ST. MARY'S UNIVERSITY
SCHOOL OF LAW

Spring term
April 21-22, 1994
ID. No. ________

FINAL EXAMINATION
SECURITIES REGULATION
MR. FLINT

Essay--6 pages

PLEASE READ CAREFULLY

There are five questions of equal value (time and percent indicated).

1. This examination is "take home", but is anticipated to involve only three hours of work. You may use your casebook, statutory supplement, and classnotes. Use of calculators is permitted. The exam, distributed on the last day of class, April 21, should be turned to the faculty receptionist by 3 p.m. Friday April 22 25, 1994.

2. Be sure to answer the specific question that is asked. Information supplied relating to some unasked question will not increase your score, consumes your time needed to answer the asked questions, and could lower your score if erroneous.

3. If additional facts are necessary to resolve an issue, specify what additional facts you believe to be necessary and why they are significant. You may not make an assumption that changes or contradicts the stated facts.

4. Quality, not quantity, is desired. Think through and briefly outline your answer before you begin to write.

5. Write legibly. Be sure to formulate your answers in complete sentences and paragraphs with proper grammar. Failure to so do will result in an appropriately lower score.

6. Do not seek an interpretation of language in the questions from anyone. If you sense ambiguity or typographical error, correct the shortcoming by shaping the question in a reasonable way and by recording your editorial corrections in your answer.

Under the Honor Code, when you turn in this examination, you affirm that you have neither given, received, nor obtained aid from any other individual in connection with this examination, nor have you known of any one so doing. If you cannot make this affirmation, you shall note such fact on your examination and must immediately advise the Dean of the reason therefor.

Sp 94

I.
[20%]

Arunah Hubbell, cattleman with twenty-five years' experience, tax attorney, and member of the Chicago Mercantile Exchange, devised a cattle feeding program through Hubbell Cattle Co., Inc., to assist wealthy clients in reducing their taxable income. The program was advertised in the Wall Street Journal and attracted several successful persons in the radio and television industry.

Rather than place these communications personalities in a publicly-offered program, Hubbell advised them that an individual program would suit their needs better since as "farmers" managing their own business they would receive greater tax benefits. Tax laws permit "farmers" who actively manage their farming business to use the cash-method so they can deduct pre-paid expenses in the year paid, thus deferring income to the subsequent year.

So the individual feeding program required participants to sign a "consulting agreement" whereby Hubbell Cattle Co., Inc., would provide advice regarding the purchase, feeding, and sale of the participant's cattle and would determine the amount of cattle to purchase depending on the amount of income the participant desired to shelter. The individual feeding program also required the participant to represent that "by experience, education or other means the participant is knowledgeable about the cattle feeding business and that he will exert substantial and significant control over, and will, exercising independent judgment, make all principal and significant management decisions concerning his cattle feeding operations."

The promotional materials of Hubbell Cattle Co., Inc., indicated that although the investors would be "at risk" for tax purposes, the risk would be reduced by "hedging" operations--buying futures on the commodities market or entering forward sale contracts to lock in a price and minimize the client's potential profits or losses. For this service the participant would pay an advising fee equal to a flat amount per head of cattle plus a percentage of the commissions on the future trades.

The participants only owned a percentage of the total pounds of cattle at the feed yard, where the cattle in their feeding program were commingled with other cattle from other programs operated by Hubbell Cattle Co., Inc. The cattle were not tagged as to the individual owner nor was any dead cattle allocated to any individual participant but distributed amongst all participants on a pro rata basis.

Unfortunately, Hubbell was not as good a hedgers as he was an accountant. In the second year of operations the participants only hedged for half of the herd and the price of cattle plummeted due to a meat packers' strike, generating substantial real losses. So the participants lost a considerable amount of their money, although they recovered some of it through the associated tax deductions. A group of these participants have come into your associate's office at Suem and Stickem, P.C., seeking recovery of their lost moneys. What is your advice and its reasoning?

II.
[20%]

Voshell, Inc., is a pork broker that buys pork products from packing houses and stores them in a cold storage warehouse operated by Gasaway, Inc. When Voshell, Inc., buys pork it normally pays 25% of the purchase price and Gasaway, Inc., finances the remaining 75% and takes a security interest in the pork. Upon the sale of the pork, Gasaway, Inc., typically is paid two or three weeks later from the sales proceeds its storage fees, principal, and interest.

In order to increase the amount of the business, Draper Voshell, the principal in Voshell, Inc., designed a "commodity fund" in which participants' funds would be used to pay for 25% of the purchase price of pork products with Gasaway, Inc., financing the rest. Voshell then contacted acquaintances about the "commodity fund" and told them that Merrill Lynch was also a participant in the "commodity fund". Funds of the participants were sent directly to Gasaway, Inc., and placed in Voshell, Inc.,'s account as directed by the participants.

Voshell also arranged to change the margin requirement at Gasaway, Inc., from 25% to 10%, for the "commodity fund" so the "commodity fund" only needed to put up 10% of the purchase price and finance the rest through Gasaway, Inc. But Voshell did not inform the investors of this new margin requirement and reported to them on their profits as if they were putting up 25%, while in actuality they were putting up 10% with extra the 15% being used by Voshell to purchase additional pork products.

In October of 1993, Voshell, Inc., requested Gasaway, Inc., to deliver six loads of stored hams to a buyer. A month later after receiving no moneys from this transaction, Gasaway, Inc., foreclosed on the remaining pork products in the warehouse and began selling it as permitted under its security agreement with Voshell, Inc.

The participants learned of Voshell, Inc.'s, default, its insolvency, and have sued Gasaway, Inc., under the federal securities laws in your (Judge Smarty Pants's) federal court. Gasaway, Inc., has moved for summary judgment. What is your ruling and its reasoning?

Sp 94

III.
[20%]

Your law firm, Silk Stocking, P.C., represents Frank Stainer, who is involved in acquiring businesses. On behalf of Stainer, you incorporated Stainer, Inc., to acquire Kubycek, Inc., from Joseph and Fanny Kubycek. In the transaction prepared by you, Stainer, Inc., paid for Kubycek, Inc., stock part in cash and by issuing promissory notes to Joseph and Fanny Kubycek in the amount of $1.5 million, guaranteed by the personal guarantee of Frank Stainer. The Kubyceks were shown financial statements dated March 31, 1993, and an update letter dated December 31, 1993, the date of the closing, which attended by you. These financial statements indicated Frank Stainer's net worth exceeded $7 million.

These financial documents contained several misrepresentations obscuring the fact that Stainer's financial empire had deteriorated between April and December 1993. You and others in your firm knew at the closing that Frank Stainer was insolvent. Stainer's largest business, Frank's, Inc., filed for bankruptcy protection in February of 1994 and Stainer filed personal bankruptcy on March 15, 1994.

Stainer paid off your firm's legal fees for the acquisition of Kubycek, Inc., with the cash reserves of Kubycek, Inc., and siphoned off its operating capital to prop up Frank's, Inc., so that Kubycek, Inc., is now virtually worthless.

These facts have recently come to the attention of the managing member of your law firm, the Big Cheese. He has entered your office, requesting advice whether the firm needs to call its errors and omissions carrier about this matter. What is your advice and its reasoning.

IV.
[20%]

When Peltier Brokerage acts as an agent, it receives a commission and passes 40% of the commission to the account executive generating that transaction. Peltier Brokerage, unless the client requests that the transaction be handled as an agent, sells stock for which it is the market maker to the customer from its own account, that is, it acquires it or takes it from its inventory. The price charged the client then is the NASDAQ quoted price for asks plus a "mark-up" as a commission. The "mark-up" is never greater than the amount that would have been charged had Peltier Brokerage acted as an agent. Peltier Brokerage also pays 40% of both the "mark-up" and spread between the bid and ask to the account executive generating the transaction.

Augustine Lacroix has a brokerage account at Peltier Brokerage. Nicolas Peltier, grandson of the founder of Peltier Brokerage, is Lacroix's account executive. Peltier Brokerage is a market maker for Salomon Oil stock in the OTC market. Lacroix, upon recommendation of Peltier based on solid research from Peltier Brokerage's research department, bought 400 shares of Salomon Oil for 17 1/2 per share. The NASDAQ bid was 15 and the ask 17 1/2, for a spread of 2 1/8. The "mark up" was 3/8. So Nicolas Peltier was paid $400 on the transaction. Although the confirmation indicated that Peltier Brokerage was a market maker in Salomon Oil, no disclosure was made concerning Nicolas Peltier's compensation.

Lacroix later sold Salomon Oil for 7 per share for a substantial loss. Recently discovering the compensation scheme and being angry over the loss, Lacroix has come into your associate's office at Suem and Stickem, P.C., seeking recovery of his lost money. What is your advice and its reasoning?

Sp 94

V.
[20%]

Your firm, Silk Stocking, P.C., represents Hatton Chemical Co., which is in the process of an initial public offering. You as one of the associates in the firm's business section are preparing the documents for submission to the Securities and Exchange Commission.

Hatton Chemical Co. was recently designated as a potentially responsible party (PRP) by the Environmental Protection Agency (EPA) under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. sections 9601 ff. The senior partner in your firm in charge of the firm's clients' environmental law problems has indicated to you, and the senior partner in charge of securities laws for the firm's clients, that Hatton Chemical Co. has been correctly designated a PRP by the EPA with respect to cleanup of hazardous waste at three sites. No statutory defenses are available. Hatton Chemical Co. is in the process of preliminary investigations of the sites to determine the nature of its potential liability and the amount of remedial costs necessary to clean up the sites. Other PRPs also have been designated, but the ability to obtain contribution is unclear, as is the extent of insurance coverage, if any. Management is unable to determine that a material effect on future financial condition or results of operations is not reasonably likely to occur.

The senior partner for securities laws has entered your office and wants to know what needs to be disclosed, if any thing, with respect to this matter. What is your recommendation and its reasoning?