ID: **Exam Name:** **BusAssoc_LSN_(Greenberg)_Final_F08**
Instructor: **Marc H. Greenberg**

Grade: ____________

1)
Yes, laws were broken during the transactions relating to Umbrella Corporation over the last month. The SEC rules are promulgated with the intent of deterring and punishing fraud upon individuals or fraud on the marketplace. They are also intended to instill public confidence in the marketplace and the efficient capital market theory.

I. Rule 10(b)5 - Insider Trading
Traditional insiders of a corporation, as noted in *Chiarella*, are Officers, Directors, and Shareholders with a 10% or greater interest in the company. The *O'Hagan* decision extended the definition of 'insider' to apply to other people with a fiduciary duty or duty of confidentiality with respect to the confidential information. This expands insider trading liability to include lawyers and accountants.

Additionally, tippers are potentially liable for the actions of the tippees for misuse of the inside information. This is not a strict liability rule. In *Dirks*, a non-insider became aware of potential fraud in a company and brought the information to the attention of people in charge of a corporation, and also attempted to expose the fraud to the public. When he was ignored, he used the information to protect his clients only and did not personally profit from the information. The court considered his mens rea and in light his lack of attempt at personal profit and his fiduciary duties to his clients, the court found him not culpable.

SEC claims, defenses, likely outcome
Since the directors received non-public information in a confidential briefing on Nov 25th, they possessed inside information. They had a duty to do one of the following: (a) not trade the stock until the information was made public on Dec 10th; or (b) trade the stock after making the information public. White, Green, and Red made those trades using inside information, and as directors, are considered insiders. They are also liable under Rule 16 *infra*.
As tippers, they are potentially liable for the actions of their tippees, if the transmission of the information was intended as a 'tip' rather than a legitimate business communication. Thus, they may be held liable for the profits of Ms. Lee, Blue, Fr. Murphy, and Tom. Although she is not a traditional insider, *O'Hagan* extends liability to Ms. Lee for her own stock transaction, since she has a fiduciary relationship with Umbrella.
Ms. Lee will probably not be held liable for the inadvertent disclosure to Tom, unless she was negligent in failing to secure confidential information in accordance with her law firm's policy. Under *Chiarella* and the *O'Hagan* extension, Tom is probably not liable, since he does not have a fiduciary relationship to Ms. Lee's client as Ms. Lee's janitor.

Rule 21 governs the penalties that the SEC may impose for violations in order to deter (punish) misconduct. This Rule allows the court to adjust the punishment for violations based upon the facts and circumstances of the conduct, but not to exceed three times the amount gained (or loss mitigated). For CEOs, the monetary punishment cap is set at the greater of treble damages or $1M. In addition to monetary penalties, violators may be subject to criminal prosecution.

Defense/Mitigation: Umbrella personnel could petition the court for a credit of time served while confined by a sociopathic computer in the Hive.
White may assert a defense that he should not be liable for his tippee, Ms. Lee, since she is Umbrella outside counsel. He may allege that his communication was a legitimate communication properly related to Umbrella's business. Additionally, White may invoke the atty-client privilege, as a communication between him as a director of Umbrella, and Umbrella's attorney. The SEC will probably assert the crime-fraud exception to atty-client. Additionally, the conduct of engaging in the inside stock transaction vitiates the argument that this was a privileged atty-client communication instead of a tip. The likely outcome favors the SEC, since they probably have access to domestic wiretapping information.
Ms. Lee may assert the same atty-client privilege as White, with the same result. She may also assert the defense that she is not a traditional insider under the *Chiarella* decision; due to *O'Hagan*, the SEC will likely prevail.

Red may likewise claim that his communication with Fr. Murphy is subject to the priest-penitent privilege. He may also claim that the seeking of confidential spiritual advice is a permissible disclosure. By purchasing the stock using inside information, the conduct of Red and Fr. Murphy indicate that this was a 'tip' related communication, and thus not privileged. The SEC will also likewise prevail with a crime-fraud exception.

Private claims, defenses, likely outcome
A private claim may be raised by a shareholder who has lost value in his stock, but the private remedy does not include penalties/punitive damages. The same defendants and defenses are applicable.

II. Rule 10(b)5 - Fraud
Rule 10(b)5 prohibits the use of any instrumentality of interstate commerce to perpetrate a fraudulent scheme or device, make fraudulent misrepresentations to the public, or to commit any fraud related to the purchase or sale of securities.
Fraud requires specific intent to profit at another's expense unlawfully by misrepresentation. The facts here do not indicate the misrepresentation required to find fraud.

III. Rule 14 - Proxy Misrepresentations
Rule 12 requires that publicly traded corporations with over $10M in assets and more than 500 shareholders of record (brokers, not beneficial holders) or those traded on a national exchange, are required to register with the SEC.
Since Umbrella is actively traded on the NYSE, a national stock exchange, it will required to comply with Rule 12. No facts indicate that Umbrella has failed to comply with this requirement; however by falling under Rule 12, Umbrella will also be subject to Rule 14.

Proxies must be registered with the SEC, and liability is imposed for knowing

misrepresentation of a material fact (defined in *TSC* as a fact that a reasonable shareholder would like to have considered when making the decision). The proxy that Mordo submitted to the shareholders should have been registered with the SEC. If it wasn't, then the SEC may impose a fine. There is no private remedy for failing to register.

If Mordo made a misrepresentation in their proxy solicitation, the SEC may impose a fine, and the shareholders would be entitled to recission plus any monetary damages caused by Mordo.

IV. Rule 16 - Swing Trading

Traditional insiders (officers, directors, 10% shareholders) are prohibited from engaging in successive purchase and sale transactions of their own company's stock within six months. The prohibition against "Swing Trading" presumes that insiders are privy to non-public information which could lead to a loss of investor confidence in the market if insiders were allowed to purchase and sell interests in their own company without limitation. This Rule dispenses with a mens rea of fraud, and imposes strict liability for violative transactions.
Since all insider transactions must be reported to the SEC, so detection of violations and enforcement of this Rule is fairly simple.

If a shareholder meets the 10% threshold as a result of a purchase, that purchase does not count towards this Rule. Only transactions made after reaching 10% are applicable. Employee stock options and certain preexisting contracts to are also exempt from enforcement.
An insider may not offset other losses against their profits for enforcement purposes. The profitable transactions are aggregated, and the losses are ignored.
No facts indicate that these circumstances apply.

SEC claims, defenses, likely outcome

Generally, the SEC detects these transactions and notifies the insider to disgorge their profits. Since strict liability is imposed and the transaction records provide clear evidence, liability is clear in these cases.
White, Green, and Red are all directors, and thus subject to enforcement of Rule 16. By purchasing on Dec 1st and subsequently selling on Dec 11th, each making a $125,000 (5000 sh. @ $25/sh) profit, these directors are strictly liable under this Rule.

The SEC will likely instruct the disgorgement of profits, and a penalty of up to treble damages under Rule 21 *supra*. The penalties, if any, would be paid to the US Treasury, and act as a deterrent.
The defenses of ignorance, stupidity, inability to use a calendar, or my dog logged into my E*Trade account will all fail. The likely outcome is in favor of the SEC.

Claims against the others will fail, since this Rule only applies to traditional insiders, and does not include the O'Hagan extension to Ms. Lee (Umbrella's outside counsel), or others. The attorney, family member, others, and their 'tippers' may still be held liable under Rule 10(b)5.

Private claims, defenses, likely outcome

The corporation may bring a claim to disgorge any profits made as a result of swing trading against the same parties as above. Unlike a SEC action, there is no additional

punitive award. If the corporation does not act against the swing trader, shareholders may request action from the Directors. If they do not proceed with an action within a reasonable time (60 days), the shareholders may institute a derivative suit on behalf of the company. This private remedy is likely to succeed, but may not be necessary due to the SEC monitoring and enforcement of Rule 16.

V. Williams Act - Cooling off period for hostile bids

Mordo made a short fuse (24 hour) hostile takeover bid. These types of bids were common to induce shareholder acceptance of the offer without careful consideration or the ability for the existing directors to respond.
This statute prohibits short fuse hostile takeovers, and Mordo was required to allow adequate time to consider the offer after a response from current leadership.

SEC claims, defenses, likely outcome
The SEC may prevent the transaction, or could potentially order the NYSE to freeze trading of the stock.

Private claims, defenses, likely outcome
The existing board will probably succeed in preventing the sale due to the violation of this statute.

VI. Duty of Care
Directors, Officers, and substantial shareholders have both a duty of care and a duty of loyalty to the corporation and its shareholders. The attorney's duties and liabilties are discussed separately below. Family members, priests, and janitors for another firm do not have these duties to the corporation or its shareholders. Therefore, the 9 directors have a duty of care to Umbrella and its shareholders.
The duty of care requires that decisions be made in the interest of the corporation, while considering all available information. There is no reasonable person standard, because ordinary reasonable people are not capable of running a large public corporation, and the business environment requires some additional risk taking.

White, Green, and Red (WGR) engaged in a stock transaction for their own benefit, thereby placing their own financial welfare ahead of Umbrella's. They made a transaction detrimental to the company, and did not make their decision in the interest of the company. Therefore, they violated the duty of care.

The "Other Six" directors (O6) are attempting to pass a poison pill resolution after a hostile offer has been made. Usually, poison pills are far more effective earlier in the corporation's lifecycle, and this poison pill is geared to protect specifically from Mordo. A seven month dead hand poison pill will likely be found draconian, and does not serve a legitimate purpose. The pill would be far more effective if the O6 used a reasonable delay prior to a shareholder vote, perhaps 60-90 days.

SEC claims, defenses, likely outcome
The SEC does not have a claim for this breach of duty.

Private claims, defenses, likely outcome

The Business Judgment Rule (BJR) is usually invoked as a defense to allegations of breach of the Duty of Care. The BJR requires that the decision be made in Good Faith (no fraud, self dealing, or conflict of interest), using competent outside advice, and in consideration of all available facts. In the case of WGR, their transaction was self-dealing and does not qualify for the BJR defense. They also breached their duty by revealing confidential information about the upcoming offer.
The O6 poison pill decision has indicators of self-interest, since the O6 wish to preserve their benefits. In this case, their aversion to Mordo as a corporate raider and dismantler appears to be well justified. The O6 decision may indeed be in the best interests of the company, but shareholders (especially Mordo, if they purchased some) may allege that seven months is too draconian and too self-dealing. The likely outcome is that the poison pill will be set aside.

Shareholders have a right to bring the issue before the board for allegations of breach of duty, and the uninvolved (impartial) board members must create an impartial committee and vote to ratify or not ratify the transaction in question. The O6 would therefore vote on the issue of the insider/swing trading, and WGR would vote on the O6 poison pill. If the result is not satisfatory to the shareholder after a reasonable period, the shareholder may bring a civil action to rescind the transaction or obtain restitution to the corporation. Mordo would probably also purchase some shares of Umbrella on the NYSE in order to make these assertions.

Whenever the Duty of Loyalty is breached, it the Duty of Care has been breached per se; however, the reverse is not necessarily true. For each person that has breached the Duty of Loyalty below, they have also breached the Duty of Care.

VII. Duty of Loyalty

The O6 poison pill scheme, if found to be self-dealing to the detriment of Umbrella and its shareholders, would be the result of O6's breach of the duty of loyalty.

White, Green, Red breached their duty of loyalty by engaging in self-dealing in their insider trade. They also breached their duty by revealing confidential information about the upcoming offer.

SEC claims, defenses, likely outcome
The SEC does not have a claim for this breach of duty.

Private claims, defenses, likely outcome
Shareholders have a right to bring the issue before the board for allegations of breach of duty, and the uninvolved (impartial) board members must create an impartial committee and vote to ratify or not ratify the transaction in question. The O6 would therefore vote on the issue of the insider/swing trading, and WGR would vote on the O6 poison pill. If the result is not satisfatory to the shareholder after a reasonable period, the shareholder may bring a civil action to rescind the transaction or obtain restitution to the corporation.

VII. Attorney's Duties

Ms. Lee has a duty to her client, Umbrella. She does not owe a duty to any of the directors as individuals. As an attorney, this is the highest fiduciary duty.
Ms. Lee engaged in self dealings (the insider trade) to the detriment of Umbrella, thus

violating this duty. She is liable to Umbrella for this breach.

As an attorney, Ms. Lee also has a duty to maintain the confidences and secrets of her client. Her inadvertant disclosure of confidential information by leaving it available for Tom to find, may have been negligent. For this, she may be liable to Umbrella for malpractice. This claim is not likely to succeed unless negligence can be proven (i.e. additional facts surrounding her practice, the security controls in place, prior incidents, etc).

The NY state bar investigate Ms. Lee for the insider trading as an act of moral turpitude, and they may investigate her competence if found liable for malpractice. Given that bureaucracy, that is unlikely to go anywhere.

Tom the janitor, as a non-legal employee of Ms. Lee's law firm, probably does not owe any duty to Umbrella.

END OF EXAM