

NO. A06-1233

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State of Minnesota  
**In Court of Appeals**

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Charles Risdall, Len Dozier, and John Risdall,  
in his capacity as personal representative of  
the Estate of Mary Risdall,

*Respondents,*

v.

Christopher C. Brown and funeral.com, inc.,

*Appellants.*

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**RESPONDENTS' BRIEF AND APPENDIX**

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## LEGAL ISSUE

**Whether an issuer of unregistered securities can avoid the right of rescission granted to purchasers of unregistered securities by Minn. Stat. § 80A.23 by simply claiming that the securities were offered “pursuant to” Rule 506 of Regulation D, 17 C.F.R. § 230.506, when the undisputed record establishes that the issuer actually made general solicitations that foreclosed any right to a registration exemption under Rule 506?**

*The district court held in the negative and granted summary judgment to Respondents, holding as a matter of law that the Minnesota securities registration laws are not preempted by a mere claim to a federal exemption from registration and that Appellants’ sale of stock to Respondents was part of an integrated offering that did not qualify for such an exemption.*

### Most Apposite Cases:

*Buist v. Time Domain Corp.*, 926 So. 2d 290 (Ala. 2005)

*Hamby v. Clearwater Consulting Concepts, LLLP*,  
428 F. Supp. 2d 915 (E.D. Ark 2006)

*Grubka v. WebAccess Int’l, Inc.*,  
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*UBS Asset Mgmt., Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66 (S.D.N.Y. 1996)

### Most Apposite Statutory Provisions:

Minn. Stat. §§ 80A.08 and 80A.23

15 U.S.C. § 77r

17 C.F.R. §§ 230.502 and 230.506

## STATEMENT OF THE CASE

Charles Risdall, Len Dozier, and John Risdall, in his capacity as personal representative in the Estate of Mary Risdall (collectively, "Plaintiffs"), purchased \$220,000 of common stock from Christopher C. Brown and funeral.com, inc. (collectively, "Defendants") in 2000. At that time, Defendant Brown purported to be looking for "start up" capital to get Defendant funeral.com, an online funeral services company, off of the ground. The stock was not registered, because Defendants allegedly planned to comply with the requirements for a registration exemption.

When their investment proved to be worthless, Plaintiffs sued Defendants under a variety of liability theories, including violation of Minn. Stat. § 80A.01 *et seq.* A.A. 35-44.<sup>1</sup> Following discovery, the parties brought cross-motions for summary judgment. A.A. 69-74.

The district court (Hon. Steven D. Wheeler, Ramsey County) denied Defendants' motion and the portion of Plaintiffs' motion that related to Plaintiffs' fraud-based claims, but ordered summary judgment in favor of Plaintiffs under Minn. Stat. § 80A.08, which requires the registration of securities offered and sold in the State of Minnesota unless an exemption is available to the issuer. A.A. 2-17. In so holding, the district court concluded that the *only* exemption that Defendants claimed to have relied upon is only available to issuers who comply with all aspects of Regulation D (the corresponding exemption under *federal* securities law) and that Defendants' series of related stock offers

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<sup>1</sup> References to in this brief to Appellants' Appendix shall be in the form "A.A. \_\_\_." References to Respondents' Appendix shall be in the form "R.A. \_\_\_."

failed to fully comply with Regulation D. *Id.* The Court based this finding on the undisputed fact that Defendants had offered securities for sale by mass mail and the Internet in violation of Regulation D's prohibition on general public solicitations. *Id.*

Judgment was ordered in Plaintiffs' favor, pursuant to Minn. Stat. § 80A.23, which provides that purchasers of unregistered securities are entitled to obtain rescission, costs and fees from the seller (*Id.*), but the actual amount of the judgment was not established until several months later, following a hearing on Plaintiffs' motion for interest, attorney fees, costs and disbursements (A.A. 18-22). Even then, judgment was not properly entered for several months due to Plaintiffs' unresolved fraud-based claims.<sup>2</sup>

Recognizing that they had little reason to pursue their fraud-based claims in the wake of the district court's registration-based order for summary judgment in their favor for the full amount of their investments, plus interest, fees and costs, Plaintiffs eventually agreed to dismiss the fraud-based claims. A.A. 31-32. At that point, the district court directed entry of judgment on its previous order (*Id.*) and judgment was entered on May 31, 2006 (A.A. 1).

Defendants now seek review by this Court.

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<sup>2</sup> A judgment was prematurely entered upon the district court's summary judgment order in late 2005. A.A. 34. The district court promptly corrected that clerical error, however. *Id.*

## STATEMENT OF FACTS

This case arises out of Defendants' sale of \$220,000 worth of unregistered securities to Plaintiffs.

Defendant Chris Brown had a dream "of having the biggest and the best and the most comprehensive funeral site on the Internet." C. Brown Dep. (9/5/01) at 20. Because that dream would require a considerable amount of money, Brown organized a stock offering in which he hoped to sell up to \$3,600,000 worth of stock to investors. A.A. 78.

Meanwhile, Brown had a separate need to raise money fast. As President of a burial vault manufacturer, Brown-Wilbert, Inc., Brown had applied corporate funds to his personal expenses. L. Harren Dep. (2/2/04) at 14, 20-21. When that company's bank found out about Brown's use of corporate funds to pay personal expenses, it wanted the money -- \$288,000 -- returned. *Id.*<sup>3</sup>

Defendants offered and sold securities from March through early August 2000. A.A. 78, 109, 115-116, 119. An initial private placement memorandum ("PPM1") was issued on March 2, 2000. A.A. 78. As noted above, Defendants hoped to raise \$3.6 million under PPM1. *Id.* According to the "Use of Proceeds" section of that document,

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<sup>3</sup> Prior to obtaining a judgment of rescission on the basis of their state law securities registration claim, Plaintiffs had simultaneously pursued Defendants for securities fraud relating, in part, to alleged funneling of investment proceeds from funeral.com to Brown-Wilbert. A.A. 39. As noted in the Statement of the Case, those claims were eventually dismissed to allow judgment to be entered on the registration claim. A.A. 31-32.

the funds raised were to be used *“to fund marketing and promotional activities, the further development and maintenance of our web-site, the purchase of necessary computer and office equipment, content acquisition and for general working capital.”* A.A. 87 (emphasis added). In addition, that same section of the document states that the company *“will likely need to raise additional capital immediately in order to fund our expansion, to develop new or enhance existing services or products, to respond to competitive pressures or to acquire complementary products, businesses or technologies.”* *Id.* Furthermore, PPM1 states that \$375,000 of the proceeds would be used to repay a promissory note payable to Defendant Chris Brown. *Id.*

Plaintiffs each purchased common stock in Defendant funeral.com, as offered under PPM1. A.A. 121, 127, 132, 139, 145, 151. Plaintiffs Charles Risdall and Len Dozier invested \$70,000 and \$100,000, respectively, on March 13, 2000; and Plaintiff Mary Risdall invested \$50,000, on April 28, 2000. *Id.* Defendants raised only \$760,006 under PPM1, including the \$220,000 invested by Plaintiffs. A. 66.

Still in need of money to start the business, Defendants issued a second private placement memorandum (PPM2), on May 17, 2000, offering more of the same shares of common stock. A.A. 109. PPM2 states that the stock is offered for sale to raise more funds for the same purposes funds were raised under PPM1-- *“to fund marketing and promotional activities, to further develop and maintain our web-site, to purchase necessary computer and office equipment and for general working capital.”* A.A. 111. Just like PPM1, PPM2 also contains the statement that the company *“will likely need to*

raise *additional capital* immediately” to fund “expansion” and “to develop new or enhance existing services or products.” *Id.*

Shortly after Defendants issued PPM2, Brown published it to the general public on two separate websites (funeral.com and vfinance.com, a venture capital website) and by mass mailing it (both in hard copy and via email) to a large number of funeral home owners and venture capital investors. A.A. 67, 116, and 165.

While PPM2 remained available on the aforementioned websites, Defendants issued yet another private placement memorandum (PPM3), offering both common and preferred stock for sale, on July 20, 2000. A.A. 117. While the preferred stock offered under PPM3 differed from the common stock previously offered under PPM1 and PPM2, the common stock offered under PPM3 was identical to the common stock offered under PPM1 and PPM2. A.A. 78, 109 and 117. Aside from the assignment of approximate dollar amounts that were to be spent on each particular purpose, the stated purpose for raising funds under PPM3 was almost identical to the purposes expressed under PPM1 and PPM2 -- “to further develop, design and maintain our web-site and . . . to fund marketing and promotional activities and for general working capital.” A.A. 119. In addition, PPM3 includes a statement identical to the statements in PPM1 and PPM2 that the company “will likely need to raise *additional capital* immediately” to fund “expansion” and “to develop new or enhance existing services or products.” *Id.*

In a letter dated August 3, 2000, the SEC informed Defendants that the Internet postings and mailings of PPM2 violated federal securities laws. A.A. 112. Defendants received the letter on August 8, 2000, and responded to it on August 14, 2000, following a meeting of the board of directors on August 10, 2000. A.A. 114–116. Defendants’ response effectively admits that they made a general solicitation to the public by offering common stock for sale on the Internet and by mass mail and states that “[a]s of *August 10, 2000*, the Company has removed all references to its private placement from both of the websites.” A.A. 116 (emphasis added).

Defendant funeral.com never got off of the ground and eventually “quit trying to raise money.” A.A. 63

## INTRODUCTION TO ARGUMENT

### A. Standard of Review

On an appeal from a summary judgment, the Court must determine whether there are any genuine issues of material fact in dispute and whether the district court erred in applying the law. *State by Cooper v. French*, 460 N.W.2d 2, 4 (Minn. 1990). Both of these questions are subject to *de novo* review. *STAR Ctrs., Inc. v. Faegre & Benson, L.L.P.*, 644 N.W.2d 72, 76-77 (Minn. 2002). Meanwhile, the Court views the evidence in the light most favorable to the party against whom summary judgment was granted, when deciding whether to affirm the judgment. *Louis v. Louis*, 636 N.W.2d 314, 318 (Minn. 2001).<sup>4</sup>

Summary judgment is inappropriate if the nonmoving party has the burden of proof on an issue and presents *sufficient evidence* to permit reasonable persons to draw different conclusions. *Gradjelick v. Hance*, 646 N.W.2d 225, 231 (Minn. 2002). Conversely, summary judgment is mandatory against a party who has the burden of proof and who fails to establish an essential element of the claim, because that failure renders all other facts immaterial. *Lloyd v. In Home Health, Inc.* 523 N.W.2d 2, 3 (Minn. Ct. App. 1994).

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<sup>4</sup> Where parties have brought cross-motions for summary judgment, each party is only entitled to have all of the factual allegations viewed in his or her favor when the court is analyzing the other party's motion. *See Home Mut. Ins. Co. v. Snyder*, 356 N.W.2d 780 (Minn. Ct. App. 1984). Thus, in the present case, Defendants are only entitled to a favorable view of the evidence for purposes of their opposition to Plaintiffs' motion for summary judgment. To the extent that Defendants are seeking judgment themselves, Plaintiffs are entitled to a favorable view of the evidence. For that reason, the Court must reject Defendants' erroneous suggestion that a reversal of the judgment in favor of Plaintiffs should lead to an order for entry of judgment in favor Defendants.

**B. Summary of Argument**

The National Securities Market Improvement Act of 1996 (“NSMIA”) preempts *state* securities registration requirements where the issuer of a security has complied with *federal* securities registration requirements. In adopting NSMIA, Congress intended to enhance the free flow of capital in the U.S. economy by relieving issuers of securities from having to comply with multiple, inconsistent state registration requirements. As stated above, however, NSMIA only preempts state law when an issuer fully complies with the applicable federal laws. Where, as in the instant case, an issuer fails to fully comply with all federal registration requirements, states are not preempted from enforcing state registration statutes.

Defendants Brown and funeral.com made general *public* solicitations with regard to securities that were purportedly being offered and sold under a federal securities regulation -- Regulation D -- that exempts certain *private* offerings from federal registration requirements. Pursuant to the SEC’s integration rules, the series of offers and sales conducted by Defendants were part of a single common offering. Under such circumstances, the failure to satisfy the Regulation D exemption requirements with respect to any one transaction renders the exemption unavailable with regard to any and all offers and sales made during the course of the entire offering.

Defendants’ failure to satisfy the exemption requirements under Regulation D results in the loss of any right Defendants may have otherwise had to a federal exemption. Moreover, because there is no federal exemption to consider, Minnesota is *not* preempted by federal law from enforcing the registration requirements set forth in

Minn. Stat. 80A.08. Defendants' sale of the unregistered securities violated Minn. Stat. § 80A.08, which requires registration of all securities sold in Minnesota.

Civil remedies available under Minnesota law in the event of a sale of unregistered securities include rescission, interest, fees, and costs. Minn. Stat. § 80A.23, subd. 1. Accordingly, after determining that there was no genuine issue of material fact regarding Defendants' illegal securities offering, the district court properly granted summary judgment to Plaintiffs with respect to their claims for rescission, interest, fees and costs. Plaintiffs respectfully request that this Court affirm that result.

## ARGUMENT

### **I. FEDERAL PREEMPTION OF STATE SECURITIES LAWS DOES NOT EXTEND TO OFFERINGS THAT DO NOT COMPLY WITH FEDERAL REGISTRATION REQUIREMENTS.**

#### **A. NSMIA Only Partially Preempts State Securities Laws.**

Congress passed NSMIA, 15 U.S.C. § 77r, to address problems arising out of overlapping federal and state securities laws. In particular, Congress intended to enhance the free flow of capital in the U.S. economy by relieving issuers of securities from having to comply with multiple, inconsistent state registration requirements. Conference Report on National Securities Markets Improvement Act of 1996, H.R. 104-864, 104th Cong., 2d Sess., 1996–1997 *Fed. Sec. L. Rep. (CCH)* ¶ 85,847 at 88,650 (1996). NSMIA preempts enforcement of state securities laws when a particular securities offering complies with federal securities registration laws (including any applicable exemption provisions). Specifically, NSMIA preempts enforcement of state registration and qualification

requirements that would otherwise apply to a “covered security.” 15 U.S.C. § 77r (b)(4). For purposes of the present case, a “covered security” is one that is sold pursuant to what is known as federal Regulation D – 17 C.F.R. § 230.501-508. See 15 U.S.C. § 77r (b)(4)(D).<sup>5</sup> Indeed, because Defendants claim to have relied exclusively upon Rule 506 of Regulation D (*i.e.*, 17 C.F.R. § 230.506), NSMIA can only preempt Minnesota law if Defendants’ securities offering properly falls within that particular rule.

Securities offered or sold in transactions that are potentially exempt from registration requirements under Rule 506 must, *in fact*, satisfy the Rule 506 requirements in order for the exemption to be available. 17 C.F.R. § 230.506 (a) and (b)(1). That a particular offer or sale may have been made “pursuant to” Regulation D during the course of the offering is irrelevant. 17 C.F.R. § 230.502 (a). Whether an exemption is available for a *particular* offer or sale depends upon whether the issuer met all of the requirements with respect to *all* offers or sales in the course of an offering. 17 C.F.R. § 230.506 (a). This can only be determined after the offering is completed.

If, upon completion, an offering satisfies all of the Rule 506 criteria, then NSMIA preempts any otherwise applicable state securities registration laws with respect to all offers and sales that are part of the offering. 15 U.S.C. § 77r (a)(1)(A) and (b)(1). To that end, the Minnesota Legislature has amended Minn. Stat. § 80A.08, to recognize the

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<sup>5</sup> Section 77r (b)(4) states that “[a] security is a covered security with respect to a transaction that is exempt from registration under this subchapter pursuant to . . . (D) Commission rules or regulations issued under section 77d (2) of this title.” Section 77d (2) exempts from federal registration requirements “transactions by an issuer *not involving any public offering.*” (emphasis added). Defendants in the instant case violated this requirement by making a general solicitation, which is a public offering.

partial NSMIA preemption, by expressly excluding “federal covered securities” from the general prohibition on the sale of unregistered securities. Minn. Stat. § 80A.08, (a) and (c). The operative effect of that amendment to Minnesota’s statute is to recognize and honor the federal exemption requirements.

When (as in the present case) unregistered securities are illegally offered or sold as part of an offering that does not comply with federal exemption requirements, however, the securities do not qualify as “federal covered securities” and NSMIA does not preempt state registration requirements. Unless all offers and sales in the course of an offering comply with Rule 506, none of the securities offered or sold in the course of the offering qualify as “covered securities.” 17 C.F.R. §§ 230.502 (a) and 506 (a). In short, absent full compliance with federal registration requirements, an issuer cannot successfully claim NSMIA preemption of Minnesota law.

**B. Congress Only Intended to Partially Preempt State Securities Registration Laws.**

State and federal case law strongly supports the enforcement of state laws when Congress has not completely preempted a field of regulation. *See Pikop v. Burlington N. R.R.*, 390 N.W.2d 743, 747 (Minn. 1986), *cert. denied*, 480 U.S. 951 (1997). *See also Chicago & N.W. Transp. Co. v. Kalo Brick & Tile Co.*, 450 U.S. 311, 317 (1981). In the absence of an explicit statement of Congress’ intent to completely occupy a field for regulation, there is a strong presumption against implying such exclusive control. *Bates v. Dow Agrosciences L.L.C.*, 544 U.S. 431, 449 (2005); *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 485 (1996); *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981).

Federal laws do not completely occupy the field of securities regulation. Congress has consistently framed federal control in that field in terms of particular classes of securities transactions (*e.g.*, those involving “federal covered securities”) and has not stated or even implied complete control over the entire field of securities regulation. Indeed, the “Preliminary Notes” to Regulation D state that, “[n]othing in these rules obviates the need to comply with any applicable state law relating to the offer and sale of securities.” 17 C.F.R. §230.501, Preliminary Notes, para. 2. Thus, enforcing state registration laws with respect to offerings that do not involve “federal covered securities” (*i.e.*, offerings that do not conform with the requirements of Regulation D) does not conflict with federal law.

In the field of securities regulation, Congress has elected only to partially preempt state laws, precluding state regulation only under particular circumstances. The policies underlying NSMIA do not dictate that all state regulation of securities registration be preempted. While Congress wanted to make compliance with securities registration requirements less burdensome, Congress clearly did not intend to prevent the states from controlling *illegal* offers and sales within their borders. States remain free to protect their citizens from fraudulent securities promotions by requiring registration when public offerings are made. Minnesota, like each of the other states, has chosen to protect its citizens in that fashion.

In the instant case, Defendants made a general solicitation to the public for the sale of unregistered securities. Because such a solicitation nullifies any possible exemption that otherwise may have applied under federal law, no basis for preempting state law

exists and the district court properly granted summary judgment to Plaintiffs based upon those state laws. Stated another way, due to their use of general solicitations, Defendants cannot carry their burden of establishing their preemption defense by demonstrating that they fully complied with Regulation D, so there is no issue of material fact left for trial and summary judgment is proper. *See UBS Asset Mgmt., Inc. v. Wood Gundy Corp.*, 914 F. Supp. 66, 68 (S.D.N.Y. 1996).

**C. Defendants Violated Minnesota Securities Registration Statutes.**

Again, Defendants' violation of Rule 506 prevents the securities involved from qualifying as "covered securities." As a result, Minnesota is not preempted from applying its registration statute.

Minnesota exempts issuers from state registration requirements *only* when they fully comply with Regulation D and file a Form D with the state. *See* Minn. Stat. §§ 80A.08, 80A.122, and 80A.15. Section 80A.15 provides as follows, in relevant part:

**Subd. 2. Transactions exempted.** The following transactions are exempted from [the registration and filing requirement contained in] sections 80A.08 and 80A.16:

\* \* \*

(h) An offer or sale of securities by an issuer made in reliance on the exemptions provided by Rule 505 or 506 of Regulation D . . . subject to the conditions and definitions provided by Rules 501 to 503 of Regulation D, if the offer and sale also satisfies the conditions and limitations in clauses (1) to (10).

Minn. Stat. § 80A.15, subd. 2, para. (h) (emphasis added). When an issuer does not comply with the requirements of Regulation D, an exemption under Regulation D is not

available under federal law and the corresponding Minnesota exemption (Minn. Stat. § 80A.15, subd. 2, para. (h)) is also unavailable.

Enforcement of Minnesota securities registration statutes when a Rule 506 exemption is not, in fact, available to the issuer does not conflict with federal law or run afoul of the state exemption for “federal covered securities.” In such cases, both the federal and state registration requirements are violated and either or both state and federal remedies are available to a purchaser. In this case, Plaintiffs chose the state remedies available under Minn. Stat. § 80A.23 and properly obtained summary judgment with regard to those remedies.

## **II. DEFENDANTS’ VIOLATION OF RULE 506 RENDERED THE FEDERAL REGISTRATION EXEMPTION UNAVAILABLE.**

Compliance with Rule 506 of Regulation D is an essential prerequisite for obtaining a federal registration exemption under that rule. Conversely, noncompliance necessarily removes a transaction’s exempt status. Defendants’ undisputed general solicitations did not comply with Rule 506 and destroyed any possibility for Defendants to receive a registration exemption under that rule.

**A. Defendants' Undisputed General Solicitations are Fatal to Defendants' Efforts to Obtain a Registration Exemption Under Regulation D.**

Federal law generally requires registration of securities that are offered or sold:

It shall be unlawful for any person, directly or indirectly, to make a use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

15 U.S.C. 77e(c). Registration exemptions may be available for particular kinds of securities and transactions that do not require the protections provided through registration. Regulation D provides a series of transactional exemptions for those securities sold in private offerings. 17 C.F.R. § 230.501 *et seq.*<sup>6</sup>

Rule 506 of Regulation D, on which Defendants base their claim of alleged preemption, has two categories of “Conditions to be met,” in order for the exemption to be available. 17 C.F.R. § 230.506 (b). First, the “General conditions” section state that “offers and sales must satisfy *all* the terms and conditions of §§ 230.501 and 230.502.” *Id.* at § 230.506 (b) (1) (emphasis added). Second, the “Specific conditions” section sets forth the number and nature of purchasers who may be involved in an exempt transaction. *Id.* at § 230.506 (b) (2). Only the “General conditions” are at issue here.

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<sup>6</sup> Regulation D is given authority by Section 4(2) of the Securities Act of 1933, which provides an exemption for transactions “not involving *any public offer.*” 15 U.S.C. 77d (2) (emphasis added). Exemptions under Section 4(2) are based on the nature of the transaction involved rather than on the nature of the security involved.

One of the conditions contained in Rule 502 that must be met is a prohibition on “general solicitation or general advertising.” 17 C.F.R. § 230.502 (c).<sup>7</sup> That condition to obtaining an exemption from normal registration requirements is both one of the most essential to compliance with Regulation D, and, perhaps, the easiest means of losing the exemption. Hugh H. Makens, *Regulation D Offerings and Private Placements*, Blue Sky Practice, ALI-ABA Course of Study, 6 (American Law Institute 2006) (cosponsored by the Securities Law Committee of the Federal Bar Association).

Rule 502 (c) provides a broad and non-exhaustive list of methods of general solicitation and advertisement that constitute a violation of the public offering prohibition. *See* 17 C.F.R. § 502 (c) (1)-(2). Additionally, the SEC has repeatedly interpreted this prohibition broadly, including such methods as Internet solicitations. Securities Act Rel. No. 33-8666, Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies (Feb. 28, 2006); Securities Act Rel. No. 33-7856, Use of Electronic Media (Oct. 28, 2000); Securities Act Rel. No. 33-7233, Use of Electronic Media for Delivery Purposes (June 27, 1995). *See also SEC v. Robinson*, Fed. Sec. L. Rep. (CCH) ¶ 91,948 (S.D.N.Y. 2002) (copied at R.A. 15); *UniversalScience.com, Inc. and Rene Perez*, Admin. Proceeding, File No. 3-10266, SEC Rel. No. 33-7879 (Aug. 8, 2000).

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<sup>7</sup> Compliance with all or part of Rule 502 is required for any of the three exemptions enumerated in Regulation D to apply (not just for the one in Rule 506 to apply). *See* 17 C.F.R. §§ 230.504 (b) and 230.505 (b).

It is undisputed that Defendants made public solicitations over the Internet via vfinance.com and on their own website from May through August 2000. A.A. 67, 116 and 165. Additionally, it is undisputed that Defendants mailed out both hard copy and email solicitations offering to sell securities to a large number of owners of funeral homes and investors with whom there was no preexisting relationship. *Id.* These actions clearly constitute general solicitation and violate Rule 502's general prohibition against public solicitations. 17 C.F.R. § 230.502. In fact, the SEC sent Defendants a letter demanding that Defendants cease such public offers. A.A. 112. Moreover, Defendants have not even attempted to argue that the conduct complied with Regulation D, either in their response to the SEC (A.A. 115) or in their brief to this Court. As a result, Rule 506's registration exemption is not available to Defendants and, therefore, no basis exists for preempting Minnesota's registration requirement.

**B. Defendants' Multiple Offers and Sales Constitute a Single Offering under Rule 502 and the Integration Doctrine.**

Defendants' general public solicitations violated Rule 506 and were part of an integrated offering that included the offers and sales of unregistered securities to Plaintiffs. Rule 502 includes a provision that integrates initially separate offers and sales into a single common offering on the basis of a five-factor test. 17 C.F.R. § 230.502 (a). For the purposes of applying the Rule 506 exemption, any violation that occurs at *any* point in an integrated offering will destroy the exemption for *all* offers and sales that took place in the course of the offering. Accordingly, the district court properly concluded that Defendants did not qualify for an exemption under Rule 506.

### 1. Whether Integration Applies Depends on a Five-Factor Test.

Rule 502 (a) and Minn. Stat. § 80A.15, subd. 2, para. (h)(10) cite the five-factor test created in SEC Rel. No. 33-4552 (November 6, 1962) as the sole method for evaluating whether individual offers and sales should be “integrated” for purposes of applying Regulation D and the related state exemption provisions. That test looks at the following factors:

- (a) Whether the sales are part of a single plan of financing;
- (b) Whether the sales involve issuance of the same class of securities;
- (c) Whether the sales have been made at or about the same time;
- (d) Whether the same type of consideration is being received; and
- (e) Whether the sales are made for the same general purpose.

17 C.F.R. § 230.502 (a); Securities Act Rel. No. 33-4552, 27 Fed. Reg. 11316 (Nov. 6, 1962).<sup>8</sup>

The SEC has repeatedly stated that this five-factor test is the sole means to be used to evaluate the integration of offers and sales. For example, when it modified the integration requirements as they relate to abandoned offerings, to include a sale as a necessary triggering event with regard to such offerings (*see* 17 C.F.R. § 230.155), the Commission explicitly stated that the adoption of the new rule was not intended to “affect

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<sup>8</sup> The five-factor integration test originally used the word “offerings” rather than “sales.” Securities Act Rel. No. 33-4552. Courts and scholars have found no significance in the change from “offerings” to “sales,” as evidenced by the fact that they continue to use the word “offerings” in discussing the current test. *See SEC v. Cavanagh*, 445 F.3d 105, 113 n. 17 (2nd Cir. 2006); *Kunz v. SEC*, 64 Fed. Appx. 659, 666 (10th Cir. 2003); Louis Loss And Joel Seligman, *Fundamentals of Securities Regulation* §3-C-1 (3d ed. 1995).

traditional integration analyses.” SEC Release No. 33-7943, Integration of Abandoned Offerings (Jan. 26, 2001). More recently, the SEC reconfirmed the five-factor test in a release concerning small public companies. SEC Release No. 33-8666, Advisory Committee on Smaller Public Companies (Feb. 28, 2006).

Significantly, neither the Commission nor the courts have issued a clear statement regarding the relative weight that ought to be given to the separate factors. *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 364 (S.D.N.Y. 1998). However, it is clear that not all of the five factors need not be demonstrated in order to establish integration. *Id.*; see also Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula that Fosters the Policies of Securities Regulation*, 25 Loy. U. Chi. L.J. 199, 221-22 (1994).

## **2. All Five Integration Factors are Satisfied in the Case.**

Even viewing the facts in the light most favorable to Defendants, as required by the established standard of review, each integration factor favors a finding of integration in this case. Therefore, the district court appropriately concluded that all of Defendants closely-related offers and sales should be integrated into a single offering for which no Regulation D exemption is available.

a. *There was a single plan of financing.*<sup>9</sup>

Based upon SEC interpretations and case law, Defendants' offerings were part of a single plan of financing to develop Defendants' Internet-based business.

Although the SEC has offered relatively little guidance regarding the interpretation of this factor,<sup>10</sup> several commentators have concluded that the financial interdependence of offers and sales is an indication of a single plan of financing. Darryl B. Deaktor, *Integration of Securities Offerings*, 31 U. Fla. L. Rev. 465, 531 (1979); Wade, *supra*, at 211-12; Loss & Seligman, *supra*, at 1214. Furthermore, if all investors are putting capital into a single entity, there is a single plan of financing. Kathryn Taylor Frame, Note, *Securities Regulation: Integration of Securities Offerings*, 34 Okla. L. Rev. 864, 872 (1981).

In the case at hand, Defendants made a series of individual offers of securities, over a four month period, that were all part of a single plan of financing to pay the start up costs of Defendant funeral.com. "Use of Proceeds" statements in each of the private placement memoranda are nearly identical. A.A. 87, 111, and 119. Some part of the proceeds was intended for marketing; some part was intended for web-site maintenance and design, and some part was intended for general working capital. *Id.* Given the

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<sup>9</sup> Although not all of the five factors need to be shown and no particular weight has been assigned to any of the factors by the SEC or the courts, factors one and five of the integration test -- namely, that there was a single plan of financing and that the sales and offers were for the same general purpose -- have often been given more weight than the other factors. Loss and Seligman, *supra*, at 280. For that reason, those two factors will be analyzed first.

<sup>10</sup> The SEC stopped issuing No-Action Letters on integration analysis in 1976.

complete overlap of the statements concerning the intended uses of the proceeds, there is no question that the offers set forth in the separate memoranda were interdependent and that there was but a single plan of financing.

Contrary to Defendants' assertions, their alleged subjective intent to issue only one private placement memorandum to finance their dot com start-up business at the time of the initial memorandum is not controlling. First, those assertions are not supported by the plain language of the "Use of Proceeds" sections of each memorandum, each of which contain the statement that the company "will likely need to raise additional capital immediately." See A.A. 87, 111 and 119. Second, Defendants' alleged intent should not be a decisive factor in determining whether a single plan of financing existed, in any event. The *Livens* decision that Defendants assert supports their argument is factually distinct from the case at hand. See *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104 (D. Mass. 1974). Indeed, that case involved six separate offers and sales -- some involving stock and at least one involving "convertible, subordinated debentures" -- over the course of nearly three years. 374 F. Supp. at 1106-07. When analyzing offers over that long a period, the court in *Livens* could not reasonably infer the existence of a single plan of financing, without substantial evidence thereof. By contrast, all of the offers and sales in question in the present case took place over a mere four month period. Thus, the inference of a single plan of financing is substantially more compelling in the present case than in *Livens*.

The other case cited by Defendants to demonstrate the alleged absence of a single plan of financing is also factually distinguishable from the instant case. *See Barrett v. Triangle Mining Corp.*, 1976 U.S. Dist. LEXIS 16883; Fed. Sec. L. Rep. (CCH), ¶ 95,438 (S.D.N.Y. 1976) (copied at A.A. 181). Unlike Defendants' public solicitations in the present case, the second offering at issue in *Barrett* was made to only six individuals who were already investors and could be considered directors of the corporation. A.A. 182. Moreover, the second offering in *Barrett* was only required after "totally unforeseen operating difficulties" were encountered in getting a mining operation running. A.A. 185. Defendants faced no similar circumstances in the present case. Instead, Defendants merely had an unsuccessful return on the initial PPM (earning proceeds of only \$760,006 rather than the \$3.6 million that was planned). Thus, the district court properly concluded that Defendants' second offer (PPM2) was part of a single, unsuccessful plan of financing that began with Defendants' first offer (PPM1).

**b. *All offers and sales were for the same general purpose.***

All of Defendants' offers and sales of securities were for the same general purpose of starting Defendant funeral.com. Each private placement memorandum states as the single purpose of the offering the intent to start Defendant funeral.com. A.A. 87, 111 and 119. There is no other general purpose cited. *Id.* Additionally, the "Use of Proceeds" statements in the separate memoranda (quoted in the Statement of Facts, *supra*, at 5-6) are thoroughly consistent with each other, providing further evidence that there was only one general purpose. *Id.*

Relatively little litigation has focused on this particular element, but fairly broad general purposes have been allowed to satisfy this factor. In *Donohoe v. Consol. Operating and Prods. Corp.*, the United States Court of Appeals for the Seventh Circuit found the general purpose of an offering to be “to drill for oil.” 982 F.2d 1130, 1140 (7th Cir. 1992). On the other hand, the court in *Donohoe* also found that, where each project or specific purpose could succeed or fail individually, integration would not apply. *Id.* Thus, in that case, the separate offers were not considered integrated.

In the instant case, however, each stated purpose could only succeed in reliance on the others. The marketing purpose was linked to developing the website; and developing the website was similarly linked to developing “general capital.” A.A. 87, 111 and 119. Each of these purposes was stated in each memorandum and, therefore, formed a general purpose that was common throughout the entire offering.

It should be noted that the funds raised need not have been applied to a single purpose under this portion of the integration analysis. Even if the funds were allocated to distinct expenditures, such as repaying a note to Defendant Chris Brown, a common purpose can be inferred if that expenditure is considered part of the *general* purpose for which the offering was initially made. *See Johnston v. Bumba*, 764 F. Supp. 1263, 1272 (N.D. Ill. 1991) (allowing integration of transactions that involved “common business venture,” despite allocation of funds to separate partnerships). It is clear, and Defendants assert, that the money for which Defendant Brown was being repaid had been spent in a manner consistent with the general purpose of starting Defendant funeral.com. *See* Tr. 26 (stating that Chris Brown spent the money on which the note was based to acquire the

domain name, begin developing the website, and otherwise accomplishing some of the stated goals of the private placement memoranda).

Therefore, the district court properly concluded that all of the offers and sales in this case were made for the same general purpose.

c. *The same class of securities was offered and sold in the relevant offers.*

Defendants offered common shares in Defendant funeral.com in each of the three private placement memoranda. As the district court recognized, “[a]lthough preferred shares were also sold, they were sold under different terms to insiders and Plaintiffs do not contend the different class of shares were part of the integration.” A.A. 11-12. Plaintiffs assert only that the common shares among all three offers are part of a common offering. By tacking on the sale of preferred shares with the common shares in PPM3, Defendants may have sought to prevent integration. Labeling will not change the fundamental nature of an offer or sale, nor does adding a class of securities.

Similarly, the district court correctly noted that the difference in price and minimum investment between each of the offers is “irrelevant.” A.A. 12. There has been little consensus as to what constitutes “the same class of securities,” and criticism has been levied at particularly narrow interpretations of this factor. A.B.A. Committee on Federal Regulation of Securities, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 *Bus. Law.* 595, 641 (1986) (suggesting that only clearly different classes of securities -- e.g., preferred, common, secured debt, non-secured debt-- be deemed to be not the “same class of securities” for integration purposes). A different

price, without different rights inuring to the shares, does not indicate a different class of securities. All the shares involved in the integration analysis in the present case are common shares bearing exactly the same rights and interests for the shareholders who own them.

**d. *The offers and sales took place at or about the same time.***

That the offers and sales of securities in this matter took place over the course of four months is compelling evidence to satisfy this integration factor. Consistent with the application of the Rule 502(a) safe harbor provision, offers and sales that take place within six months cannot be presumed to be separate offers. 17 C.F.R. § 230.502(a). *Johnston*, 764 F. Supp. at 1272 n. 6. Three similar offering documents in a four month period offering the same securities to raise money for the same stated purposes strongly supports the district court's conclusion that an integrated offering occurred in this case.

Although the time factor has not been heavily litigated, it remains a relevant and instructive factor in the integration test. When combined with evidence of a common general purpose, as demonstrated above, the contemporaneous timing of the PPMs demonstrates that there was a single plan of financing and, as a result, an integrated offering. *See Wade, supra*, at 213 (citing LaserFax, Inc., SEC No-Action Letter, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,136 at 76,614 (Aug. 15, 1985)).

**e. *The same consideration was received.***

Cash was received or was expected to be received in exchange for the stock offered in each of the three private placement memoranda. Accordingly, the same form of consideration was used in each and every offer.

Defendants' contention that this particular part of the integration test should be ignored must be rejected. Receipt of the same consideration can be determinative. Russell B. Stevenson, Jr., *Integration and Private Placements*, 19 Rev. Sec. & Com. Reg. 49, 54 (1986); *see also* Deaktor, *supra*, at 536. Moreover, Defendants' argument that cash is too common a form of consideration to be of any significance is not even supported by the authorities that Defendants cite in support of that argument. *See* Deaktor, *supra*, at 535 (explaining that arguments to the SEC that the use of cash is so common as to render it insignificant for the purposes of this factor have been dismissed as "too simplistic"); Wade, *supra*, at 219 (citing A. G. Becker & Co., SEC No-Action Letter, 1975 WL 11399, at \*3) (same).

**3. Additional Factors Indicate that Defendants' Actions Destroyed the Rule 506 Exemption.**

Consistent with the recognized proposition that the traditional integration analysis is not a rigid test that requires proof of each of the five factors, additional factors have been considered from time to time. For example, in rejecting an integration argument, one court looked at the fact that the various offers and sales at issue were made by more than one person or entity. *See Value Line Fund v. Marcus* [1964–1965 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965) (copied at R.A. 29). No such issue exists in the instant case, however, as Defendant Brown conducted all offers and sales on behalf of Defendant funeral.com.

There is also no question that, whether or not Defendants intended to violate Rule 506, they did, in fact, do so. Scholars have advised that even faultless issuers must

remain aware of the “pitfalls” of the integration doctrine. *See Wade, supra*, at 210; Deaktor, *supra*, at 472. Beyond considering the mechanics of each offer and sale as it occurs, issuers must “carefully examine previous and possible *subsequent* offerings to determine whether any combination of the offerings might later be integrated.” *Wade, supra*, at 210. Thus, regardless of any intent to violate Rule 506 or the absence of such intent, Defendants have, in fact, violated Rule 506 and have destroyed that Rule’s exemption.

**III. THE MERE FACT THAT DEFENDANTS PURPORTED TO OFFER AND SELL SECURITIES TO PLAINTIFFS “PURSUANT TO RULE 506” DOES NOT ENTITLE DEFENDANTS TO AN EXEMPTION.**

It is irrelevant that, at the time of the actual offers and sales to Plaintiffs, Defendants were purporting to sell the funeral.com stock “pursuant to Rule 506 of Regulation D” and had not yet violated Regulation D. Under the law, issuers must comply with *all* of the Regulation D requirements with respect to *any and all* offers or sales made during the course of the offering. 17 C.F.R. § 230.506, (a) and (b). Defendants indisputably made *public* offers of securities and, thereby, violated the restriction against “general solicitations” imposed by Regulation D, which exempts *private* offerings. A.A. 67, 116 and 165. As a result, no exemption under Regulation D is available to Defendants for any offers or sales made during the entire course of the integrated offering, including the offers and sales to Plaintiffs. In short, though Defendants’ transactions were nominally made “pursuant to Rule 506,” the fact that Defendants made general solicitations prevents any exemption from attaching.

Defendants' preemption defense relies upon a misinterpretation of Plaintiffs' statement that the sale of securities to them was made "pursuant to" Regulation D. Plaintiffs agree that Defendants purported to be making all offers and sales in the course of the offering pursuant to Regulation D. Furthermore, Plaintiffs are not aware of any reason why Regulation D was not available to Defendants as of the time of the sales to Plaintiffs. Indeed, as far as Plaintiffs are aware, if Defendants had made no offers or sales after those made to Plaintiffs, Regulation D would, in fact, still be available to Defendants. In other words, *as of the date of that they were made*, the sales to Plaintiffs were made pursuant to Regulation D. But Defendants' argument improperly overlooks the fact that Defendants' subsequent violation of Regulation D's prohibition on general solicitations to the public made the protections afforded by Regulation D unavailable to Defendants. Moreover, as noted above, when the Regulation D exemption became unavailable, it became unavailable with regard to *any and all* offers and sales made during the entire course of the offering, including the sales previously made to Plaintiffs.

**A. Recent Decisions of Other Courts Support the District Court's Ruling.**

The only appellate court to yet address the issue and the two federal district courts that have most recently addressed the issue have all held that an issuer cannot defeat a state law claim based upon a failure to register the securities by *baldly asserting* that he or she offered and sold securities "pursuant to" a federal exemption. *See Buist v. Time Domain Corp.*, 926 So. 2d 290, 298 (Ala. 2005); *Hamby v. Clearwater Consulting Concepts, LLLP*, 428 F. Supp. 2d 915, 921 (E.D. Ark. 2006); *Grubka v. WebAccess International, Inc.*, 2006 U.S. Dist. LEXIS 44721 (D. Colo. 2006) (copied at R.A. 6).

Those courts require actual proof that the issuer, in fact, complied with the requirements of the claimed exemption, before any registration-based state law claim will be deemed to be preempted by federal law. In short, those courts do not allow state law to be preempted by the mere assertions of sellers of securities.

In *Buist*, the Alabama Supreme Court held that, where the issuer does not provide actual evidence of compliance with Regulation D exemption requirements, the exemption does not apply and NSMIA does not prevent the state from regulating the registration of the transaction. 926 So. 2d at 298. The issuer in that case had argued that all of the shares of stock sold to the claimant were sold "pursuant to a Form D filing under Rule 506 of Regulation D" and that, as a result, the claimant's state law registration claims were preempted. *Id.* at 295. Specifically, the issuer contended that, by simply laying claim to a federal registration exemption at or before the time of the sale of any shares of stock to the claimants, the issuer established the shares as "covered securities" exempt from state regulation. *Id.* The Alabama Supreme Court expressly rejected those arguments and ruled that the issuer had to actually prove that an exemption was available before preemption would apply. *Id.* at 298.

Regarding the question of whether the making of an offer or sale "pursuant to Regulation D" irrevocably entitles the issuer to an exemption, the court in *Buist* expressly held to the contrary:

Even if the filing of a Form D is sufficient to obtain the exemption necessary for a finding of federal preemption, proof that an exemption was obtained is no evidence that the exemption exists at any later date, because . . . a failure to comply with a requirement of Rule 506 "voids" the

exemption, thereby eliminating the possibility of preemption. In other words, the exempt status of the sale of securities that deviates from any of the material commitments made in its Form D filing is repealed retroactively.

926 So. 2d at 297-98 (emphasis added).

The court in *Hamby* recently reached the same conclusion as the court in *Buist*. 428 F. Supp. 2d at 921. In *Hamby*, the court denied the summary judgment motion of issuers who had claimed that their “mere statement” that a sale of securities “was made pursuant to an exemption from federal registration” is all that is needed to preempt state law. *Id.* at 920-21. After noting that “the only way to assert federal preemption is to first show that an exemption from federal registration actually applies,” the court in *Hamby* held that the issuers were not entitled to summary judgment under their preemption theory because they had failed to carry their burden of proving that the sales of securities were exempt as a matter of law. *Id.*

Relying upon *Buist* and *Hamby*, the court in *Grubka* likewise recently rejected the argument that an issuer can avoid a state law claim (via preemption) by simply asserting that the securities in question were sold “pursuant to” a claimed exemption. R.A. 13. After expressly noting its agreement with “the *Hamby* court’s reasoning,” the court in *Grubka* went on to explain:

Nowhere does the [federal exemption] statute indicate that a security may satisfy the definition if it is sold pursuant to a putative exemption. If Congress had intended that an offeror’s representation of exemption should suffice it could have said so, but did not. Such an intent seems unlikely, in any event; that a defendant could avoid liability under state law simply by disclaiming its alleged compliance with

Regulation D is an unsavory proposition and would eviscerate the statute.

R.A. 13 (emphasis added).

A leading securities practitioner, author and lecturer, has also noted that an issuer must fully comply with all the requirements of a claimed exemption to preserve that exemption. Makens, *supra*, at 3 (“Rule 506 preemption from full state regulation is lost if the private placement does not, in fact comply with the specific requirements of the rule.”). Furthermore, in an aside that is directly applicable to the facts of the present case, Prof. Makens explains:

[T]he easiest way to lose the Rule 506 preemption is to conduct general advertising or solicitation in violation of Rule 502. This prohibition is construed broadly, and even covers Internet advertising.”

*Id.* at 6.

When the foregoing legal principles are applied to the present case, it is clear that the district court correctly rejected Defendants’ preemption defense. Actual preemption analysis is not even necessary, since Defendants did not satisfy the threshold issue of exemption eligibility. Defendants could not establish that they were eligible for the protections of Regulation D, because it is undisputed that they made general solicitations by mail and on the Internet in violation of Regulation D.

**B. The Cases Cited by Defendants are Unsupported and Unpersuasive.**

Defendants rely on a trio of discredited federal district court cases to try to support the proposition that an issuer need only claim sales were made “pursuant to” Regulation D to trigger preemption of any state securities law claims. *See Temple v.*

*Gorman*, 201 F. Supp. 2d 1238, 1243-44 (S.D. Fla. 2002), *Lillard v. Stockton*, 267 F. Supp. 2d 1081, 1116 (N.D. Okla. 2003); *Pinnacle Commc'ns Int'l, Inc. v. American Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006). *Temple* is the first of this line of cases and is the basis for both of the subsequent decisions. See *Lillard*, 267 F. Supp. 2d at 1116 and *Pinnacle*, 417 F. Supp. 2d at 1087. As observed by the *Buist*, *Hamby*, and *Grubka* courts, however, the *Temple* holding is merely an *ipse dixit*, utterly unsupported by any actual legal analysis. *Buist*, 926 So.2d at 297; *Hamby*, 428 F. Supp. 2d at 921 n. 2; *Grubka*, R.A. 13. Accordingly, each of those courts expressly rejected the *Temple* holding and this Court should do the same.<sup>11</sup>

C. **The “Pursuant to” Statement Contained in Plaintiff’s District Court Submission is Not Dispositive.**

Through numerous citations in their appellate brief to a passage in one of Plaintiffs’ district court submissions, Defendants seem to be trying to mislead the Court as to the actual issue that was contested and decided in the district court. The passage in question acknowledged that Defendants offered and sold securities to Plaintiffs “pursuant to Rule 506.” A.A. 197. In an argument that is being made for the first time on appeal, Defendants wrongly imply that that passage represents a concession by Plaintiffs concerning the ultimate issue in this case, *i.e.*, whether Defendants are entitled to the

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<sup>11</sup> Although the *Pinnacle* case was decided in the U.S. District Court for the District of Minnesota, it is *not* binding on this court. See *Northpointe Plaza v. Rochester*, 457 N.W.2d 398 (Minn. App. 1990) (citing *Jendro v. Honeywell, Inc.*, 392 N.W.2d 688, 691 n. 1 (Minn. App. 1986)). Federal case law may be persuasive with regard to federal statutes, but “state courts are bound only by decisions of the United States Supreme Court.” *Id.*

protections of Regulation D. The fact is, no such concession was made in the district court. Plaintiffs merely acknowledged that Defendants were claiming that the sales to Plaintiffs were “pursuant to Rule 506.” Plaintiffs did not concede, and were not understood by Defendants or the district court to have conceded, that Defendants were entitled to an exemption under Rule 506.

A few pages after the passage on which Defendants now seem to want to selectively focus, Plaintiffs unequivocally took issue with the contention that merely purporting to rely on Rule 506 is all that is required to make a security a “covered security” so as to trigger an exemption from registration. *See* Plaintiffs’ Memorandum of Law in Opposition to Defendants’ Motion for Summary Judgment, at 6-7. For example, Plaintiffs argued as follows:

Defendants claim that the securities sold were “covered securities” merely because they were offered and sold “pursuant to” Rule 506. Under Sec. 77r, however, a security is not a “covered security” merely because the Defendants say they made offers and sales “pursuant to” Rule 506. Rather, they must prove that the offering “*is* [*in fact*] exempt from registration” under Rule 506. (*Id.*).

To say that Defendants may invoke federal preemption merely by declaring in offering documents that an offering is made “pursuant to” Rule 506 is to say that anyone selling securities can invoke federal preemption at-will by merely declaring it. This would be patently absurd and is not the law. If Defendants can carry their burden to prove that the offering was, *in fact*, exempt under Rule 506, then Plaintiffs would agree that the securities they invested in are “covered securities” not subject to registration in Minnesota. Indeed, in that case, *Minn. Stat. 80A.08(c)* exempting federally “covered securities” from Minnesota registration would apply. But, if Defendants cannot carry this burden, then, the securities were not “covered securities” and Minnesota’s registration

requirement may be applied—i.e., in that case Minnesota is not preempted.

*Id.* (emphasis in original). Although Defendants included selected pages from that same memorandum in the appendix to their appellate brief, they did not see fit to include the pages that make it clear that Plaintiffs were not conceding the ultimate issue.

A review of the entire district court record will further reveal that Defendants are wrongly trying to twist the record to make it appear that Plaintiffs conceded the key issue. At no point in the record do Defendants or the district court indicate any belief that Plaintiffs were not disputing Defendants' exemption claim. Under the circumstances, it is patently unreasonable for Defendants to now suggest that Plaintiffs somehow conceded the central issue in the case.

#### **IV. DEFENDANTS' PUBLIC OFFERS OF UNREGISTERED SECURITIES, IN VIOLATION OF MINN. STAT. § 80A.08, ENTITLE PLAINTIFFS TO RESCISSION.**

Minnesota's Blue Sky Laws, Minn. Stat. § 80A.01 *et seq.*, contain the following explicit registration requirement:

It is unlawful for any person to offer or sell any security in this state unless (a) it is registered under sections 80A.01 to 80A.31 or (b) the security or transaction is exempted under section 80A.15 or (c) it is a federal covered security.

Minn. Stat. § 80A.08 (emphasis added). Although the statute provides for a pair of exceptions to the general rule that all securities must be registered, Defendants' public sales efforts prevented the funeral.com stock from qualifying for either of those exceptions. *See* Argument, *supra*, at 14-18. Moreover, it is undisputed that Defendants

made no effort to register the securities in question. App. Br. at 3. Thus, Defendants sold unregistered securities in direct violation of Minn. Stat. § 80A.08 and are subject to civil liability (including rescission) for that violation. *See* Minn. Stat. §80A.23.

Subdivision 1 of Section 80A.23, which is expressly directed at “registration-related actions,” provides as follows, in relevant part:

Any person who sells a security in violation of sections 80A.08 or 80A.18, . . . is liable to the person purchasing the security, who may sue either in equity for rescission upon tender of the security or at law for damages if that person no longer owns the security.

*Id.* (emphasis added). That subdivision goes on to state that a purchaser who opts to rescind is “entitled to recover the consideration paid for the security together with interest at the legal rate, costs, and reasonable attorney's fees, less the amount of any income received on the securities.” *Id.* The judgment entered by the district court conforms to these statutory provisions and should be affirmed.

Defendants try to muddy the waters with a suggestion that equitable principles should be invoked to preclude rescission in this case. This Court should reject that misleading argument.

Admittedly, Minnesota courts have refused to allow rescission where securities purchasers knew of an issuer's illegal activity and still elected to continue with a transaction. *See, e.g., Logan v. Panuska*, 293 N.W.2d 359 (Minn. 1980); *McCauley v. Michael*, 256 N.W.2d 491 (Minn. 1977). Similarly, investors who actively participated in the management of a business and made no attempt to rescind their purchase of unregistered securities until after the business failed were precluded from obtaining

rescission in *Bond v. Charlson*, 374 N.W.2d 423, 429-430 (Minn. 1985). The situation in the present case, however, is vastly different than the situations addressed in *Logan*, *McCauley*, and *Bond*.

In the present case, Defendants did not qualify for a registration exemption because they made general solicitations via the Internet and mass mailings. A.A. 67, 116, and 165. Plaintiffs had absolutely no role in the making of those general solicitations and did not actually know of those particular illegal activities until this lawsuit. Plaintiffs' only involvement with funeral.com was as investors. In that regard, Plaintiffs are in a much different position than were the claimants in *Logan*, *McCauley*, and *Bond*, who were actively involved with managing the companies in which they had invested or who otherwise had firsthand knowledge of the companies' start up operations. Indeed, there is simply no basis for applying "unclean hands," "in pari delicto" or any similar estoppel-based equitable defense in this case.

This Court should also reject Defendants' suggestion that it is somehow unfair to allow Plaintiffs to rescind on the basis of Defendants' clear violation of Minnesota securities law. In particular, the Court should reject Defendants' contention that their violation is so insignificant that it should simply be excused. Section 80A does not purport to establish rules that a court may ignore at its discretion. Furthermore, Defendants' argument that their violations were *de minimus* overlooks the fact that the violations were substantial enough to take them outside the safe harbors that Rule 508 provides for "insignificant deviations."

Rule 508 provides a safe harbor for “insignificant deviations from a term, condition or requirement of Regulation D,” but goes on to state that “any failure to comply with paragraph (c) of § 230.502 [the prohibition on public solicitation] . . . shall be deemed to be significant to the offering as a whole.” 17 C.F.R. § 230.508. In other words, Rule 508 plainly establishes that any violation of the prohibition on public solicitation with respect to unregistered securities is too significant to be excused. In the present case, Defendants made a large number of direct mailings and made further public solicitations via the Internet. A.A. 67, 116, and 165. Accordingly, Defendants’ assertions that their securities law violations were too insignificant to be actionable must be rejected.

The Court should also reject Defendants’ spurious assertion that rescission is improper because, according to Defendants, this case involved only allegations of technical violations and no allegations of actual fraud. Minn. Stat. § 80A.23 expressly grants the remedy sought by Plaintiffs and awarded by the district court. Furthermore, Plaintiffs *did* allege securities fraud in the Complaint. A.A. 39-43. While it is true that Plaintiffs eventually dismissed those allegations, that dismissal did not occur until after the district court granted summary judgment to Plaintiffs on their securities registration claim. A.A. 32. Having already obtained an order for rescission, attorney fees and costs, Plaintiffs had nothing further to gain from going to trial on the securities fraud claims. In other words, the dismissal was merely a procedural step to permit the present appeal and cannot reasonably be viewed as a concession that Defendants did not commit any fraudulent acts.

Finally, there are sound policy reasons for discouraging securities issuers like Defendants from offering or selling unregistered securities. NSMIA and the Minnesota Blue Sky Laws were carefully crafted to ease the burden on issuers, particularly small businesses, but that was in no way a move toward leniency or laxity in securities regulation. To find that Defendants' have no responsibility to Plaintiffs in this matter would provide a license to disreputable issuers to freely offer unregistered securities to the investing public. This was not the intent of Congress or the Minnesota Legislature when they framed the federal and state securities laws. To the contrary, the Minnesota Legislature clearly sought to discourage public solicitations for the purchase of unregistered securities, by establishing the equitable remedy of rescission for violations of the registration statute. To avoid undercutting that obvious intention, Plaintiffs' right to rescission under the facts of this case must be affirmed.

**V. STRONG PUBLIC POLICY CONSIDERATIONS DEMAND THAT STATES BE FREE TO ENFORCE THEIR LAWS AGAINST ILLEGAL SALES OF UNREGISTERED SECURITIES.**

Since the 1930's, the federal government and all fifty states have adopted laws requiring issuers of securities to file registration statements fully disclosing all investment information that is material to investors' decisions to invest in securities. These laws were deemed by Congress and the fifty states who passed them to be necessary to the protection of the investing public. But these laws also created a complicated patchwork of often inconsistent regulations that imposed a significant burden on issuers seeking to comply with them. This burden impaired the free formation and flow of capital

necessary to American commerce. As noted earlier in this brief, Congress passed NSMIA to relieve this burden.

NSMIA relieves the registration burden by preempting states from requiring registration of offers and sales of securities by issuers who *obey* federal law. The idea is that, when issuers comply with federal law, investors are sufficiently protected. This includes compliance with Regulation D in the case of private offerings of unregistered securities. The Minnesota Legislature demonstrated its agreement with the federal policy by amending its securities statute to mirror the provisions of NSMIA, so that issuers who comply with federal law, particularly with Regulation D, are exempt from state registration requirements. *See* Minn. Stat. § 80A.08 (a) - (c).

The strong public policy being served by NSMIA and Minnesota's registration laws will be *turned upside down* if Defendants have their way in this case. Rather than having the level of protection intended by Congress and the Minnesota Legislature, investors would have far less protection. Any issuer of securities, *even while violating federal law*, will escape state regulation by merely *declaring* that their offering is exempt under Regulation D. They may then proceed to make public offerings of securities within the state without fear of state regulation, or even a lawsuit brought under state law (as the present case was). Meanwhile, the chance of federal action against the issuer is not a meaningful deterrent, since federal securities enforcement resources are severely limited, as seen from the wave of national securities fraud in the late 1990's.

Minnesota enacted Section 80A.23, under which the district court has granted relief to the Plaintiffs, to provide a very strong civil remedy against issuers and promoters

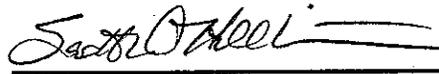
of unregistered securities. Neither Congress nor the Minnesota Legislature intended to deny this protection to Minnesota citizens who are offered or sold unregistered securities in illegal transactions. NSMIA was *not* intended to deprive state regulators and the citizens they protect of the remedies provided under state law against issuers who violate both federal and state laws in the offer and sale of securities.

**CONCLUSION**

For all of the foregoing reasons, Plaintiffs respectfully request that the Court affirm the judgment of the district court in all respects.

Respectfully submitted,

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Dated: September 27, 2006.

**CERTIFICATE OF COMPLIANCE**

I hereby certify that this brief was prepared using Microsoft Word, in Times New Roman font, 13 point, and according to the word processing system's word count, is no more than 10,726 words, exclusive of the cover page, table of contents, table of authorities, signature block and appendix, and complies with the typeface requirements of Minn. R. Civ. App. P. 132.01.

Dated: September 27, 2006.



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Scott D. Hillstrom

The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2) (with amendments effective July 1, 2007).