

Sal is a software creator who wants to make an app that will make him a billionaire.

Sal believes that it is possible to reduce the amount of fuel used by large trucks. He is convinced that a software “hack” on the existing computer-controlled fuel system will allow a truck to travel farther on the same amount of fuel.

Sal’s problem is a lack of start-up money to create the software. Computer programmers need to be employed and time rented on a “supercomputer” to make the necessary algorithms. Sal finds a way to raise the capital and forms a public corporation so that shares of the corporation can be sold to fund the research.

The corporation is duly formed in California as Miles Per Gallon Plus, Inc. (MPG+) and stock is offered to the public. But there is no response. People are not interested in owning a company’s stock that “might” solve a problem. Sal needs to convince people that MPG+ will be able to produce and sell software that will greatly increase the number of miles per gallon used by a truck.

Sal decides to build an inexpensive “prototype” so that he can try to show investors that his software device actually works. Sal spends less than \$3, buying a simple piece of plastic with two little green lights. He adds a cord that allows the plastic piece to be plugged into a USB port on the truck’s dashboard. Next Sal hired a large truck with a driver. Sal also rented a fuel mileage tester that was installed on the truck to measure precisely how many miles the truck could travel on a gallon of fuel.

Sal instructed the driver to start in San Luis Obispo and drive to the top of Cuesta Grade, 8 miles away. Hauling up the highway to the top of the grade, with a 40,000-pound payload, took 2 gallons of fuel. At the top of Cuesta Grade Sal plugged the fake prototype into the truck’s USB connection. The truck returned the 8 miles back to San Luis Obispo, which took only 1 gallon of fuel.

Sal started to advertise that his APP was a huge success. MPG+ advertised that a truck without the device being plugged into the truck only achieved 4 miles per gallon, but with the MPG+ plugged in, the truck doubled the miles traveled on a gallon of fuel.

Of course, doubling the miles per gallon would be a huge benefit to the trucking industry and an APP that doubled the number of miles a truck could travel on each gallon of fuel would be worth billions.

When the public heard that big trucks could travel twice as far on the same amount of fuel Sal’s MPG+ stock was in demand. Joe bought \$250,000 worth of MPG+ stock after reviewing the advertisements. Months went by and although Sal was working day and night with the experts that had been hired MPG+ was unable to put a product on the market that made any improvement mileage.

Joe was losing patience by then and started an investigation. Joe learned that the same truck, cargo and driver had made the test and that when the prototype was plugged into the truck the mileage had actually doubled. Since no new product was being made by MPG+ the stock became less desirable and by now the value of Joe’s stock had dropped to only \$50,000.

Joe’s investigation continued until the truck driver was located. It eventually came out that the prototype device had been plugged in at the top of Cuesta Grade and unplugged in San Luis Obispo. Joe realized that the MPG+ prototype had not made any difference in the amount of fuel that had been used. Simple gravity had made the difference in the two mileage figures. When the heavy truck went

from a low 276 feet above sea level and climbed over 1,500 feet to the top of Cuesta Grade, it naturally took a lot more fuel than simply coasting down from the high elevation to the much lower one.

Joe comes to you to see what can be done about the loss of his investment. What legal advice will you give to Joe? If Joe is able to bring a suit against Sal and MPG+ will Joe prevail?

Discuss

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### With Response Outline

Sal is a software creator who wants to make an app that will make him a billionaire.

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Sal’s problem is a lack of start-up money to create the software. Computer programmers need to be employed and time rented on a “supercomputer” to make the necessary algorithms. Sal finds a way to raise the capital and forms a public corporation so that shares of the corporation can be sold to fund the research.

The corporation is duly formed in California as Miles Per Gallon Plus, Inc. (MPG+) and stock is offered to the public. But there is no response. People are not interested in owning a company’s stock that “might” solve a problem. Sal needs to convince people that MPG+ will be able to produce and sell software that will greatly increase the number of miles per gallon used by a truck.

Sal decides to build an inexpensive “prototype” so that he can try to show investors that his software device actually works. Sal spends less than \$3, buying a simple piece of plastic with two little green lights. He adds a cord that allows the plastic piece to be plugged into a USB port on the truck’s dashboard. Next Sal hired a large truck with a driver. Sal also rented a fuel mileage tester that was installed on the truck to measure precisely how many miles the truck could travel on a gallon of fuel.

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Joe was losing patience by then and started an investigation. Joe learned that the same truck, cargo and driver had made the test and that when the prototype was plugged into the truck the mileage had actually doubled. Since no new product was being made by MPG+ the stock became less desirable and by now the value of Joe’s stock had dropped to only \$50,000.

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Joe realized that the MPG+ prototype had not made any difference in the amount of fuel that had been used. Simple gravity had made the difference in the two mileage figures. When the heavy truck went from a low 276 feet above sea level and climbed over 1,500 feet to the top of Cuesta Grade, it naturally took a lot more fuel than simply coasting down from the high elevation to the much lower one.

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Discuss -----

## OUTLINE OF RESPONSE BY STUDENTS

1. Business Organization: Public Corporation
2. Proper allegations and suit:
  - A. Securities Exchange Commission (SEC) Rule 10(b) or 10(b)-5, Elements:
    - (1) Issue involves sale of stock;
    - (2) Fraud: Sal's defense
      - (a) Same truck,
      - (b) Same Driver,
      - (c) Same distance,
      - (d) Mileage did change when device plugged in.
      - (e) Forward projections that possible that software might be developed in future.
    - (3) Misrepresentation: Joe's allegations, Sal's Duties:
      - (a) Duty to inform, explain uphill vs. downhill,
      - (b) No half-truths, Device plugged in – but useless,
      - (c) Materiality, elevation factor,
      - (d) Scier, Sals intent present.
    - (4) Minor points:
      - (a) Can bring 10(b) in private action.
      - (b) Joe had standing as the owner of stock in MPG+.
      - (c) No facts that Sal owned any stock, but OK since involves Sal's Fraud/Misrep.
      - (d) Joe's loss shows transaction causation.
      - (e) Effect on Sal after suit.

B. Conclusion:  
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Faculty Notes on Exam Number 1:

Somewhat lengthy facts, but simple response for passing grade.

Section 10(b) case, required elements; obvious misrepresentation by omission of material fact that mileage was predicated on hauling cargo up, or down, steep road; not because of software. Sal's intent (scier) specifically must be specifically alleged.

Duties owed by Sal. Reliance by Joe, and Joe's loss.

DRAFT 1

Bus Law SLOB343 LABII Spring 2020 Final Essay --- Fill In --- Number 2

Sal was a UPS delivery driver, living in California. Sal's off hours were devoted to riding bicycles.

The downside of riding bicycles is, and has always been, keeping air in the tires. Sal was often frustrated by being forced to stop and fix flat tires; having to take the wheel off, remove the tire, patch the tube and pump air into the tire before continuing the ride.

Sal had recently acquired a "3d Printer" and decided to try to "print" a tire that did not need to be inflated. After several failed attempts a solid rubber tire showed potential, if it could be perfected.

Sal quit driving for UPS, started to refine the design and was able to produce 6 airless tires a week. Sal's goal had been to make a profit large enough to live on, but selling 6 tires a week just covered Sal's overhead.

1. At this point, what type of business organization does Sal have?  
\_\_\_\_\_
2. Was Sal required to register or pay a fee to any governmental organization before starting the business?  
\_\_\_\_\_
3. Is Sal personally responsible for all debts of the business?  
\_\_\_\_\_
4. Sal falls in love with Fran and they get married. Sal and Fran both desire to manage the business and make a profit selling the 3d printed bike tires. What type of business organization does Sal and Fran have at this point?  
\_\_\_\_\_
5. Are Sal and Fran both personally responsible for all debts of the business?  
\_\_\_\_\_

Sal and Fran, working together now produced and sold 9 airless bike tires a week and wanted to expand. They asked Joe, a bike mechanic, Jane, an accountant, and Susan, a very wealthy entrepreneur, to join into their business. Susan was concerned that if something went wrong, she might have a personal liability, so Susan made sure that Sal, Fran, Joe, and Jane knew that she would not join in the business unless she was immune from all liability for business debts.

6. What type of business has been created at this point?

\_\_\_\_\_

7. Did this business have to pay any fee or register with any governmental entity prior to starting operations?

\_\_\_\_\_

8. Are Sal, Fran, Joe, Jane and Susan each jointly and severally liable for all debts of the business?

\_\_\_\_\_

9. If number 8 is negative, which of the individuals is not liable for all debts of the business?

\_\_\_\_\_

Because of Susan's influx of funds, Joe and Jane's expertise and Sal and Fran's leadership the business begins to exceed all expectations; the profits doubling every two months. With an expansion of the production and sales, more stock is required, and four employees are added.

Sal holds a meeting of the business owners and they decide to change the form of the business to one that will reduce or eliminate their personal liability for the debts of the business. The fastest growing type of business in the United States is chosen to protect the members from personal liability.

10. What type of business has been created?

\_\_\_\_\_

11. Did this business have to pay a fee or register with any governmental agency prior to starting operations?

\_\_\_\_\_

12. Has the personal liability for each member been reduced under this form of business?

\_\_\_\_\_

Two successful years go by and the demand far exceeds the production capabilities of the enterprise. The original airless --- 3d printed --- bike tires are becoming a worldwide phenomenon. Everyone wants these tires on their bicycles so that flats don't interrupt their bike ride. All members agree that they want to expand again and continue to hold the top spot as bicycle tire manufacturers around the globe. But to do this a huge investment must be made in 3d printing equipment. In fact, they need to raise at least 8 million dollars. Financing is explored and the possibility of a loan is discussed. None of the members want to be responsible for paying back a loan of this magnitude.

Sal comes to your office to ask if there is some way to raise a very large amount of money; that the officers and directors of the business don't have to pay back, a business form that would be easily transferrable to new owners should the original owners chose to sell portions of their ownership interests.

13. You recommend that the business be conducted as a:

\_\_\_\_\_

14. Does this type of business need to pay a fee or register with any governmental organization prior to commencing operations?

\_\_\_\_\_

15. Will the officers and directors of this business generally be protected from personal liability for business debts?

\_\_\_\_\_

DRAFT 1 With Responses

Bus Law SLOB343 LABII Spring 2020 Final Essay --- Fill In --- Number 2

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The downside of riding bicycles is, and has always been, keeping air in the tires. Sal was often frustrated by being forced to stop and fix flat tires; having to take the wheel off, remove the tire, patch the tube and pump air into the tire before continuing the ride.

Sal had recently acquired a "3d Printer" and decided to try to "print" a tire that did not need to be inflated. After several failed attempts a solid rubber tire showed potential, if it could be perfected.

Sal quit driving for UPS, started to refine the design and was able to produce 6 airless tires a week. Sal's goal had been to make a profit large enough to live on, but selling 6 tires a week just covered Sal's overhead.

1. At this point, what type of business organization does Sal have?  
\_Sole Proprietorship\_\_\_\_\_
2. Was Sal required to register or pay a fee to any governmental organization before starting the business?  
\_\_No\_\_\_\_\_
3. Is Sal personally responsible for all debts of the business?  
\_\_Yes\_\_\_\_\_
4. Sal falls in love with Fran and they get married. Sal and Fran both desire to manage the business and make a profit selling the 3d printed bike tires. What type of business organization does Sal and Fran have at this point?  
\_\_Sole Proprietorship\_\_\_\_\_
5. Are Sal and Fran both personally responsible for all debts of the business?  
\_\_Yes\_\_\_\_\_



Sal and Fran, working together now produced and sold 9 airless bike tires a week and wanted to expand. They asked Joe, a bike mechanic, Jane, an accountant, and Susan, a very wealthy entrepreneur, to join into their business. Susan was concerned that if something went wrong, she might have a personal liability, so Susan made sure that Sal, Fran, Joe, and Jane knew that she would not join in the business unless she was immune from all liability for business debts.

6. What type of business has been created at this point?

\_\_\_\_\_ General Partnership or simply Partnership \_\_\_\_\_

7. Did this business have to pay any fee or register with any governmental entity prior to starting operations?

\_\_\_ No \_\_\_\_\_

8. Are Sal, Fran, Joe, Jane and Susan each jointly and severally liable for all debts of the business?

\_\_\_ Yes \_\_\_\_\_

9. If number 8 is negative, which of the individuals is not liable for all debts of the business? (All are liable)

\_\_\_\_\_

Because of Susan's influx of funds, Joe and Jane's expertise and Sal and Fran's leadership the business begins to exceed all expectations; the profits doubling every two months. With an expansion of the production and sales, more stock is required, and four employees are added.

Sal holds a meeting of the business owners and they decide to change the form of the business to one that will reduce or eliminate their personal liability for the debts of the business. The fastest growing type of business in the United States is chosen to protect the members from personal liability.

10. What type of business has been created?

\_\_\_ Limited Liability Company (LLC) \_\_\_\_\_

11. Did this business have to pay a fee or register with any governmental agency prior to starting operations?

\_\_ Yes \_\_\_\_\_

12. Has the personal liability for each member been reduced under this form of business?

\_\_ Yes \_\_\_\_\_

Two successful years go by and the demand far exceeds the production capabilities of the enterprise. The original airless --- 3d printed --- bike tires are becoming a worldwide phenomenon. Everyone wants these tires on their bicycles so that flats don't interrupt their bike ride. All members agree that they want to expand again and continue to hold the top spot as bicycle tire manufacturers around the globe. But to do this a huge investment must be made in 3d printing equipment. In fact, they need to raise at least 8 million dollars. Financing is explored and the possibility of a loan is discussed. None of the members want to be responsible for paying back a loan of this magnitude.

Sal comes to your office to ask if there is some way to raise a very large amount of money; that the officers and directors of the business don't have to pay back, a business that would be easily transferrable to new owners should the original owners chose to sell portions of their ownership interest.

13. You recommend that the business be conducted as a:

\_\_ Public Corporation \_\_\_\_\_

14. Does this type of business need to pay a fee or register with any governmental organization prior to commencing operations?

\_\_ Yes \_\_\_\_\_

15. Will the officers and directors of this business generally be protected from personal liability for business debts?

\_\_ Yes \_\_\_\_\_

Question 3

The New York Stock Exchange had always fascinated Denise. After graduating from UCSB Denise attended law school. She passed the California and New York Bars then got a job as an associate with a large law firm in Manhattan. Denise had no time to make new friends or have any social life since she was working 80+ hours a week.

Denise often thought about her best friend, Jill, who still lived in Santa Barbara. Jill had been Denise's friend at UCSB and they often surfed together. Jill's only interest in life was surfing and she hoped to be a professional surfer someday. Denise worried about Jill because of the large school loans that Jill had taken out in order to attend UCSB. Jill's only income was from giving surfing lessons. There was only enough income to pay Jill's rent and food, and nothing was going to pay the loans back.

After a few months Denise started working for LJ, a partner in the firm. LJ was a specialist in facilitating and advising public corporations that wanted to merge. Denise found it fascinating to hear about hundreds of millions of dollars changing hands as if it was just a routine trip to the grocery store.

Denise was a fast learner and quickly realized that mergers between public corporations was where the real money and power resided. Working hard and dedicating herself to a career specializing in antitrust law she was able to become a "player" in the world of big money mergers.

LJ was primarily interested in practicing "transactional" law and staying behind the scenes when it came to giving interviews or being involved in advertising for the firm. Denise, on the other hand, was very photogenic and enjoyed being the 'face' of the large firm's merger department.

The Wall Street Journal had mentioned Denise as one of the attorneys who had put together a billion-dollar merger which pleased LJ. Denise was gaining recognition every day. Still, Denise missed her friend Jill and they Skyped whenever they could. Denise was drawn to high finance, while Jill had no interest in financial matters and understood even less.

Jill did learn that money mattered when the rent was due along with the high cost of living in Santa Barbara. Denise was aware of Jill's lack of financial acumen and wanted to help her friend. Of course, Denise knew about upcoming business mergers before the general public was informed, even before the shareholders of the merging corporations. Denise realized that if Jill knew about the mergers and told which stocks to buy or sell that large profits could be made. Jill's aunt died and left Jill \$21,000. Jill told Denise about her inheritance.

Denise knew about confidentiality from law school, so she was cautious when she told Jill what to buy or sell. They had a sort of unspoken communication from their college days, so Denise's advice was always circumspect; saying something to the effect of "You might be interested in such and such corporation and if you bought some of its stock, it would really help your money problems."

Denise did not tell Jill about the work that Denise was doing with the mergers and she knew that Jill would not have any clue about the complicated world of high finance anyway. But to avoid even the rumor of impropriety Denise did not buy or sell any stocks herself and told no one else about forthcoming mergers.

- a. Is Denise have any liability because of her providing information to Jill about stocks? Discuss.
- b. Is Jill liable for her purchase and sale of securities based on Denise's tips? Discuss.

END OF QUESTION 3

## Exam Question number 3; (Denise). Possible Answer

Call of the Question: Does liability extend to Denise or Jill under the securities and exchange rules established by Congress?

Issue: Did the information Denise provided to Jill amount to inside information, in an actionable manner, making either or both liable under government regulations?

Rule:

The Securities and Exchange Act of 1934 (the Act) governs transactions regarding securities. Rule 10(b) of the Act concerns Securities Fraud. Under Rule 10(b) any person who commits an act of fraud in connection with a sale or purchase of a security is liable for securities fraud. The rule extends to situations known as insider trading. Under section 10(b)-5 the persons who can be held liable as insiders include; Tippers/Tippees, and Misappropriators.

Application:

Any person who is in possession of material (pertinent) inside information regarding a company must disclose that information to the general public before trading on it, or if disclosure is not possible, the insider must abstain from making a securities transaction. Whether or not the subject information is viewed as "material" (i.e. important enough to warrant scrutiny) is based on a reasonable person's analysis of the information and if the information would be relevant to their decision making process to purchase or sell the stock.

Denise was an insider under 10(b)-5. Additionally, insiders are those who owe a fiduciary duty to the corporation, including directors, board officers, attorneys, administrators and others related to the business of the corporation. Insider trading occurs when a fiduciary uses insider information to profit from the purchase or sale of securities. Based on the facts in this situation; Denise worked for a firm that dealt in mergers and Denise was aware of mergers before the general public or the shareholders of the merging corporations. Additional requirements under 10(b)-5 include scienter (guilty intent), which Denise obviously had in trying to surreptitiously help Jill with her financial problems. Another requirement is interstate commerce which is met when Denise, in Manhattan told Jill, in California, about upcoming mergers.

Denise's attempt to provide the information in a clandestine manner serves as further evidence of her scienter; especially in light of the fact that insider trading is considered wrong because it corrupts the sanctity of a free marketplace.

As stated in the facts Denise knew about mergers and told Jill about them. Although Denise provided the information indirectly; that Jill should buy a certain stock, and did not declare that a merger was about to take place Denise did provide information not known to the general public. A reasonable person may deduce from the information Denise provided, as Jill did, that there would be a significant change in stock value with the acquisition by another company.

Possible liable parties/Insiders: Under Chiarella, the court adopted the elements of Cady, Roberts case and held that the insiders are those individuals that have a relationship of trust and confidence with the issuer because of the position that they hold in the company. Insiders are privy to confidential information because of their position in the company and the confidential information is for corporate purposes only. Also, it would be unfair to let insiders trade based on inside information which is undisclosed to the public.

Tippers/Tippees:

When a tipper provides inside information to someone else who trades on the basis of the inside information, tipper can be held liable under 10(b)-5 if she provided the inside information for any improper purpose such as pecuniary gain or reputational benefit that would translate to future earnings. Tippee can also be held liable derivatively if the tippee knew or should have known that the that the tipper breached a duty.

Jill received the information and is therefore known as a tippee. A tippee's liability is derivative of the tipper (Denise). Therefore, whether or not Jill is liable for insider trading depends on Denise's liability for insider trading.

Under the misappropriation theory, a person can be held liable or prosecuted by the government (SEC) for trading on the basis of inside information because the insider has a relationship of trust and confidence with the source of the information the duty does not need to be towards the issuer. 10(b)-5(2) has an inconclusive list of situations where the misappropriator doctrine applies which includes anyone who agrees to keep the information confidential, anyone who receives confidential information from sibling, parent child, and spouse, or when the person providing the information and the person receiving the information have a history of maintaining confidences (as in this case based on the facts) between them so that the person providing the information would expect the person receiving the information to keep the information confidential.

Conclusion:

In this case, Denise owes a duty of confidentiality to the law firm she works for and to the corporation that is their client in a merger deal. The information Denise divulged came from her inside knowledge. Jill has obtained a benefit as a result of Denise's tip. Although Denise did not gain financially, she did enhance her reputation (at least with Jill and knew she was acting in a disloyal manner. Denise is liable for insider trading and therefore Jill is also guilty as a tippee.

END

1)

Q1

**Joe v. Sal & MPG+**

Sal is a software creator who wants to make an app to allow a truck to travel further on the same amount of fuel. Sal raised capital and was able to form a public corporation. The facts do not speak as to Sal's position, but we will assume that he is a director of the corporation. A corporation must have at least one director, but can have more than one. Joe is an investor who purchased \$250k in stock. Due to the lack of new product being made by MPG+, the stock became less desirable and the value of Joe's stock is \$10k. A shareholder may bring a direct suit for breach of fiduciary duty owed and can also bring a derivative suit on behalf of the corporation for harm done to the corporation. Here, we will only discuss Joe's suit against Sal and MPG+.

**SEC Rule 10b**

SEC Rule 10b-5 provides liability whenever any person uses fraud or deception in the purchase or trading of public stocks. This rule can also be used in private actions for actions by shareholders who have been deceived. 10b-5 violations can be as a tipper, tippee, direct trading by an insider, or by a misappropriator. To prove fraud, must show an intent to defraud, a material misrepresentation, and reliance upon the misrepresentation directly connected with the purchase of stocks. Here, Joe may bring a suit against Sal for violation of Sec10b-5.

*Tipper*

A tipper is liable if information was shared for the improper purpose of direct or indirect personal gain. Personal gain can include money, gifts, reputation, and the tipper is not required to trade in securities personally. Sal needed to convince people that MPG+ will be able to produce and sell software that will increase mpg. Sal builds an inexpensive prototype, hires a large truck with a driver, and a fuel mileage tester. Sal instructed the driver to start in San Luis Obispo and drive to the top of the Cuesta grade. At the top of the grade, Sal plugged in the prototype and returned back to San Luis Obispo. Sal was able to attract investors, including Joe. Here, Sal wanted to create an app that would make him a billionaire. Sal wanted to make MPG+, his corporation, successful and needed a successful app. Sal constructed the test for showing the effectiveness of the app, and then advertised the app was a huge success.

### *Fraud*

To prove, must show an intent to defraud, a material misrepresentation, and reliance upon the misrepresentation directly connected with the purchase of stocks. Here, Sal needed to convince people that MPG+ will be able to produce and sell software that will increase mpg. Sal builds an inexpensive prototype, hires a large truck with a driver, and a fuel mileage tester. Sal instructed the driver to start in San Luis Obispo and drive to the top of the Cuesta grade. At the top of the grade, Sal plugged in the prototype and returned back to San Luis Obispo. Sal advertised the app was a huge success. Joe thereafter purchased \$250k worth of stocks. Joe will claim that Sal had an intent to defraud investors when he instructed the driver to drive to the top of Cuesta grade with a 40000lb payload and installed the prototype in at the top of the grade to calculate MPG while coasting down the grade, which doubled the mpg. Sal will claim that he was merely encouraging investors. Joe will claim that Joe's misrepresentation about the app was a material misrepresentation - the corporation is geared at producing and selling software which can increase mpg for a truck. Sal will claim that it was not material, because he was still working on getting a working app together, and the investors still had a goal for the corporation. However, most shareholders would find the representation about a working app to be material to the purchase of these stocks. Joe will argue that he only purchased the stocks after hearing about the advertising of MPG+. Joe will claim that his purchase was directly connected to the material misrepresentation about the app. It is likely that Sal will be liable to Joe under SEC10b.

### **Duty to Act in Good Faith**

All director and officers have a duty to act in good faith and in the best interest of the corporation and the shareholders. Here, Sal needed to convince people that MPG+ will be able to produce and sell software that will increase mpg. Sal builds an inexpensive prototype, hires a large truck with a driver, and a fuel mileage tester. Sal instructed the driver to start in San Luis Obispo and drive to the top of the Cuesta grade. At the top of the grade, Sal plugged in the prototype and returned back to San Luis Obispo. Sal advertised the app was a huge success. However, Sal's claims about the prototype were not completely accurate. The fuel efficiency was based on the truck coasting from the top of the grade to the bottom. Joe will claim that Sal knew that his claims about the app were false. Sal will claim he needed to simply encourage investors in order to get capital to make a working product. Joe will point to the fact that Sal's prototype was made for less than \$3, and made no genuine attempt at doing anything as described. Sal will claim that he did continue to work diligently for months and he worked day and night with no success in getting a product on the market that made any difference. Investors take a risk when supporting a new company. However,

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there is a certain amount of assurances owed by the officers and directors when making statements publicly about their products. It is likely that the court will find Sal has breached his duty of good faith and will be liable to Joe.

### **Duty of Care**

All directors and officers have a duty of care to the corporation. Here, Sal needed to convince people that MPG+ will be able to produce and sell software that will increase mpg. Sal builds an inexpensive prototype, hires a large truck with a driver, and a fuel mileage tester. Sal instructed the driver to start in San Luis Obispo and drive to the top of the Cuesta grade. At the top of the grade, Sal plugged in the prototype and returned back to San Luis Obispo. Sal advertised the app was a huge success. However, Sal's claims about the prototype were false. The fuel efficiency was based on the truck coasting from the top of the grade to the bottom. Joe will claim that Sal knew that he was misrepresenting the success of the app.

### *Business Judgement Rule*

The business judgment rule is the standard of care owed and presumes that actions taken by directors and officers are in the best interest of the corporation and its shareholders. However, when a director or officer's conduct is unreasonable, the business judgment rule may be violated. Here, Sal is likely the director of MPG+. It is presumed that his actions are in the best interest of the corporation and shareholders. Here, Sal was able to find a way to raise capital and form a public corporation. However, there was no response from the market because Sal needed to convince people that MPG+ will be able to produce and sell software that will increase mpg. Sal builds an inexpensive prototype, hires a large truck with a driver, and a fuel mileage tester. Sal instructed the driver to start in San Luis Obispo and drive to the top of the Cuesta grade. At the top of the grade, Sal plugged in the prototype and returned back to San Luis Obispo. Sal advertised the app was a huge success. Here, Sal's actions would be presumed in the best interest of the corporation. Joe will point to the fact that Sal spent less than \$3 to construct the prototype. Sal could have put more time, effort, and work into building something that may have functioned. Sal's prototype was a simple piece of plastic with 2 little green lights. Joe will claim that Sal later advertised the app was a success, however Sal knew there was no way that an app would function on a device as such. Sal will claim that his actions were required as the director in order to build capital for the corporation. Sal needed investors so that he could continue development on the app. His actions, while maybe not the most diligent undertaken, were actions taken in order to float the corporation through the first few months. The court may or may not find liability under these circumstances.

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**END OF EXAM**

2)

**Is Denise an Insider with a fiduciary duty? Yes.**

**Insider trading:** Occurs when an insider with a fiduciary duty to a corporation trades securities on the basis of inside information that was not disclosed to the public. The information is material, and a reasonable investor would consider the information important when making the decision to invest. The information must be given for a personal benefit. Insider trading is a transaction between tippers and tippees. A tipper is one who gives a tip of inside information to someone who trades based on the information. A tippee is the person who trades based on the information from the tipper.

Tipper/ Tippee activity gives rise to a 10b-5 violation. The tipper is liable if she: (1) passed insider information in breach of a duty; and (2) benefited from the pass. The tippee is liable if she: (1) traded on the tip; and (2) knew or should have known that the information was improperly passed.

**Rule 10b-5** makes it illegal to use any fraudulent scheme in connection with the purchase or sale of security. To make a prima facie case for a 10b-5 violation, the plaintiff must show: (1) transaction involved an instrument of interstate commerce; (2) fraudulent conduct; (3) related to a material fact; (4) in connection with either the purchase or sale of security; (5) intent to defraud; and (6) actual reliance.

Here, Denise is an attorney working for LJ, in a firm specializing in large corporate mergers. She was becoming the "face" of the firm and was even mentioned in the Wall Street Journal for her work on a big merger. She knew about upcoming biz mergers before shareholders and the public. Denise is an insider.

**Fiduciary duty:** This is a duty to act in utmost good faith and fair dealing. And to not appropriate property for his/her own use. As the face of the department who is privy to a billion dollar deals, and a lot of dynamic information, it is likely Denise had a fiduciary duty to the law firm to keep matters confidential. This is on top of her ethical duties as an attorney.

**Did Denise give Jill material information? Probably not.**

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Rule 10b-5 (see above rule)

**Interstate commerce:** Denise did not use an instrument of interstate commerce to communicate with Jill about stock trades. She used her mouth over the years. And gave information prior to her employment at LJ when Denise had **no fiduciary duty**, she gave hints to Jill on corporations she might be interested in because she was always fascinated with the New York Stock Exchange. But while employed under LJ, she did not tell Jill about the merger deals. So, no 10-b violation unless Denise was a tipper.

**Is Denise a tipper? No.**

She is liable as a tipper if she: (1) passed insider information in breach of a duty; and (2) benefitted from the pass.

[1] She did not pass information in a breach of a fiduciary duty if the conversations took place during their unspoken relationship college days. Facts suggest the conversations did not occur while she was under the employ of LJ. The information given to Jill at one point were circumspect, and not definite. Especially given the fact that Jill was not financially astute and had very little idea of what Denise was talking about. And Jill had no interest in financial matters.

[2] Benefit: Jill's aunt died and left Jill \$21,000. Denise did not use this information to her benefit. Because she did not tell Jill to invest in the upcoming merger she knew about. She only gave circumspect information about other companies.

Denise is likely not a tipper and did not benefit from the circumspect information she verbally passed on over the years. The only benefit would be emotional in hoping that Jill would get herself out of her lousy school loan situation. No facts suggest she had intent to deceive Jill or personally benefit. They are life long friends and she just wants Jill to be well. Material information would require enough detail for a reasonable investor to make a decision. Facts do not suggest such detail was provided.

**Is Jill a tippee? Probably not.**

Jill is liable if she: (1) traded on the tip; and (2) knew or should have known that the information was improperly passed.

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No facts suggest Jill purchased any securities on any of Denise's circumspect tips. Facts do not suggest the circumspect tips were material --important enough that an investor would need to know it to make an investment decision. Any information that Jill learned could have been from reading the Wall Street Journal. Information given to the public is not insider information and not material.

It is likely Jill did not know Denise was breaching her fiduciary duties by giving her vague hints on what to buy. No facts suggest that Jill understood her law career or even cared to hear what Denise was chatting about. Jill knew "money mattered", but had no interest in finances and did not act on anything she was told over that period of time.

However, the court may find that Jill should know there was an ongoing confidence breach because it would be implied that the two have a history of sharing confidences and private conversations as life long friends.

**Disclose or abstain rule:** In a corporation, when a person learns something he must disclose it all, by telling the Board and risking possible fiduciary duty breaches, or abstain and not do anything with the information. The issue is that we do not know if the law firm is a corporation with an active board. Denise did not buy or sell any stocks herself and did not tell anyone about forthcoming mergers. She will likely not be guilty of a 10b-violation.

**Opinion Defense:** Denise can always argue that the circumspect information was just her opinion. Not a misrepresentation. And not insider information.

**Conclusion:** Denise is probably not liable as a tipper because she did not use an instrument of interstate commerce (unless Skype counts??) to share information. The information was likely not material because it was circumspect and not based on real numbers that would compel a person to act --Example-- "Hey John, we are selling out for 500k tomorrow." No facts suggest that Jill relied on anything she heard. No facts state she spent her aunt's 21k on anything. All facts show that Jill had zero interest in Denise's fascination with the stock market and probably had no idea that she was breaching a duty. But rather just chatting away like best friends often do.

**Author's note:** This fact pattern was not clear. The call of question "b" infers Jill actually made purchases and sales off the tips. However, the fact pattern indicates only that she learned "money mattered" which would be an eventual revelation by any starving surfer in

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Santa Barbara. This author framed her answer on the information provided in the main fact pattern.

**END OF EXAM**

3)

### **Federal Securities Regulation**

The Security Exchange Act of 1934 governs transactions regarding securities. Section 10b of the Act addresses securities fraud.

#### Section 10b-5: Insider Trading

Section 10b-5 specifically prohibits 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 their position, and trades on that information. If the insider passes the information along to someone else, the insider is considered a tipper and the person receiving the information and trades on it is a tippee. To bring suit under 10b-5, one must show that the defendant conducted themselves in a manner which was manipulative, fraudulent, or deceptive; the conduct was material; and the defendant acted with scienter - the intent or knowledge of the wrongdoing.

#### **Denise's Liability**

##### Insider

Typical securities insiders, such as directors, officers, and controlling shareholders (>10%) owe a duty of trust and confidence to their corporation that is breached by trading on insider information. Constructive insiders, such as CPAs, attorneys, and bankers performing services for the issuer, also owe such a duty. Any insider who is in possession of material insider information must disclose the information to the general public before trading on it, or, if disclosure is not possible, the insider must abstain from making a securities transaction.

Here, Denise is an attorney performing services for LJ. Therefore, Denise is a constructive insider and owes a duty of trust and confidence to her client, LJ. As part of her new job at LJ, Denise became privy to private information relating to mergers between public corporations before the general public or even before the shareholders of the merging corporations were aware. She quickly came to realize that this was where the real money and power resided. This information certainly amounts to material, non-public information in

that a reasonable investor would consider it important when deciding whether or not to trade. Therefore, Denise, as an insider in possession of material, non-public information, must disclose the information before trading or abstain from trading. Though there are no facts to indicate Denise traded on this information, she may still be held liable as a tipper.

### Tipper

A tipper is liable when they have a duty to an issuer or are in a position of confidentiality, obtain material, non-public information as a result of that duty or confidence, and provide that information to a tippee for some personal benefit.

Here, Denise gained the information as a result of her position as the attorney for LJ. Therefore, she owes a duty to her client to keep the information private so as to not breach her duty of confidentiality. Denise breached this duty by giving the information to Jill. Though Denise may argue that she never explicitly told Jill the insider information, she will still most likely be deemed to have breached her duty because she still gave Jill the essential information needed to successfully trade on the information. Speaking in coded communication will not alleviate any liability, in fact it will most likely be used to show Denise acted with scienter in that she knew what she was doing was wrong, so she tried to conceal it. The information Denise provided to Jill is material in that a reasonable investor would like to know about any upcoming mergers before making an investment and the information is non-public because it had not yet been released to the general public or even to the corporation's shareholders. Lastly, Denise will argue that she did not receive any personal benefit. However, this argument will likely not be successful because she did gain an emotional benefit - she felt better about herself for helping Jill and less worried about Jill's financial situation resulting from her school loans. The facts also show that Denise had no time to make new friends and had no social life, therefore the emotional benefit stemming from helping out her best, and perhaps only, friend is likely significant.

Denise will likely be held liable for insider trading for her role as a tipper.

### **Jill's Liability**

### Tippee



A tippee is derivatively liable for insider trading if they knew, or should have known, that the tipper breached a duty of trust or confidence to an issuer, and the tippee used the material information to purchase or sell securities. Because a tippee is derivatively liable, they may only be found liable if the tipper elements have first been met.

Since Denise has likely already met the elements required to be a tipper, Jill may be held derivatively liable as a tippee. As discussed above, the information that Denise passed on to Jill was both material and non-public and Jill used the information provided by Denise to purchase and sell securities. Additionally, Jill knew that Denise was an attorney for LJ and owed them a duty of trust and confidence. However, Jill did not know that the information she was being provided with was the result of Denise's breach of duty. Though it may be argued that Jill should have known about the breach, the facts show that Denise went out of her way to not only avoid telling Jill the truth but to avoid even the rumor of impropriety. She did not tell Jill about the work she was doing, she did not buy or sell the stocks herself, and she told no one else about the upcoming mergers. Additionally, it states that Jill "had no interest in financial matters and understood even less" and that she "would not have any clue about the complicated world of finance anyway." Therefore, the argument that Jill should have known that Denise was in breach of her duties to JL is likely too speculative.

Jill will likely not be held liable for insider trading because she did not know that she was being provided with confidential, insider information.

**END OF EXAM**