

JULY 1999 CALIFORNIA BAR EXAMINATION ESSAY QUESTIONS AND SELECTED ANSWERS

Corporations

QUESTION

Sally is vice president for research at Chipco Corporation (Chipco), a microchip manufacturer. Chipco's stock is traded on a national stock exchange. During the course of her work for Chipco, Sally's research team developed technology that could reduce microchip production costs by 75%. However, Sally knew that additional testing was necessary to ensure commercial viability of the technology.

Chipco retained lawyer Laura to advise it on patenting the new technology. On March 12, 1998, Laura arranged a conference call with Sally and other Chipco personnel, who explained the new technology to Laura. This information was personally as well as professionally interesting to Laura because she already owned 12% of Chipco's outstanding stock as part of her personal investment portfolio. On March 16, 1998, Laura telephoned attorney Arnold, an opposing counsel in an unrelated matter, and mentioned that her client Chipco might soon become a major competitor in the microchip business because of new breakthrough technology. Shortly thereafter, Sally, Laura and Arnold each telephoned a broker and purchased shares of Chipco stock at \$10.00 per share.

On April 10, 1998, a financial newspaper reported a rumor that Chipco had developed new breakthrough technology. Within the next 2 days, Chipco stock increased to \$20.00 per share. Chipco had been purchasing large blocks of its own shares and it became fearful of continued price escalation of its shares. Therefore, Chipco promptly responded to questions from the press about the rumor by issuing a release which stated, "Chipco has not developed new commercially viable technology at this time." As soon as the statement was reported by the press, the price of Chipco shares fell to \$11.00 per share.

On August 20, 1998, after successfully testing for commercial viability, Chipco publicly announced its new technology, and Chipco shares again rose to \$20.00 per share. By September 5, 1998, Sally, Laura and Arnold had each sold all their shares of Chipco stock at the higher price.

Has there been any violation of federal securities laws by:

1. Sally? Discuss.
2. Laura? Discuss.
3. Arnold? Discuss.
4. Chipco? Discuss.

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ANSWER A

Sally – 10B-5 Violations plus 16B Violations

10B-5 Violations

Sally is an insider for ChipCo due to her position as vice president. Thus, Sally owes ChipCo a fiduciary duty to act in good faith and in a manner she reasonably believes is in the best interest of the corporation. This duty of loyalty has been enunciated in Rule 10b-5 released by the SEC in order to protect the securities markets from unscrupulous conduct.

Insider Trading

Sally, an insider of ChipCo, has a duty to disclose material and public information when trading in stock of her own company or to completely abstain from trading. Rule 10b-5 announces that insiders may not use instrumentalities of interstate commerce, such as the telephone, to buy or sell securities defrauding the only party to the transaction (i.e., fraudulent conduct in connection with the buying and selling) with the intent to deceive, manipulate or defraud the other party who is relying on the insider's representations or absence at such representations.

Sally called her broker on the telephone instructing him to purchase shares of ChipCo. This constitutes the use of an instrumentality of interstate commerce.

In so doing, Sally as an insider knew full well that the basis on which she was trading was material nonpublic information. The information was material because it is the type of material that a reasonable investor would consider important in making investment decisions regarding ChipCo. This is exemplified by the fact that once the rumors got out to the public about the possible innovations developed by ChipCo, ChipCo stock skyrocketed from \$10.00 per share to \$20.00 per share.

The information that Sally traded on was also nonpublic exemplified by the fact that the Research and Development department (R/D) was still working on the testing regarding viability of the technology.

Sally will argue that the information was not material because it was still speculative and uncertain whether the technology was viable. However, an investor trading (buying or selling stock) from Sally would consider this information important.

Thus, in order for Sally to trade with the public she must disclose this material nonpublic information to avoid defrauding potential buyers or sellers who have relied on Sally's non-disclosure. Sally failed to disclose the facts of pending technology to the public when Sally telephoned her broker.

At the time she purchased the shares she thus violated 10b-5 because without disclosing proper information she defrauded the market in connection with the buying

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and selling of ChipCo securities. This also gives rise to the scienter required; i.e., intent to deceive or manipulate the market. Thus the SEC (and any plaintiffs who bought or sold in reliance on Sally's failure to disclose can bring a private right of action under Rule 10b-5 can bring Sally to court for violating Rule 10b-5 for failing to disclose when trading or not trading, abstaining, and not disclosing.

16B Violations

Section 16B seeks to prevent insiders and shareholders from speculating on the success or decline of their company through short swing trading. 16B will disgorge any profits obtained by an officer, director, or 10% shareholder in short swing trading; i.e., buying and selling within six months.

Sally will be forced to disgorge her profits R/C:

- (i) ChipCo is traded on the National stock exchange,
- (ii) Sally was vice president; i.e., officer, either at the time she bought ChipCo shares and at the time she sold ChipCo shares
- (iii) She bought and sold ChipCo shares within a 6 month period - presumably she bought the shares somewhere toward the end of March and sold the shares on September 5, a span of less than six months.
- (iv) The ChipCo shares are equity securities thus Sally's profits will be disgorged in the amount of the highest sale price and the lowest buy price within the six month trading. Thus Sally's penalty for short term trading will be \$10 x the number of shares bought and sold.

Laura's Liability – 10b-5 plus 16B

Insider Trading

Same analysis as Sally because Laura as counsel for ChipCo owes a fiduciary duty to ChipCo as a temporary insider. Thus, Laura, violated 10b-5 by trading based on material nonpublic information.

Tipper Liability

As a fiduciary for ChipCo, Laura has a duty of confidentiality not to disclose material nonpublic information that she knows or reasonably should know is not for public dissemination but are trade secrets and projects of the company to be kept in-house.

By disclosing the facts of the release of technology to Arnold, Laura breached that fiduciary duty of confidentiality to ChipCo. To be liable for Tipper liability she must have personally benefited from the disclosure. It is arguable that she personally benefited by telling Arnold, opposing counsel, on an unrelated matter, to ensure her reputation and to soften-Arnold up during litigation encouraging Arnold to not make certain objections or to make concessions during negotiations or settlement.

Thus, Laura is liable for tipper liability under 10b-5.

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16B

Same analysis as Sally if Laura was a 10% shareholder both at the time she bought the shares in March and when she sold the shares in September. R/C the facts indicate she owned 12% on March 12. She is a 10% or greater stockholder subject to 16B violation for short swing profit trading.

Misappropriation

It can be argued that Laura misappropriated confidential information received from ChipCo when Laura owed ChipCo a fiduciary duty of confidentiality and loyalty she misappropriated by trading. Probably liable Rule 10b-5.

Arnold

Inside Liability

No liability because Arnold is not a classic insider like Sally nor a temporary insider like Laura.

Tippee Liability

Arnold can be liable for Tippee derivative liability under 10b-5 because Arnold traded based on information received from Laura, a party that Arnold knew or should have known has breached a duty to the corporation by disclosing material nonpublic confidential information to Arnold. Thus Arnold liable as tippee under 16b-5 due to trading intentionally to deceive market, and reliance.

Misappropriation

It can be argued, probably unsuccessfully, that Arnold misappropriated information he received from Laura by trading on it. However, he has owed no fiduciary duty to Laura thus will probably not be liable.

16B

No liability for Arnold because Arnold was neither an officer or director of ChipCo when buying or selling and was not a 10% or greater shareholder when he bought and sold the ChipCo stock. Presumably, he was only a 10% shareholder when he held the stock in September.

ChipCo

ChipCo, as a corporation, owes a duty to the public trading market not to make misrepresentations of material fact that the public trading market is likely to rely on in connection with a purchase or sale of ChipCo stock.

Here, ChipCo disseminated misleading press releases to the public to quell any leaks regarding the rumors of newly developed technology. In addition, ChipCo made

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these misrepresentations when repurchasing its own stock from the market; similar to Texas Gulf Sulphur.

Assuming that ChipCo used instrumentalities of interstate commerce such as the newspaper and wire, ChipCo will be liable for making misrepresentation of material fact defrauding the public traders into thinking that ChipCo was not working on anything special encouraging them to sell their stock.

Thus the SEC and any defrauded plaintiffs who sold can sue Chipco on private right of action.

ANSWER B

- 1) Sally - Rule 16 - Sally has violated the Federal Prohibition of short term trading by two corporate insiders (Rule 16e). Rule 16 applies anytime a stock is purchased at a lower price than it is sold by an officer, director or 10% shareholder within a six month window of time. Additionally, the stock must be traded on a national exchange or meet other requirements.

Here, Sally is an officer of ChipCo, whose stock is traded on a national stock exchange. She purchased stock on March 16, 1998 at \$10.00 a share. She subsequently sold the stock on September 5 (within 6 months of the purchase) at \$20.00 per share. She must therefore disgorge the profits therefrom.

Rule 10b5 - Sally probably also violated Rule 10b5. 10b5 requires that in concession with the buying or selling of stock, corporate insiders have a duty to either refrain from trading or disclose relevant information. Additionally, an instrumentality of interstate commerce must have been used in connection with buying or selling the stock.

Here Sally knew about the development of the new technology and knew thus a reasonable investor would find that information material. She, therefore, had a duty to disclose the information or refrain from trading, and she breached that duty when she purchased the stock. Since she used the telephone to call her broker, she used an instrumentality of interstate commerce. Therefore she violated Federal Rule 10(6)5.

- 2) Laura - Like Sally, Laura's purchase and sale of stock within a six month period violated Rule 16. Laura was a 12% shareholder before she purchased the additional stock on March 16, so the rule applies to her. As mentioned above, ChipCo trades on two national stock exchanges. Because Laura bought stock at a lower price than for which she sold within a six month window, she violated Rule 16. Here, however, she is not required to disgorge the profits on the shares that she owned prior to March 16.

10b5 - Laura is also probably liable for violation of Rule 10b5 on two grounds.

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First, like Sally, Laura owed a fiduciary duty to the corporation and was under a duty not to trade on inside information unless she disclosed it. Because she knew the information she learned in the conference call was material, she could not buy additional stock without disclosure. Since Laura used the instrumentality of commerce when she used the telephone call to her broker. Therefore, she violated Rule 10(b)5.

She may also have violated 10(b)5 in disclosing that ChipCo had developed new technology to Arnold. “Tippers” are liable under 10(b)5 when they have a fiduciary duty to a corporation that they breach by disclosing material information to a third party for an improper purpose.

Here, as an attorney for ChipCo, Laura had a fiduciary duty to the corporation. She breached that duty by disclosing material information (one a reasonable investor would deem important) to Arnold. It is unclear whether her purpose was improper; courts typically look to see if the “Tipper” received some benefit in making the tip. The benefit need not be pecuniary; here, it might be argued that Laura benefited by assuming the esteem of a fellow attorney or might have been seeking either reciprocal treatment, or else special consideration in the case in which she was dealing with Arnold. In any case Arnold relied on her tip and bought some of ChipCo’s stock. Therefore, if the court thinks that Laura gave the tip for an improper purpose, she violated 10b5 in this second respect as well.

- 3) Arnold - Rule 10(b)5 - Arnold might be subject to 10(b)5 liability as a “Tippee.” Tippees violate Rule 10(b)5 when they receive a tip from a person who owes a fiduciary duty to the issuing corporation, knowing that the Tipper has breached the fiduciary duty, and subsequently buy or sell in reliance on the tip.

Here Arnold received the tip from Laura, who was in a fiduciary relationship with ChipCo. Arnold probably knew that the tip was a breach of fiduciary duty; he knew that Laura was ChipCo’s attorney, and he is himself an attorney and must be familiar with what is required in the way of fiduciary duties. Finally, relying on the improper tip, he purchased some of ChipCo’s stock. Again, he used the phone, an instrumentality of interstate commerce, to call his broker.

However, it is important to note that Arnold cannot be held to have violated Rule 10(b)5 unless Laura also did so; that is, there can be no tippee liability without a tipper, so all the elements of Laura’s liability must be satisfied first.

- 4) ChipCo – Rule 10(b)5 - ChipCo may have violated Rule 10(b)5 by issuing the press release. Rule 10(b)5 prohibits fraudulent misrepresentations in connection with buying or selling stock using the instrumentality of interstate commerce. The misrepresentation must be material as well.

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Here the news release may or may not have been fraudulent. It merely says that “ChipCo has not developed commercially viable technology.” In a strict sense, this is true, since the facts state that Sally knew it was not commercially viable. However, a court might find that ChipCo intended to mislead the general public in making the statement. Furthermore, ChipCo was actively acquiring its own stock, knowing that the technology would soon be released. Because it was buying and its statement led to stockholders selling ChipCo stock, that element has been satisfied as well.

The misrepresentation was obviously material and relied upon since after the announcement, the price of the stock plummeted.

Finally, since ChipCo is traded on a national exchange, an instrumentality of interstate commerce was involved. Therefore ChipCo has in all likelihood violated Rule 10(b)5.