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Private Placements – Litigation Issues

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INTRODUCTION

Private Placements – Litigation Overview

- Certain Federal Securities claims do not apply (e.g., '33 Act, § § 11, 12(2) and 17(a)); '34 Act, § 18)
- Utilization of common law and Blue Sky Claims
- Investors may be reluctant to sue
- Difficulty in finding "Deep Pockets" - search to target non-issuer Defendants
- Class certification unlikely
- Plaintiff's securities lawyers usually not interested
- More exposure to SEC than private plaintiffs

I. CLAIMS TO ASSERT

A. § 12(a)(1) of '33 Act, 15 U.S.C. § 77I(a)(1)

- Text: "In general. Any person who . . . offers or sells a security in violation of section 77e of this title . . . shall be liable . . . to the person purchasing such security from him . . ."
- Section 77e makes it unlawful to sell unregistered securities by way of interstate commerce

A. § 12(a)(1) of '33 Act, 15 U.S.C. § 771(a)(1) (cont'd)

- Civil liability appears almost absolute – if you offer or sell a security in violation of Section 5 you are liable
- No requirement to prove scienter or negligence – Seller's knowledge of the violation need not be proven
- Must prove use of the interstate commerce or the mails, even an interstate phone call sufficient - easy standard – but the use must be with respect to specific plaintiff

A. § 12(a)(1) of '33 Act, 15 U.S.C. § 77l(a)(1) (cont'd)

- Statute of Limitations, 15 U.S.C. § 77m
 - "No action shall be maintained to enforce any liability . . . unless brought within one year after the violation upon which it is based. In no event shall any such action be brought to enforce a liability . . . more than three years after the security was bona fide offered to the public, or . . . more than three years after the sale." (Emphasis added).
 - Limitations must plead timely commencement
 - One year from violation
 - No more than 3 years after security "bona fide offer to public"
 - Limitations - equitable tolling doctrine probably not applicable

A. § 12(a)(1) of '33 Act, 15 U.S.C. § 771(a)(1) (cont'd)

- Privity "immediate seller" – Pinter v. Dahl, 486 U.S. 622 (1988) – "Seller" includes the owner who passes title plus a person who solicits the purchaser if said solicitor is serving his own or the buyer's financial interest.
- Damages – rescission or monetary
- Section 12(a)(1) requires a plaintiff to "tender back" the securities
 - A defense if not done

B. Rule 10(b)-5 under '34 Act, 17 C.F.R. 240.10b-5

- Text: "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,
 - To employ any device, scheme, or artifice to defraud,
 - 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
 - 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."

B. Rule 10(b)-5 under '34 Act, 17 C.F.R. 240.10b-5 (cont'd)

- Implied right of action
- The Three Prongs: "It shall be unlawful . . .
 - To employ any device, scheme, or artifice to defraud,
 - 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
 - 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.
- The SEC claims that (a) and (c) include "drafting or devising" a misstatement, as well as making. See John P. Flannery, Securities Exchange Act Release No. 73840, at 18 (Dec. 15, 2014) (citing United States v. Landford, 535 U.S. 813, 816 n.1 (2002)), appeal docket no. 15-10820 (1st Cir. Jan. 16, 2015).

B. Rule 10(b)-5 under '34 Act, 17 C.F.R. 240.10b-5 (cont'd)

- Heightened Pleading Standards
- In a Non-Class Action – no "fraud on the market"
 - Proof of reliance ("justifiable reliance")
- Scieneter; Materiality; Causation
- Limitations - § 804 of Sarbanes-Oxley Act of 2002, Pub. L. 107-204, amended 28 U.S.C. § 1658 to provide, in relevant part: "a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws. . . may be brought not later than the earlier of
 - 2 years after the discovery of the facts constituting the violation; or
 - 5 years after such violation."

B. Rule 10(b)-5 under '34 Act, 17 C.F.R. 240.10b-5 (cont'd)

- Persons liable
 - 10(b): One who makes the statement (one "with ultimate authority over statement, including the content and whether and how to communicate it") – Janus Capital Grp. v. First Derivative Traders, 131 S. Ct. 2296 (2011).
 - No aiding & abetting
 - Some "scheme" or "conspiracy" liability
 - The (a) and (c) prongs

C. Common Law Claims – Possible Claims

- Fraud
- Negligent misrepresentation
- Consumer protection – For example, the Massachusetts Consumer Protect Statute, which prohibits unfair or deceptive practices in "trade or commerce," defines "trade" and "commerce" to include securities. Mass. Gen. Laws c. 93A, § 1(b). See Welch v. Barach, 84 Mass. App. 993 N.E.2d 742, 743 n.4 (Mass. App. Ct. 2013); Marram v. Kobrick Offshore Fund, Ltd., 809 N.E.2d 1017, 1032 n.26 (Mass. 2004).
- Fiduciary Duty
- Contract

D. State Blue Sky Claims – Private Right Of Action?

- Mass. Gen. Laws c. 110A, § 410(a)(2)
- "Any person who . . . offers or sells a security by means of any untrue statement of a material fact or any 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, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person buying the security from him . . ."

D. State Blue Sky Claims – Private Right Of Action? (cont'd)

- The Massachusetts Supreme Judicial Court has made these points regarding the provisions:
 - Plaintiffs need not plead negligence or scienter
 - Plaintiff does not have to prove reliance
 - Plaintiff's sophistication is irrelevant
 - Plaintiff needs only show lack of knowledge of misleading statement or omission
 - The omission or misstatement need only be material- it need not be cause of the loss

D. State Blue Sky Claims – Private Right Of Action? (cont'd)

In Massachusetts SJC Points (continued)

In general, statement or omission must concern a fact – not an opinion or belief – unless they are inconsistent with facts. See also Omnicare, Inc. v. Laborers Dist. Council Constr. Ind. Pension Fund, No. 13-435 (S. Ct. decided Mar. 24, 2015).

The SJC also stated:

In addition Mass. Gen. Laws c. 110A, §410(g) prohibits waiving compliance with any provision of the act. Other jurisdictions have held that written contract terms – including an integration clause – cannot be construed to waive plaintiffs rights.

See generally Marram, supra, for all these points.

D. State Blue Sky Claims – Private Right Of Action? (cont'd)

- Utah Code Ann. § 61-1-1
 - It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly to:
 - employ any device, scheme, or artifice to defraud;
 - 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 are made, not misleading; or
 - engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

E. Attorney Client Privilege Issues

- Draft of offering statements and other disclosures are usually discoverable
- When an attorney comments on a draft, the portions of a draft that are ultimately disclosed in the final document are not subject to the privilege.
- In certain circumstances, information provided by the attorney may also not be covered by the privilege. In re Grand Jury Proceedings, 727 F.2d 1352, 1355 (4th Cir. 1984) (information provided by attorney in drafting private placement documents not subject to privilege because attorney was assisting in preparation of document intended to be distributed to others).

II. SEC ENFORCEMENT

- Broader Arsenal
 - AID and ABET
 - Conspiracy
 - Section 17(a) of '33 Act, 15 U.S.C. § 77q(a):

"It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly--
 - to employ any device, scheme, or artifice to defraud, or
 - to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
 - to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

II. SEC ENFORCEMENT (cont'd)

- §§ 17(a)(2) and 17(a)(3) do not require scienter
 - Aaron v. SEC, 446 U.S. 680 (1980); see also See John P. Flannery, Securities Exchange Act Release No. 73840 (Dec. 15, 2014), appeal docket no. 15-10820 (1st Cir. Jan. 16, 2015)).
- Other Advantages
 - SEC claims that § 17(a) does not require manipulation or deceptive conduct. See Flannery, supra at 22.
 - SEC claims that Janus "has no bearing on § 17(a)" because the term "make" is "not in the operative language of" § 17(a). Flannery, supra at 24.
- Probably no private right of action for 17(a)

II. SEC ENFORCEMENT (cont'd)

- PENALTIES
 - § 8A of the '33 Act, 15 U.S.C. § 77h-1(g)
 - Three Tiers
 - \$7,500 maximum for a natural person, \$75,000 for an entity
 - \$75,000 / \$375,000 for violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement
 - \$150,000 / \$725,000 for violations involving fraud, etc. that results in "substantial loss or risks of substantial losses" or "substantial pecuniary gain" to the violator
 - § 21B(a) of the '34 Act, 15 U.S.C. § 78u-2(a)(1)
 - Same three tiers: \$5,000 / \$50,000, \$50,000/ \$250,000 and \$100,000/\$500,000 for violations
- BARS / SUSPENSIONS – can follow one forever

III. ATTORNEYS AS DEFENDANTS

- "Seller" under 12(a)(1)
- "Maker" or possibly "Schemer" under 10b-5
- SEC aid/abet or conspire
- Opinion Exposure
 - SEC v. 8000, Inc., et al., No. 12-cv-7261 (S.D.N.Y.)
 - In the Matter Carl N. Duncan, Securities Exchange Act Release No. 68501 (Dec. 20, 2012) (Rule 102(e)(3)(1) proceeding).
 - The SEC's complaint alleged, among other things, that Duncan prepared and issued false legal opinions and letters in connection with a scheme to inflate trading volume in the common shares of 8000, Inc. and the company's stock price.

III. ATTORNEYS AS DEFENDANTS (cont'd)

- "Gatekeeper" exposure
 - SEC Litigation Release No. 23158 - SEC v. Treaty Energy et al., No. 4:14-cv-812 (E.D.Tex Dec. 15, 2014)
 - The SEC's complaint alleged that Treaty Energy's outside counsel abused his gatekeeper role and enabled the scheme by authoring improper legal opinion letters that allowed the company and its officers to illegally distribute unregistered stock to the public. It further alleged that counsel was aware that the company's founder was running the company and Treaty Energy was abusing registration rules under the federal securities laws. Yet, the SEC alleged, these facts did not deter him from issuing the opinion letters that allowed the scheme to proceed.

IV. "BROKERS" AND "FINDERS FEES"

- Definitions
 - Section 3(a)(4) of Exchange Act defines "Brokers" as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. §78c(a)(4)(a).
 - Section 15(a)(1) – makes it illegal for a broker to make use of any means or any instrumentality of interstate commerce and effect any transactions in, or to induce or attempt to induce the purchase or sale of any security unless said broker is registered with the Commission or is associated with a registered entity. 15 U.S.C. §78o(a)(1).

IV. "BROKERS" AND "FINDERS FEES" (cont'd)

- Scienler not required to prove violations (see In the Matter of Kenneth C. Meissner, et al., Securities Exchange Act Release No. 73226 (Apr. 7, 2015) (holding that an individual who was not registered as a broker-dealer violated § 15(a)(1) by soliciting investors, disseminating a private placement informational document and receiving transaction based compensation)).
- However, no private right of action under Section 15, but SEC sues under it all the time.

V. DISCOVERY ISSUES

- Drafts of Offering Materials
- Attorney Comments
- Third Party Files

VI. HOW DOES ONE RECOVER THEIR LOSSES FROM A SETTLEMENT FUND?

- Plan of Distribution (SEC v. Franco et al., No. 01 Civ. 03872 (JGK) (S.D.N.Y.) (Nalco Chemical))
 - Fair Fund was \$8.6 Million in Escrow
 - 130 Ineligible
 - 94 Eligible – Approximate Loss About \$17MM
 - Fees and Expenses come out of total

VI. HOW DOES ONE RECOVER THEIR LOSSES FROM A SETTLEMENT FUND? (cont'd)

- How Does Receiver/Administrator Determine "Approved Claims?" (Great scrutiny/concern regarding fraudulent claims)
 - Original Signature
 - Valid TIN or SSN
 - Authority of signatory (An issue with advisors, custodians and trustees)
 - Data missing on form
 - Lack of valid documentary proof
- Notice of Deficient Proof (See Mintz Levin Institutional Class Action Recovery Practice: <http://www.mintz.com/practices-industries/practice/litigation/institutional-investor-class-action-recovery>)