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SEC v. Talbot: The "Misappropriation-Plus" Theory

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CASE SUMMARY

SEC V. TALBOT: THE “MISAPPROPRIATION-PLUS” THEORY

INTRODUCTION

On April 22, 2003, Thomas Talbot, a businessman, attorney, and member of the board of directors of Fidelity National Financial, attended a board meeting. During that meeting, he learned that LendingTree, a company in which Fidelity owned an approximate 10% interest, was potentially going to be sold at a significant premium.¹ Fidelity's vice president, who had acquired the information from LendingTree's CEO, considered the information confidential; he then relayed the information to Fidelity's CEO, who presented the information at the April 22 Fidelity board meeting.² Fidelity's CEO did not tell the board that the information was confidential; however, all other board members present at the meeting considered it confidential.³ Mr. Talbot, on the other hand, attributed no confidentiality to the discussion, believing that the information of the sale was only a “rumor” and not a “factual statement.”⁴ After the meeting, LendingTree sent Fidelity a confidentiality agreement that restricted the use of the information by Fidelity's officers, directors and employees, but Fidelity did not inform its directors of the agreement.⁵

Two days after the meeting, Mr. Talbot purchased 5,000 LendingTree shares on margin, at approximately \$13.50 per share, for a

¹ Fidelity stood to make about \$50 million from the transaction. *SEC v. Talbot*, 530 F.3d 1085, 1087-88 (9th Cir. 2008).

² *Id.* at 1088.

³ *Id.*

⁴ *Id.*

⁵ *Id.* at 1089.

378 GOLDEN GATE UNIVERSITY LAW REVIEW [Vol. 39]

total of \$67,500.⁶ Mr. Talbot continued to monitor LendingTree's stock, and on April 30, 2003, he purchased an additional 5,000 shares at \$14.50 per share for \$72,500, bringing Mr. Talbot's total investment in LendingTree to \$140,000 within eight days of hearing the alleged "rumor."⁷ Upon the approval of the acquisition of LendingTree on May 5, 2003, the company's stock price rose about 41%. Mr. Talbot immediately sold all his shares for a profit of almost \$68,000.⁸ Subsequently the Securities and Exchange Commission (the "Commission") brought an action against Mr. Talbot, alleging that he violated Section 10b and Rule 10b-5 of the Securities Exchange Act of 1934 (the "Exchange Act") by trading on material, nonpublic information.⁹

I. BACKGROUND OF SECTION 10B AND RULE 10B-5

Congress passed the Exchange Act in response to the stock market crash of 1929,¹⁰ creating the Commission.¹¹ Section 10b¹² gave the Commission the authority to regulate fraudulent practices used in securities transactions.¹³ In 1942, the Commission adopted Rule 10b-5 to prevent a company's president from buying shares from shareholders at a low price by misrepresenting the company's financial condition.¹⁴ The language of Rule 10b-5¹⁵ was originally intended to help the

⁶ *Id.* at 1088.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 1089.

¹⁰ See *United States v. Naftalin*, 441 U.S. 768, 775 (1979).

¹¹ 15 U.S.C.A. § 78d (Westlaw 2009).

¹² Section 10b states as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C.A. § 78j(b) (Westlaw 2009). See Thomas Hazen, *Fundamentals of Securities Law, The Jurisprudence of SEC Rule 10b-5*, SN018 A.L.I.-A.B.A. 539, 541 (2008) (explaining that Section 10b of the Exchange Act is a catch-all provision, which by its terms did not make any act unlawful unless the Commission adopted a rule prohibiting it).

¹³ See Steve Thel, *The Original Conception of Section 10b of the Securities Exchange Act*, 42 STAN. L. REV. 385, 388 n.20 (1990).

¹⁴ See Hazen, *supra* note 12, at 541.

¹⁵ Rule 10b-5 states as follows:

It shall be unlawful for any person, directly or indirectly, by the use of any means or

government in the prosecution of securities fraud.¹⁶

In the 1960s and early 1970s, federal appellate and district courts extended Rule 10b-5's application to a private right of action.¹⁷ The Supreme Court further expanded the Rule by giving broad meanings to the terms "fraud,"¹⁸ "purchase or sale,"¹⁹ and "connection."²⁰ However, from 1975 to the present day, a more conservative Supreme Court has

instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (LEXIS 2009). See Hazen, *supra* note 12, at 541 (citing Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 891 (1967) (the language of Rule 10b-5 followed the language of Section 17(a)(1) by adding the words "in connection with the purchase or sale of any security," and while Section 17(a)(1) of the Securities Exchange Act of 1933 prohibited fraud and misstatements in the *sale* of securities, there was no comparable provision prohibiting such practices in connection with the *purchase* of securities.)).

¹⁶ See Hazen, *supra* note 12, at 541 (the private causes of action included liability for negligent and deliberate misrepresentations, for corporate management's breaches of fiduciary duty, and for failure by directors, underwriters, accountants and lawyers to prevent wrongdoing by others.); see also Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 891, 922 (1967) (At a conference in the late 1960s, Milton Freeman described the origin of Rule 10b-5: "I never thought that twenty-odd years later it would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with this problem [prosecution of securities fraud]. It had no relation in the Commission's contemplation to private proceedings.").

¹⁷ See Hazen, *supra* note 12, at 541.

¹⁸ See *Superintendent of Ins. of State of N. Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 (1971) (citing with approval *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967), for the proposition that it was not "sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities,'" and that "Section 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception"); *SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 467 (1969) ("Section 10(b) and Rule 10b-5 together constitute one of the several broad anti-fraud provisions contained in the securities laws."); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) (stating that Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes").

¹⁹ See *SEC v. Nat'l Sec.*, 393 U.S. at 467 (where shareholders of acquired insurance company were allegedly misled prior to their approval of merger, the shareholders of the acquired company were considered to have "purchased" shares in new company by exchanging them for their old stock and antifraud provisions of securities laws respecting misstatements in connection with "purchase or sale" of any security were applicable).

²⁰ *Id.* at 468 (holding that "full disclosure in connection with the solicitation of proxies" falls within the requirement of Section 10(b), which "applies to all proscribed conduct in connection with a purchase or sale of any security"); see also Hazen, *supra* note 12, at 541 (for the general proposition of the expansion of the meaning of these terms by the Supreme Court).

generally reversed this trend through a more narrow reading of the terms of Rule 10b-5.²¹

II. LIABILITY UNDER SECTION 10B AND RULE 10B-5

Section 10b and Rule 10b-5 regulate “classical” insider trading.²² Under the classical insider trading theory, Section 10b and Rule 10b-5 prohibit a corporate insider from trading in the securities of his or her corporation on the basis of material, nonpublic information.²³ Classic insiders include officers, directors, and other permanent insiders of a corporation, as well as attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.²⁴ However, liability initially did not reach an outsider who owed no fiduciary relationship to the corporation in whose shares he or she traded.²⁵ The Supreme Court addressed this issue by creating a complementary theory of liability – the “misappropriation” theory – that reaches corporate outsiders who owe no duty to the investors with whom they trade.²⁶

Under the misappropriation theory, liability is generated from “a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”²⁷ Specifically, in *United States v. O’Hagan*, the Supreme Court recognized the “misappropriation theory” of liability under Section 10b and Rule 10b-5, when a trader misappropriates information in breach of a duty owed to the source of the

²¹ *Id.*; see *Hazen*, *supra* note 12, at 541 (“In the 1970s and 1980s, the Supreme Court in a series of cases limited the scope of the private right of action under Rule 10b-5; this trend carried through the end of the century.”); see, e.g., *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994) (eliminating the implied private right of action imposed through aiding and abetting liability under Rule 10b-5); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361-62 (1991) (adopting a statute of limitations of one year after discovery and no longer than three years after the violation for section 10b actions, effectively shortening the statute of limitations); *Chiarella v. United States*, 445 U.S. 222, 235 (1980) (holding that absent a duty to disclose based on a fiduciary or similar relationship, silence does not give rise to liability); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring that scienter be shown in section 10b private actions).

²² *SEC v. Talbot*, 530 F.3d 1085, 1090-91 (9th Cir. 2008).

²³ *Id.* at 1091 (citing *United States v. O’Hagan*, 521 U.S. 642, 651-52 (1997)).

²⁴ *O’Hagan*, 521 U.S. at 652 (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)).

²⁵ *Id.*; see also *Dirks*, 463 U.S. at 654 (holding that there can be no duty to disclose in situations where the person who had traded on inside information was not the corporation’s agent, a fiduciary, or a person in whom the sellers of the securities have placed their trust and confidence); *Chiarella v. United States*, 445 U.S. 222, 231 (1980) (holding that an employee for a financial printer who traded on information learned through his job was not guilty of insider trading because the printer and the employee were not classic insiders and had no duty of trust to the company in whose stock the employee traded).

²⁶ *Talbot*, 530 F.3d at 1091 (citing *O’Hagan*, 521 U.S. at 651-52).

²⁷ *Id.*

information.²⁸ In that case, the defendant was a partner in a law firm that represented Grand Metropolitan PLC in connection with a potential tender offer for the Pillsbury Company's common stock.²⁹ Even though the defendant did not work on the matter, he used the information received in his partnership capacity at the firm to purchase and sell Pillsbury Company's securities for about \$4.3 million.³⁰ The Supreme Court found that because the defendant failed to disclose his trading of Pillsbury stocks to Grand Metropolitan and to his law firm, his conduct was deceptive within the meaning of Section 10b.³¹ Thus, the Supreme Court held that the misappropriation theory may reach beyond corporate insiders to impose liability for trading by corporate outsiders as well.³²

III. *SEC v. TALBOT*'S PROCEDURAL HISTORY

In *SEC v. Talbot*, the U.S. District Court for the Central District of California granted summary judgment in favor of Mr. Talbot.³³ The court held that Mr. Talbot could be liable under the *O'Hagan* misappropriation theory only if he or Fidelity owed a fiduciary duty of confidentiality to LendingTree as the "originating source" of the information on which Mr. Talbot traded.³⁴ It determined that it was not enough that Fidelity was the information's "immediate source."³⁵ According to the district court, Mr. Talbot was not liable for his actions without a continuous chain of fiduciary relationships between Fidelity, Mr. Talbot and LendingTree.³⁶ The district court also denied the SEC's motion for summary judgment, finding a genuine issue of material fact as to the materiality of the information on which Mr. Talbot traded.³⁷

IV. THE NINTH CIRCUIT'S ANALYSIS IN *SEC v. TALBOT*

On appeal from the summary judgment in favor of Mr. Talbot, a panel of the Ninth Circuit reversed and remanded the district court's decision, holding that Mr. Talbot could be liable under the

²⁸ *O'Hagan*, 521 U.S. at 652.

²⁹ *O'Hagan*, 521 U.S. at 647.

³⁰ *Id.* at 647-48.

³¹ *Id.* at 660.

³² *Id.* at 652.

³³ *SEC v. Talbot*, 530 F.3d 1085, 1089 (9th Cir. 2008).

³⁴ *Id.*

³⁵ *Id.* at 1089-90.

³⁶ *Id.* at 1090.

³⁷ *Id.*

“misappropriation” theory, and not as an insider at Fidelity.³⁸ The court held that in order for Mr. Talbot to be liable, the SEC needed to demonstrate that Talbot (1) knowingly misappropriated confidential material and nonpublic information (2) for securities trading purposes, (3) in breach of a duty arising from a relationship of trust and confidence owed to the source of the information at issue (as opposed to a duty owed to the corporation whose stock he traded).³⁹

No party challenged the fact that the information was nonpublic, or that Mr. Talbot knowingly used the information to trade in securities. Therefore, the SEC only needed to prove that Mr. Talbot breached a fiduciary duty arising from a relationship of trust and confidence owed to the source of the information, and that the information he traded on was material.⁴⁰ The Ninth Circuit agreed with the SEC’s contention that Mr. Talbot owed a duty to Fidelity to keep the information about LendingTree’s transaction confidential, and that he breached his duty by trading securities for personal profit.⁴¹ However, the Ninth Circuit found that the district court had misinterpreted *O’Hagan* by requiring a continuous chain of fiduciary duties linking the trader to the original source of the inside information in order for the misappropriation theory to apply.⁴² The Ninth Circuit declined to “read an ‘originating source’ requirement into *O’Hagan*” and held that Mr. Talbot could be liable based on a breach of fiduciary duty owed to the company where he was a director.⁴³

The Ninth Circuit stated that its interpretation of *O’Hagan* as not including an “originating source” requirement is confirmed by *United States v. Carpenter*.⁴⁴ In *Carpenter*, the employee breached his duty to his employer, the immediate source of the information on which his tippees traded.⁴⁵ The Second Circuit, later affirmed by an evenly divided Supreme Court, rejected the argument that the employee needed to have breached a duty to the corporation or shareholders of the corporation whose stocks the tippees had purchased or sold on the basis of the information, and held it was enough that the employee breached a duty to

³⁸ *Id.* at 1098.

³⁹ *Id.* at 1092 (citing SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990)).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.* at 1093.

⁴³ *Id.*

⁴⁴ *Id.* at 1094; see *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff’d by an evenly divided Court*, 484 U.S. 19 (1987).

⁴⁵ See *Carpenter*, 791 F.2d at 1026, 1029.

his employer as the immediate source of the information.⁴⁶ Similarly, in this case, Mr. Talbot, as a member of Fidelity's board of directors, owed a duty arising from his relationship of trust and confidence to Fidelity, the immediate source and owner of the information.⁴⁷ Moreover, the information was confidential as property "'entrusted' to him by Fidelity in his capacity as a Fidelity director,"⁴⁸ and thus, Mr. Talbot had committed a "textbook misappropriation."⁴⁹

The Ninth Circuit disagreed with Mr. Talbot's contention that no reasonable factfinder could find that Mr. Talbot was obligated to keep the LendingTree information confidential.⁵⁰ The court found that Mr. Talbot's conduct fell within *O'Hagan's* theory of liability.⁵¹ In *O'Hagan*, the partner of the law firm was in a relationship of trust and confidence with his firm; here, Mr. Talbot, as a member of Fidelity's Board, was in a similar relationship with Fidelity.⁵² The Ninth Circuit found support for this conclusion in Delaware case law, as well as in common sense.⁵³

The Ninth Circuit also disagreed with Mr. Talbot's contention that, because Fidelity did not indicate that the information was confidential, he reasonably believed the information on which he traded was only a "rumor."⁵⁴ The court found the information confidential as a matter of

⁴⁶ *Id.*

⁴⁷ *Talbot*, 530 F.3d at 1094.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 1095.

⁵² *Id.*

⁵³ *Id.* (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests."); see also *Teren v. Howard*, 322 F.2d 949, 953 (9th Cir. 1963); *Boyer v. Wilmington Materials, Inc.*, 754 A.2d 881, 907 (Del. Ch. 1999) ("[D]irectors of corporations organized under Delaware law owe a fiduciary duty to the corporations upon whose boards they serve and to the stockholders of those corporations.") (internal quotations marks and citation omitted); RESTATEMENT (SECOND) OF AGENCY § 395 (1958) ("Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge."); WILLIAM E. KNEPPER & DAN A. BAILEY, 1 LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 4-23 (7th ed. 2007) ("A corporation is entitled to keep confidential information obtained and assembled in the course of conducting its business. Such information is a type of property to which the corporation has an exclusive right. A director has a duty to use reasonable diligence to protect and safeguard his corporation's property, and he may not use it in his own personal interests, even if he or she causes no injury to the corporation.") (footnotes omitted).

⁵⁴ *Talbot*, 530 F.3d at 1095.

law.⁵⁵ It pointed to the fact that Fidelity's CEO announced the information at a meeting of the Board, and "not in a passing reference to a company in which Fidelity had no interest."⁵⁶ Because of the discussion of the transaction and the weight of the subject matter, the court considered it improbable that someone with thirty years of experience on different boards of directors would not realize that this was confidential information not to be used for personal gain.⁵⁷ Moreover, the court found it significant that all the other directors present at the meeting considered the information confidential.⁵⁸

Rather than granting judgment as a matter of law, however, the Ninth Circuit reversed and remanded the district court's decision, because there was a genuine issue of material fact as to whether the information Mr. Talbot traded on was material.⁵⁹ The court of appeals considered whether there was an increase in the stock price after the merger's public announcement, whether the information came from an insider or someone else, and whether the potential acquisition was accompanied by some specific qualifications and certainty.⁶⁰ The court remanded this issue because it could find facts both for and against a finding that the information was material.⁶¹

On one hand, two directors perceived the acquisition to be at an advanced stage, Mr. Talbot purchased the LendingTree's stocks shortly after the meeting, and Mr. Talbot sold all the stocks that he owned after the stock rose around 41% upon the announcement of the acquisition.⁶² The court found that these facts could support a finding that the information was material. On the other hand, Mr. Talbot testified that he considered the transaction to be just a rumor and not a factual statement, and that there was no "definite description of the worth of the potential acquisition," which might lead a jury to conclude that the information was immaterial.⁶³ According to the Ninth Circuit, this conflicting evidence as to the materiality of the information required remanding the materiality issue to the district court.⁶⁴

⁵⁵ *Id.*

⁵⁶ *Id.* at 1095-96.

⁵⁷ *Id.* at 1096.

⁵⁸ *Id.*

⁵⁹ *Id.* at 1097.

⁶⁰ *Id.* at 1097-98.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 1098.

⁶⁴ *Id.*

V. THE IMPLICATIONS OF *SEC v. TALBOT*

SEC v. Talbot expanded the scope of potential liability for misappropriation of information used by board members and officers of companies in the trading of stock, creating a "misappropriation-plus" theory. *Talbot* also expanded the scope of the duty of a company's non-insider to either disclose *any* material, non-public information about that company learned through his position on the board of directors of a different company, or else refrain from trading in that company's securities.⁶⁵ The Ninth Circuit concluded that directors have a duty to consider confidential *all* material, non-public information learned at a board meeting because the company is "the rightful owner of the information."⁶⁶

According to the court, this duty is breached when a director uses the information for personal gain.⁶⁷ The company, however, does not need to be harmed by the director's conduct in order for the director to be liable.⁶⁸ This is because an injury to the trading public is produced by the very act of deceiving the public concerning the source of the information.⁶⁹ A non-insider's special access to information due to his or her employment confers an advantage over the general public that results in a diminished public perception of the integrity of the markets.⁷⁰ Moreover, for liability to attach, there is no need for the company on whose board the director serves to have any duty, or even be aware of a duty, to keep the information confidential.⁷¹ The court concluded that Mr. Talbot should have known that the information learned at the meeting was confidential, based on his thirty years of experience, and he should not have traded on it, even if he thought the information was based only on rumors and not concrete facts.⁷²

This case serves as a warning sign for directors in the Ninth

⁶⁵ *Id.* at 1097.

⁶⁶ *Id.*

⁶⁷ *Id.* at 1092.

⁶⁸ *Id.* at 1097.

⁶⁹ *Id.*

⁷⁰ *Id.* (citing Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 123 (1984)).

⁷¹ *Id.* at 1092 n.2 (the SEC did not prove that either Fidelity or Talbot owed any fiduciary duty to LendingTree to keep the information confidential); *see id.* at 1088 (Fidelity was possibly going to make \$50 million from the increase of the stock price following the acquisition of LendingTree, but Fidelity did not show intent to use the information in any other way). Talbot allegedly considered the information to be only rumors and not confidential. The Ninth Circuit dismissed that argument based on his experience on different boards of directors and the discussions of the possible acquisition of LendingTree. *Id.* at 1095.

⁷² *Id.* at 1096.

Circuit's jurisdiction.⁷³ Specifically, this case should caution those serving on boards of directors not to purchase the stock of *any* company mentioned during the board's meetings, whether or not the company's prospects are directly discussed or are mentioned only in passing, and it could also discourage qualified business people from taking board positions.⁷⁴ This is because under *Talbot* a director may be held liable under "textbook" misappropriation theory⁷⁵ for acting on information that the director perceived as mere rumor or non-confidential information.⁷⁶

VI. CONCLUSION

While Section 10b and Rule 10b-5 initially imposed liability only for classic insider trading, liability has been expanded to include not only the misappropriation theory, but also a "misappropriation-plus" theory. It is hard to predict the implications of the *Talbot* decision – whether it will deter non-insiders, and more importantly, members of boards of directors. It might depend on whether the SEC decides to prosecute more directors under this "misappropriation-plus" theory.

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⁷³ See *id.* at 1092-97.

⁷⁴ See *id.* at 1095-96.

⁷⁵ *Id.* at 1094 (considering the misappropriation in *Talbot* a "textbook misappropriation").

⁷⁶ See *id.* at 1096.

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