**Alternate Case Problems**

*Chapter 21*

**Investor Protection, Insider Trading,**

**and Corporate Governance**

**21-1. SEC Rule 10b-5.** Louis Ferraro was the chairman and president of Anacomp, Inc. In June 1988, Ferraro told his good friend Michael Maio that Anacomp was negotiating a tender offer for stock in Xidex Corp. Maio passed on the information to Patricia Ladavac, a friend of both Ferraro and Maio. Maio and Ladavac immediately purchased shares in Xidex stock. On the day that the tender offer was announced—an announcement that caused the price of Xidex shares to increase—Maio and Ladavac sold their Xidex stock and made substantial profits (Maio made $211,000 from the transactions, and Ladavac gained $78,750). The Securities and Exchange Commission (SEC) brought an action against the three individuals, alleging that they had violated, among other laws, SEC Rule 10b-5. Maio and Ladavac claimed that they had done nothing illegal. They argued that they had no fiduciary duty either to Anacomp or to Xidex, and therefore they had no duty to disclose or abstain from trading in the stock of those corporations. Had Maio and Ladavac violated SEC Rule 10b-5? Discuss fully. [*SEC v. Maio,* 51 F.3d 623 (7th Cir. 1995)]

**21-2. Section 10(b).** Joseph Jett worked for Kidder, Peabody & Co., a financial services firm owned by General Electric Co. (GE). Over a three-year period, Jett allegedly engaged in a scheme to generate false profits at Kidder, Peabody to increase his performance-based bonuses. When the scheme was discovered, Daniel Chill and other GE shareholders who had bought stock in the previous year filed a suit in a federal district court against GE. The shareholders alleged that GE had engaged in securities fraud in violation of Section 10(b). They claimed that GE's interest in justifying its investment in Kidder, Peabody gave GE "a motive to willfully blind itself to facts casting doubt on Kidder's purported profitability." On what basis might the court dismiss the shareholders' complaint? Discuss fully. [*Chill v. General Electric Co.,* 101 F.3d 263 (2d Cir. 1996)]

**21-3. SEC Rule 10b-5.** Grand Metropolitan PLC (Grand Met) planned to make a tender offer as part of an attempted takeover of the Pillsbury Company. Grand Met hired Robert Falbo, an independent contractor, to complete electrical work as part of security renovations to its offices to prevent leaks of information concerning the planned tender offer. Falbo was given a master key to access the executive offices. When an executive secretary told Falbo that a takeover was brewing, he used his key to access the offices and eavesdrop on conversations to learn that Pillsbury was the target. Falbo bought thousands of shares of Pillsbury stock for less than $40 per share. Within two months, Grand Met made an offer for all outstanding Pillsbury stock at $60 per share and ultimately paid up to $66 per share. Falbo made over $165,000 in profit. The Securities and Exchange Commission (SEC) filed a suit in a federal district court against Falbo and others for alleged violations of, among other things, SEC Rule 10b-5. Under what theory might Falbo be liable? Do the circumstances of this case meet all of the requirements for liability under that theory? Explain. [*SEC v. Falbo,* 14 F.Supp.2d 508 (S.D.N.Y. 1998)]

**21-4. Definition of a Security.** In 1997, Scott and Sabrina Levine formed Friendly Power Co. (FPC) and Friendly Power Franchise Co. (FPC‑Franchise). FPC obtained a license to operate as a utility company in California. FPC granted FPC‑Franchise the right to pay commissions to “operators” who converted residential customers to FPC. Each operator paid for a “franchise”—a geographic area, determined by such factors as the number of households and competition from other utilities. In exchange for 50 percent of FPC’s net profits on sales to residential customers in its territory, each franchise was required to maintain a 5 percent market share of power customers in that territory. Franchises were sold to telemarketing firms, which solicited customers. The telemarketers sold interests in each franchise to between fifty and ninety-four “partners,” each of whom invested money. FPC began supplying electricity to its customers in May 1998. Less than three months later, the Securities and Exchange Commission (SEC) filed a suit in a federal district court against the Levines and others, alleging that the “franchises” were unregistered securities offered for sale to the public in violation of the Securities Act of 1933. What is the definition of a security? Should the court rule in favor of the SEC? Why or why not? [*SEC v. Friendly Power Co., LLC,* 49 F.Supp.2d 1363 (S.D.Fla. 1999)]

**21–5. Violations of the 1934 Act.** 2TheMart.com, Inc., was conceived in January 1999 to launch an auction Web site to compete with eBay, Inc. On January 19, 2TheMart announced that its Web site was in its “final development” stages and expected to be active by the end of July as a “preeminent” auction site, and that the company had “retained the services of leading Web site design and architecture consultants to design and construct” the site. Based on the announcement, investors rushed to buy 2TheMart’s stock, causing a rapid increase in the price. On February 3, 2TheMart entered into an agreement with IBM to take preliminary steps to plan the site. Three weeks later, 2TheMart announced that the site was “currently in final development.” On June 1, 2TheMart signed a contract with IBM to design, build, and test the site, with a target delivery date of October 8. When 2TheMart’s site did not debut as announced, Mary Harrington and others who had bought the stock filed a suit in a federal district court against the firm’s officers, alleging violations of the Securities Exchange Act of 1934. The defendants responded, in part, that any alleged misrepresentations were not material and asked the court to dismiss the suit. How should the court rule, and why? [*In re 2TheMart.com, Inc. Securities Litigation,* 114 F.Supp.2d 955 (C.D.Ca. 2000)]

**21–6. Insider Reporting and Trading.** Ronald Bleakney, an officer at Natural Microsystems Corp. (NMC), a Section 12 corporation, directed NMC sales in North America, South America, and Europe. In November 1998, Bleakney sold more than 7,500 shares of NMC stock. The following March, Bleakney resigned from the firm, and the next month, he bought more than 20,000 shares of its stock. NMC provided some guidance to employees concerning the rules of insider trading, and with regard to Bleakney’s transactions, the corporation said nothing about potential liability. Richard Morales, an NMC shareholder, filed a suit against NMC and Bleakney to compel recovery, under Section 16(b) of the Securities Exchange Act of 1934, of Bleakney’s profits from the purchase and sale of his shares. (When Morales died, his executor Deborah Donoghue became the plaintiff.) Bleakney argued that he should not be liable because he relied on NMC’s advice. Should the court order Bleakney to disgorge his profits? Explain. [*Donoghue v. Natural Microsystems Corp.,* 198 F.Supp.2d 487 (S.D.N.Y. 2002)]

**21–7. Insider Trading.** Scott Ginsburg was chief executive officer (CEO) of Evergreen Media Corp., which owned and operated radio stations. In 1996, Evergreen became interested in acquiring EZ Communications, Inc., which also owned radio stations. To initiate negotiations, Ginsburg met with EZ’s CEO, Alan Box, on Friday, July 12. Two days later, Scott phoned his brother Mark, who, on Monday, bought 3,800 shares of EZ stock. Mark discussed the deal with their father Jordan, who bought 20,000 EZ shares on Thursday. On July 25, the day before the EZ bid was due, Scott phoned his parents’ home, and Mark bought another 3,200 EZ shares. The same routine was followed over the next few days, with Scott periodically phoning Mark or Jordan, both of whom continued to buy EZ shares. Evergreen’s bid was refused, but on August 5, EZ announced its merger with another company. The price of EZ stock rose 30 percent, increasing the value of Mark and Jordan’s shares by $664,024 and $412,875, respectively. The Securities and Exchange Commission (SEC) filed a civil suit in a federal district court against Scott. What was the most likely allegation? What is required to impose sanctions for this offense? Should the court hold Scott liable? Why or why not? [*SEC v. Ginsburg,*362 F.3d 1292 (11th Cir. 2004)]

**21–8.**  **Violations of the 1934 Act.** To comply with accounting principles, a company that engages in software development must either “expense” the cost (record it immediately on the company’s financial statement) or “capitalize” it (record it as a cost incurred in increments over time). If the project is in the pre- or post-development stage, the cost must be expensed. Otherwise it may be capitalized. Capitalizing a cost makes a company look more profitable in the short term. Digimarc Corp. announced that it had improperly capitalized software development costs over at least the previous eighteen months. The errors resulted in $2.7 million in overstated earnings, requiring a restatement of prior financial statements. Zucco Partners, LLC, which had bought Digimarc stock within the relevant period, filed a suit in a federal district court against the firm. Zucco claimed that it could show that there had been disagreements within Digimarc over its accounting. Is this sufficient to establish a violation of SEC Rule 10b-5? Why or why not? [*Zucco Partners, LLC v. Digimarc Corp.,* 552 F.3d 981 (9th Cir. 2009)]

**21–9.**  **Insider Trading.** Jabil Circuit, Inc., is a publicly traded electronics and technology company. A group of shareholders who owned Jabil stock from 2001 to 2007 sued the company and its auditors, directors, and officers for insider trading. Stock options were a part of Jabil’s compensation for executives. Sometimes, stock options were backdated to a point in time when the stock price was lower, so the options would be worth more to certain company executives. Backdating is not illegal so long as it is reported, but Jabil did not report the fact that backdating had occurred. Thus, expenses were underreported, and net income was overstated by millions of dollars. The shareholders claimed that by rigging the stock price through backdating, the executives had engaged in insider trading and could pick favorable purchase prices and that there was a general practice of selling stock before unfavorable news about the company was reported to the public. The shareholders, however, had no specific information about these stock trades or when (or even if) a particular executive was aware of any accounting errors during the time of any backdating purchases. Were the shareholders’ allegations sufficient to assert that insider trading had occurred under Rule 10b-5? Why or why not? [*Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc.,* 594 F.3d 783 (11th Cir. 2010)]

**21-10. A Question of Ethics**

Between 1970 and 1981, Sanford Weill served as the chief executive officer (CEO) of Shearson Loeb Rhodes and several of its predecessor entities (collectively “Shearson”). In 1981, Weill sold his controlling interest in Shearson to the American Express Co., and be­tween 1981 and 1985, he served as president of that firm. In 1985, Weill developed an in­terest in becoming CEO for BankAmerica and secured a commitment from Shearson to invest $1 billion in BankAmerica if he was successful in his negotiations with that firm. In early 1986, Weill met with BankAmerica directors several times, but these contacts were not disclosed publicly until February 20, 1986, when BankAmerica announced that Weill had sought to become its CEO but that BankAmerica was not interested in his offer. The day after the announcement, BankAmerica stock traded at prices higher than the prices at which it had traded during the five weeks preceding the announcement. Weill had discussed his efforts to become CEO of BankAmerica with his wife, who had dis­cussed the information with her psychiatrist, Dr. Willis, prior to BankAmerica’s public announcement of February 20. She had also told Dr. Willis about Shearson’s decision to invest in BankAmerica if Weill succeeded in becoming its CEO. Willis disclosed to his broker this material, confidential information and purchased BankAmerica common stock. After BankAmerica’s public announcement and the subsequent increase in the price of its stock, Willis sold his shares and realized a profit of approximately $27,500. The court held that Willis was liable for insider trading under the misappropriation the­ory. [*United States v. Willis,* 737 F.Supp. 269 (S.D.N.Y. 1990)]

**1.** The court stated in its opinion in this case that “[i]t is difficult to imagine a rela­tionship that requires a higher degree of trust and confidence than the traditional relationship of physician and patient.” It then quoted the concluding words of the Hippocratic oath: “Whatsoever things I see or hear concerning the life of men, in my attendance on the sick or even apart therefrom, which ought not be noised abroad, I will keep silence thereon, counting such things to be as sacred secrets.” The court held that Willis had violated his fiduciary duty to Mrs. Weill, his patient, by investing in BankAmerica stock. Do you agree that Willis’s private investments, which were based on information learned through his sessions with Mrs. Weill, constituted a violation of his duty to his patient? After all, Willis had not “noised abroad” Mrs. Weill’s secrets—that is, he had not told others (except for his stock­broker) about the information. If you had been in Willis’s shoes, would you have felt ethically restrained from trading on the information?

**2.** Can you think of any ways in which Willis’s trading could have been harmful to Mrs. Weill’s interests? Does your answer to this question have a bearing on how you answered Question 1?

**3.** Do you think that the misappropriation theory of liability imposes too great a burden on outsiders, such as Willis? Why or why not? How might you justify, from an ethical point of view, the application of the misappropriation theory to “outsider trading”?