ST. MARY'S UNIVERSITY
SCHOOL OF LAW

Spring Term 1999
Exam No.__________

FINAL EXAMINATION
SECURITIES REGULATIONS
PROFESSOR G. FLINT

ESSAY
PLEASE READ CAREFULLY

ALL ANSWERS ARE TO BE WRITTEN ON THE BLUE BOOKS PROVIDED WITH THIS EXAMINATION.

There are two questions of equal value (time and percent indicated). The time for completing the examination is three hours.

1. This examination is "open book." You may use your casebook, statutory supplement, and classnotes. Use of calculators and cleansed laptops are permitted.

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

3. If additional facts are necessary to resolve an issue, specify what addition 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 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.

SECURITIES REGULATION EXAMINATION

I. (50%--1 ½ hours)

You are an associate at Suem & Stickem, P.C., a plaintiff's firm. Benjamin Rockwell, the managing partner, has walked in your office. Arunah Hubbell had come by to visit with him about the following matter. Benjamin Rockwell wants you to tell him whether the firm should take the following case.

Arunah Hubbell was employed as the sales manager of a subsidiary of Joseph Baker, Inc., a privately-held technology firm. The subsidiary is a Nevada corporation doing business in Texas. Joseph Baker, Inc., is a British corporation. Shortly after his employment in 1996 John Lynch, president of Joseph Baker, Inc., permitted Arunah Hubbell to purchase shares in Joseph Baker, Inc. One condition of the purchase was that he sign a contract. The contract provided that if he severed service with Joseph Baker, Inc., for any reason prior to four years after the date of the contract, Joseph Baker, Inc., had the option to purchase Arunah Hubbell's shares at cost. This was the only information he was given concerning Joseph Baker, Inc., and its shares. In 1998 Joseph Baker, Inc., sent a report and financial statement to its shareholders, including Arunah Hubbell. The report indicated that the value of the shares had risen by a factor of 5 since 1996. In 1999 Joseph Baker, Inc., was reorganized and John Lynch terminated the employment of Arunah Hubbell in accordance with that reorganization. Shortly thereafter Joseph Baker, Inc. send a letter to Arunah Hubbell exercising its right to repurchase its shares held by Arunah Hubbell pursuant to the 1996 contract at $20,000. Arunah Hubbell is greatly angered. He claims that his repurchased shares of Joseph Baker, Inc., which cost him $20,000 in 1996, were worth $100,000 at the time of repurchase on the basis of the most recent sale to another employee. The financial statements of Joseph Baker, Inc., indicates that several other employees may have been treated similarly. There are line items for shares sold to employees and for shares repurchased from employees, aggregating in the millions. One of the firm's law clerk's memorandums concludes that Texas law permits terminating employees at will. For those employees terminated without cause Texas law implies a "good faith" provision into employee benefit contracts that voids any forfeiture provision.

Discuss the securities laws violations, both federal and state, that this transaction involves and the possible remedies that Arunah Hubbell might have.

II. (50%--1 ½ hours)

You are a litigator in the Division of Enforcement of the Securities and Exchange Commission. Nicholas Gasaway, our superior ,has placed a file about Kidd Turner, Inc., containing the following information on your desk. Nicholas Gasaway wants to know whether the Securities and Exchange Commission should take any action with respect to the matter reported in the file.

Kidd Turner, Inc., is a public biotechnology company with a new drug approved for sale by the Federal Drug Administration. Kidd Turner, Inc., markets this new drug through a "bill and hold" program. Kidd Turner, Inc.'s, salespeople bill the customers for certain purchases; however, delivery will be made later after that batch of the new drug is manufactured and approved for release. The delivery dates sometimes could be several months later. James Madison Rogers, president of Kidd Turner, Inc., devised the "bill and hold" program to insure that Kidd Turner, Inc., met stock market analyst's projections for income generated by the new drug. James Madison Rogers proposes to record as income these "bill and hold" transactions when billed. In 1997, John Lynch, a junior partner with Kidd Turner, Inc.,'s independent auditors, determined that this recording of income was not proper under generally accepted accounting principles for "bill and hold" transactions. For Kidd Turner, Inc.'s, "bill and hold" transactions title (risk of loss) to the drugs frequently did not pass to the customers prior to delivery, often there was no fixed amount of drugs sold, and there was no fixed schedule of delivery. However, since the amount of income from this new drug involved in 1997 was small, John Lynch allowed the income to be reported on the fiscal 1997 financial statements. In 1998 John Lynch applied for and became the Chief Financial Officer of Kid Turner, Inc. In the third quarter of 1998, John Lynch wrote to James Madison Rogers. John Lynch still had doubts about the "bill and hold" sales. John Lynch was going to check orally with the three largest customers that they had indeed requested Kidd Turner, Inc. to store the drugs for them and actually intended to take delivery in the near future. John Lynch later received information from Kidd Turnner, Inc.'s, engineers that some of the involved batches of the new drug would be delayed since they had a few manufacturing problems. So rather than contact the customers, John Lynch relied on representations of Kidd Turner, Inc.'s, salespeople. These salespeople claimed the customers had committed to purchase the involved drugs. So on the Form 10-Q for the third quarter, Kidd Turner, Inc., reported revenue of $2 million, of which $1million came from the "bill and hold" program. These revenues were up 60% over the year before. The management's discussion and analysis prepared by John Lynch stated that the increase was due to "the increasing acceptance" of the new drug. John Lynch did indicate that Kidd Turner did have a "new sales and marketing program.". The Form 10-Q was incorporated by reference on a Form S-3 used by Kidd Turner, Inc., during the fourth quarter. Kidd Turner, Inc.'s, independent auditors required restatement of the third quarter's financial statements in preparing the financial statements for the Form 10-K.

Discuss the federal securities laws violations that this transaction involves and the possible courses of action the Securities and Exchange Commission might take.