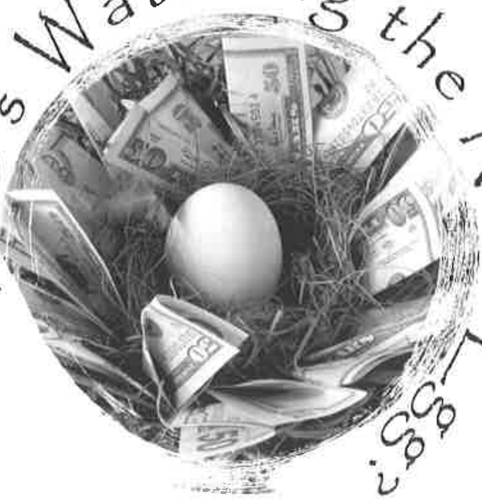
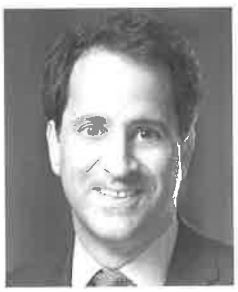
Who's Watching the Nest Egg?





Steve Berman

By Steve Berman
OTLA Guardian

About ten years ago, I found myself litigating two different cases for clients that bore little resemblance to one another. In the first case, my client was a retired public school teacher suing her financial advisor for recommending she invest $50,000 in an unsecured promissory note. In the second case, my client was a mutual fund suing an investment bank and a company that had prepared a financial feasibility study for deceptively marketing and selling millions of dollars of bonds to the mutual fund. A large national mutual fund and a retired elementary school teacher have little in common. Yet, their stories were similar in that both had purchased a "security" that was not what it was represented to be. I think that is when I first came to view the Oregon Securities Law as something of a great leveler, and a valuable tool that protects both small investors and well-heeled established business entities. And, in the coming years, the Oregon Securities Law may need to be relied on more frequently to protect smaller investors and small businesses.

The Oregon Securities Law is a bit of a statutory maze that takes time to work through. Generally, under the Oregon Securities Law, liability attaches to any person who, in the course of selling a security makes "an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading." ORS 59.115; ORS 59.135. Liability also attaches against "every person who participates or materially aids in the sale." ORS 59.115(3). In non-legalese, a person (or entity) that sells an investment instrument can be held financially responsible for making false statements about that investment instrument or for failing to disclose important bad facts about the investment instrument. The people who "materially aided" in the sale — lawyers, accountants, banks — are also liable. A claim must be brought within two years of discovery or three years of the transaction, whichever is later. ORS 59.115(6).

The Oregon Securities Law protects individual investors as well as institutional investors. A prevailing plaintiff who brings a claim under the law is entitled to the value of the security, actual damages, and attorneys' fees and costs. ORS 59.115(10). The law provides trial lawyers with an incentive to pursue claims for individual investors whose losses may be small in value (compared to the losses sustained by an institutional investor) but significant to a person who has lost his or her life savings. Moreover, Oregon courts construe the Oregon Securities Law liberally "to afford the 'greatest possible protection' to the public." *Berquist v. International Reality, Ltd.*, 272 Or 416, 423 (1975). Oregon courts have shown reluctance to grant summary judgment on the issue of whether a defendant has made material misstatements or omissions. *Everts v. Holtmann*, 64 Or App 145, 151-156 (1983). Oregon courts have rejected the argument — at least as to individual investors — that a purchaser of a security has an obligation to inquire as to the veracity or accuracy of the seller's statements or omissions. *See, e.g., Towrey v. Lucas*, 128 Or App 555, 563-564 (1994). Oregon courts similarly have rejected the argument that boilerplate disclaimers in offering documents and prospectuses shield a defendant from liability. *Everts*, 64 Orr App at 152. Simply put, a defendant cannot avoid liability under the

Oregon Securities Law on the theory an investor should not have believed the defendant.

Protecting

Small and large investors gain additional protection, because the definition of a security under the Oregon Securities Law is broad and inclusive. The starting place for determining whether something is a security under the Oregon Securities' Law is the statutory definition. For the purpose of the Oregon Securities Law, a "security" is:

> a note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in a pension plan or profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, variable annuity, certificate of deposit for a security, certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such title or lease, real estate paper . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificates for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing. ORS 59.015(19)(a).

Typically, the definition is the starting and ending point for any inquiry. If an instrument calls itself one of the defined terms, it generally will be treated as a security under the Oregon Securities Law. Where a party's interest is not clearly defined as a security under the statutory definition, Oregon law examines whether the interest meets the test for an investment contract under the statute. An "investment contract" is:

> (1) an investment of money (or money's worth), (2) in a common enterprise, (3) with the expectations of a profit, (4) to be made through the management and control of others.

Pratt v. Kross, 276 Or 483, 497 (1976). The ability of the purchaser to control the management of others is the key factor in determining whether a particular investment is a security. *See, e.g., SEC v. Glenn W. Turner Enter., Inc.*, 348 F Supp. 766, 775 (D Or 1972), aff'd, 474 F2d 476 (9th Cir), cert. denied, 414 US 821 (1973). The investment contract test is applied in favor of finding an instrument to fall within the statutory definition.

Knowing your investment

Within this statutory scheme, the claims for both the retired school teacher and the mutual fund were straightforward. The retired school teacher had about $150,000 in an Individual Retirement Account. She changed investment advisors, and her new advisor sold her an instrument called an "8 percent participating subordinated note." About three years after she purchased the note, it went into default and was worthless. The school teacher lost the entire value of her investment. The investment vehicle, a promissory note, easily fell within the statutory definition of a "security." And, the retired school teacher had a persuasive argument her decision to purchase the note was based on material misstatements and omissions. For example, the note was an unsecured promissory note issued by a Delaware limited liability company to purchase a senior housing facility in California. The note was an extremely risky investment. It was entirely unsuitable for the retired school teacher, who had a low risk tolerance and did not meet the basic financial requirements for purchasing the note. Yet, the investment advisor assured the school teacher the note was low risk (a material misstatement), and he did not inform the school teacher she did not meet the financial requirements to purchase the note (a material omission). The investment advisor, and his firm, faced liability for soliciting the sale based on the misstatements and omissions. The case resolved shortly before it was to be tried. The Oregon Department of Consumer and Business Affairs subsequently found the investment advisor had violated the Oregon Securities Law for selling the same note to other investors, and the advisor was fined.

The mutual fund's claims were similar to the retired school teacher's claims. The mutual fund had purchased millions of dollars of bonds. The bonds were issued to finance the construction and initial operation of a golf course. Before the bonds were issued, a market analysis company had prepared a golf course feasibility report that projected the golf course would be financially viable. The feasibility report was included in the materials provided by the underwriter of the bonds to the mutual fund when the underwriter solicited the mutual fund to

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purchase the bonds. Because the golf course was not (and never had been) financially viable, the bonds went into default and ultimately became worthless. Unbeknownst to the mutual fund at the time of purchase, before the bonds were issued, the company that conducted the market analysis and the underwriter of the bonds both had information that belied statements in the golf course market analysis and in other offering documents prepared by the underwriter. Because material information was not disclosed to the mutual fund prior to the purchase, the underwriter who solicited the sale faced liability for a material omission. And, the company that conducted the feasibility study also faced liability for materially aiding in the sale. After a short detour to the Ninth Circuit, that case also resolved.

Fragile times ahead

In the coming years, I anticipate seeing more claims brought under the Oregon Securities Law, by both individual investors and small businesses. We are entering into a new political era on the federal level, with an executive and a Congress hostile to federal regulation of financial institutions. The purported business-friendly, deregulated, anti-consumer protection environment this new kakistocracy aspires to create will almost certainly lead to an increase in speculative, ill-conceived and fraudulent investment instruments appearing on the market. Those investment instruments will fail, and investors will seek recourse.

A more recent change in federal tax policy also should trigger more disputes between small business owners. In June 2013, the Internal Revenue Service promulgated rules allowing sellers and purchasers of an S corporation to make what is referred to as a "336(e) election." Broadly, these new regulations now allow purchasers of an S corporation to treat a stock sale as an asset sale for tax purposes. By using a 336(e) election, both the seller and purchaser of a small company can structure a less complex transaction that allows the buyer more flexibility for a step-up in basis of the assets of the acquired company. As a result, more small business acquisitions may now be considered stock sales rather than asset sales. Those stock sales could be subject to the requirements of the Oregon Securities Law, whereas a straight asset sale would not be.

For securities litigators, the most pressing (and yet unanswered) question about 336(e) transactions is whether they fall within the ambit of the Oregon Securities Law. On the one hand, a 336(e) election follows a sale of stock, and stock is a security as that term is defined in the law. On the other hand, once a buyer of a company exercises its 336(e) election, the stock sale effectively is converted to an asset sale, and the buyer gets the tax benefits of an asset sale. The buyer, having claimed the financial benefits of an asset sale may be estopped from seeking to reclassify the transaction as a stock sale for the purposes of pursuing litigation.

If Oregon courts choose to treat 336(e) transactions as stock sales subject to the Oregon Securities Law, then a whole host of small business acquisitions previously outside the reach of the law would be subject to it. In every 336(e) transaction, the purchaser would have the protection of the Oregon Securities Law and could pursue claims against both any seller who made material misstatements and omissions about the corporation being acquired and those who materially aided the seller in the transaction (including, potentially, the seller's accountants and lawyers).

Even playing field

One of the reasons I enjoy pursuing securities cases is the Oregon Securities Law does not discriminate based on wealth, financial resources or the amount at issue in the underlying transactions. The law gives protection to all victims of financial wrongdoing, from retired public school teachers to institutional investors, and potentially even to entrepreneurs who purchase an existing business. As someone who litigates cases under the statute, I get both the emotional rewards of helping someone of limited means get back his or her life savings and the intellectual rewards of working through the minutia of complex financial transactions (and where and how they went awry) for businesses and others who have sustained significant losses. It is a good balance that humanizes an often document intensive practice, for a law that sets an even playing field for all clients.

Steve Berman's practice focuses on complex business, securities and consumer disputes. He is a member of the OTLA Guardian of Civil Justice at the Guardian's Club level. Berman is a shareholder at Stoll Berne, 209 SW Oak Ave., Ste. 500, Portland, OR 97204. He can be reached at sberman@stollberne.com or 503-227-1600.