction with Ag Country.

Therefore, Denise will be personally liable to Ag Country for her investment as a general partner up to the amount of her investment.

Is Central Coast Bud Boutique liable?

As discussed above, Denise properly formed a limited partnership operating under the name of Central Coast Bud Boutique. In a principal-agent relationship, Central Coast is acting as the principal and Denise is acting as the agent. Denise has apparent authority to enter into contracts on the principal's behalf if it is necessary to carry out the principal's objectives. The principal is bound by these contracts.

Here, Denise is acting as an agent of Central Coast Bud Boutique and she placed an order with Ag Country for a total contract price of $50,000 with monthly payments of $10,000. She signed the agreement as general partner, which not only binds her personally as discussed above, but also binds her company.

Therefore, Central Coast Bud is liable to Ag Country for damages. Because this constitutes a buyer breach, Ag Country can seek damages and either get the difference between the contract price and the market price or the contract price and the resale price.

b.

Can Central Coast Bud continue in business given Strait's refusal to fund?

In a limited partnership, if there is a withdrawal by either a general partner or a limited partner, the partnership can no longer continue. Although dissolution is generally considered a harsh remedy by the courts, a partnership cannot continue with just the existence of one partner, Denise.

Therefore, Central Bud will no longer be able to continue in business without Steve.

2)

Does Randy's purchase and sale of Sprout violate Section 10b-5 of the Securities Exchange Act of 1934?

Insider Trading

Rule 10b-5 is the provision within Section 10b that specifically prohibits the trade on the basis of insider information. Insider trading is when an insider has a fiduciary duty to a corporation, learns of material, non-public facts as a result of his/her position, and trades on that information. If the insider passes the tips of information along to someone else, the insider is considered a tipper and the person receiving the information and trades on it is a tippee. The information must be given for personal benefit.

Tipper:

A tipper is liable if they learn of material, non-public information as a result of breaching a fiduciary duty and passed the information along to another person for the purposes of trading, for the tipper's personal benefit. Here, Randy was interviewing an intellectual property lawyer for a possible job in Randy's firm, and during the interview, the associate revealed his knowledge of material, non-public information about Sprout, which would make the associate a constructive insider/tipper. The personal benefit that the associate gained is being able to show off his knowledge about IP law, in hopes that he would get a job in Randy's firm. Randy would argue that it wasn't for personal benefit, he was just merely passing along the information as part of the conversation about current market trends and activities.

Material, non-public facts: The associate revealed that Spout was days away from launching a genetically engineered corn seed that was resistant to the European Corn Borer, a pest that annually costs corn growers hundreds of millions of dollars. Because

this information has not yet been released to the public, and this is the type of information that a reasonable investor would consider important in deciding whether or not to trade, this information is considered material.

Breach of fiduciary duty: The associate is a four-year lawyer who is employed at a law firm. As a attorney, he has fiduciary duty his firm and his clients and he also has a duty of confidentiality to his clients. When he revealed to Randy that his client Sprout was going to release the corn seed, he breached his duty of confidentiality.

Tippee: A tippee is derivatively liable if the tipper breached, and they knew or should have known that the tipper breached.

Randy traded on the information that he received from the associate,which makes him a tippee. He purchased 10,000 shares of Sprout in his own name, and two months after the purchase, he sold his shares once the stock leveled off. Randy, as an attorney himself who represents tech clients and VCs, knew very well that when the associate revealed the information about Sprout, that it was material fact and the associate breached his duty to his client and his firm. Randy's knowledge about the breach is also demonstrated by him "wrestling with his decision over a sleepless night".

Defenses:

In order to avoid a 10b-5 violation, Randy could argue that the associate did not breach a duty of a fiduciary duty. He could say that the information was just merely part of the interviewing process and that the associate was so excited about getting the job, that he didn't realize that he was giving material information to Randy. He was just trying to demonstrate to Randy that he has extensive knowledge in patent and IP law.

The burden is on Randy to show that the associate did not breach his duty. If he can successfully prove this, he will not be held derivatively liable.

He could also argue that the information that the associate gave to him was not material, it was just information about an upcoming launch that would have no importance to anyone who wanted to trade. This argument would likely fail given that this seed would have a significant impact on the corn industry.

He may also argue that as a partner in an LLP, he has limited liability and would be insulated from this violation although this argument would fail because his limited liability does not include insulation from the SEC.

Therefore, it is likely that the SEC would find Randy liable under 10b-5 and he would not be idemnified for any legal expenses incurred, per his partnership agreement.

Misappropriation

If the SEC is unsuccessful with their suit against Randy for insider trading, it may prosecute him for misappropriation, which applies to anyone who violates their duty of trust and confidence owed to the source of information.

Here, Randy may be liable for misappropriation as an outsider who has traded on material, non-public information.As a lawyer Randy owes a duty of trust and confidence in any situation where a duty of trust is expected or assumed/implied. Here, the duty of confidence and trust would be owed to the source of information held by Sprout as well as the associate. A duty of trust would be owed to the source of information held by the associate during the job interview, as both men are attorneys and are held to a different ethical standards in their profession. Once the associate starting talking to Randy about Sprout, Randy had a duty to immediately stop him from discussing the details. Although he did 'move him off topic' he should have stopped the conversation and made a firm demand to the associate to discontinue sharing any information about Sprout. Instead,

Randy decided to let the associate continue talking. Randy also owed a duty of trust to the source of information held by Sprout, even though Randy is not affiliated with Sprout in any way, Randy knew that Sprout was a publicly traded company, and being an IP lawyer, Randy should have known that his type of information would require him to keep it confidential, which he didn't.

Randy doesn't have any solid defenses to misappropriation, so it is likely that a court would find him guilty of misappropriation, and he would not be idemnified for any legal expenses incurred, per his partnership agreement.

3)

Does Bob and Ketchum & Cheatham LLP (BKC) have a valid claim against Randy breach of fiduciary duties in the theft of a business opportunity?

The business opportunity doctrine proves that if an offer is made to a director, partner, or other person with authority in overseeing business affairs, then that person must disclose the opportunity to the business first before taking the opportunity to him or herself and reaping all the profits. A defense mechanism usually put on is whether the business itself is in the line of business of the type the opportunity was offered. The business must also demonstrate that it was willing and able to perform. This is loosely structured by the courts because a business may, almost always, be potentially able to perform by seeking out a loan to acquire the money for the investment. A different test for determining the line of business test are the A.L.I. factors.

Here, in order for BKC to have a claim against Randy (R) they must first establish the fiduciary duties owed to one another. Since the facts state that this is an LLP of which Bob and Randy are both managing general partners, all of partners owe a fiduciary duty to one another. BKC will claim that the fiduciary duty was broken because R decided to not disclose the information to the firm because he wanted to take all the benefits for himself. R should have disclosed to the firm that he had the information and that he was going to trade on it. At a minimum, R should have disclosed the facts to the firm and had the firm decide what to do. This, however, would chill R's freedom to buy Sprout stock because he would not be able to trade on Sprout until the firm affirmatively decides on whether to buy or abstain from buying Sprout stock. Disclosure is always key to a business opportunity doctrine claim. In fact, disclosure is key to a lot of other business claims against a partner or a director as well.

Next, BKC will have to demonstrate that they were actually interested in the trade and information that R traded on and that they were in the same line of business as buying those stocks. BKC will argue that R knew that the firm had made 15 other similar purchases for stock before and has always held the stock under the corporate's name rather than the individual partners. BKC will argue that R should have known that BKC would be interested in buying those securities and since he is a general managing partner, had information about the firm's earnings, liabilities, and cash flow in order to determine whether the firm was actually capable of purchasing the Sprout stock for themselves.

Does BKC have an obligation to indemnify Randy for his legal fees in defending the SEC action?

The written partnership agreement provides an indemnity clause which will be held valid under the statute. Moreover, partners can limit or contract with one another in their partnership agreements to almost anything except to limit their fiduciary duties. The clause specifically states that a person will be indemnified for a *successful defense* of any claim connected with the partnership. If the SEC dismisses all charges in exchange for disgorgement of Randy's profits from the Sprout trade, the it will not be a "successful defense" but more of a stipulation or agreement. Therefore, Randy will unlikely be indemnified in the dismissals of the SEC action.

However, if it is deemed as a successful defense action then the express clause will provide indemnity for Randy.

END OF EXAM