NO. A06-1233

State of Minnesota
In Supreme Court

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

Appellants,

v.

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

Respondents.

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STATEMENT OF ISSUES

1. Whether, for purposes of applying the state and federal securities regulations, Internet advertising and general solicitation of investors conducted as part of an ongoing attempt to finance a start-up business is part of the same "offering" as recent previous sales by the same issuer of the same class of securities for the same type of consideration and for that same general purpose of financing the new business?

   Imposing a sales requirement that no other court has ever applied in the context of the integration rule set forth in Rule 502 of Regulation D, the Court of Appeals held in the negative.

   Most Apposite Cases:

   SEC v. Ralston Purina Co., 346 U.S. 119 (1953)

   SEC v. Chinese Consol. Benevolent Ass'n, 120 F.2d 738 (2d Cir. 1941)

   SEC v. Cavanagh, 445 F.3d 105 (2nd Cir. 2006)

   Most Apposite Statutory Provisions:

   15 U.S.C. § 77e

   15 U.S.C. § 77d(2)

   17 C.F.R. §§ 230.502 and 230.506

   Minn. Stat. § 80A.08

2. Whether the National Securities Market Improvement Act ("NSMIA") preempts the State of Minnesota from enforcing its securities registration statute when an issuer merely asserts that the security being offered and sold is an exempt "covered security" under NSMIA without actually complying with the relevant exemption requirements.

Rejecting the holding in the only U.S. Court of Appeals decision that has addressed the issue, as well as the law in the majority of the jurisdictions that have considered the issue, the Court of Appeals held in the affirmative.

<u>Most Apposite Cases</u>:

Brown v. Earthboard Sports USA, Inc., 481 F.3d 901 (6th Cir. 2007)

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

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

Grubka v. WebAccess Int'l, Inc., 445 F. Supp. 2d 1259 (D. Colo. 2006)

<u>Most Apposite Statutory Provisions</u>:

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 response to the first of a series of private placement memoranda used by funeral.com to raise "start up" capital for their online funeral services company. The stock was not registered with the SEC or the State of Minnesota because Defendants claimed the offering was exempt from federal registration under Regulation D, 17 C.F.R. §§ 230.501-.508 (2006), and, as such, qualified as an "federal covered security" under Minnesota law. Minnesota is preempted from enforcing its registration statute against issuers of "federal covered securities." After the sales to Plaintiffs, Defendants engaged in general pubic solicitations and advertising prohibited by Regulation D and the Securities Act of 1933.[1]

When the stock proved to be worthless, Plaintiffs sued Defendants under a variety of liability theories (including violation of Minn. Stat. § 80A.01 *et seq.*) (A.A. 48-57), and the parties eventually brought cross-motions for summary judgment (A.A. 67-72).

The district court 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 the Minnesota registration statutes. A.A. 17-32. In so holding, the district court concluded that a registration exemption under Regulation D is only available to issuers who actually comply with all aspects of Regulation D. *Id.* Applying

1 References to in this brief to Appellants' Appendix shall be in the form "A.A. __."

the integration rule set forth in Rule 502 of Regulation D, the district court further concluded that Plaintiffs' series of stock offers and sales were all part of a single offering and, as such, that Plaintiffs' undisputed violation of Regulation D's prohibition on general public solicitations and advertising during the course of that offering precluded application of the exemption to any of Defendants' offers and sales (including the sales to Plaintiffs). *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, restitution, 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. 33-37). Even then, judgment was not properly entered for several months due to Plaintiffs' unresolved fraud-based claims.

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. 46-47. 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. 16).

Defendants appealed from the judgment, and the court of appeals reversed. A.A. 1. Plaintiffs then successfully petitioned this Court for review of the decision of the court of appeals. A.A. 14. At that same time, the Court authorized the State of Minnesota to file an amicus brief in this matter.

STATEMENT OF FACTS

This case arises out of Defendants' illegal 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." A.A. 132. 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. 76.

Defendants conducted an offering of unregistered common stock from March through early August 2000, using three separate offering memoranda. A.A 76, 107 and 115.

The first private placement memorandum ("PPM1") was issued on March 2, 2000, offering 600,000 shares for sale at $6 per share,[2] in an effort to raise up to $3.6 million. A.A. 76. PPM1 stated that this amount was needed to fund the start up of the business, including $375,000 to reimburse Defendant Brown for start up expenses that he had previously paid. A.A. 81-85. According to the "Use of Proceeds" section, the funds raised were to be used to "*increase marketing and promotional expenses, web-site development, purchase equipment, salaries and general working capital.*" A.A. 80 (emphasis added). In addition, PPM1 stated that the company "will likely need to raise *additional capital* immediately in order *to fund our expansion, to develop new or enhance*

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2 The actual average price per share was less than listed, since investors who paid the listed price were also offered a small number of the same common shares at $1 per share.

existing services or products, to respond to competitive pressures or to acquire complementary products, businesses or technologies." A.A. 85 (emphasis added).

Plaintiffs each purchased common stock in Defendant funeral.com, as offered by PPM1. A.A. 124-25. Plaintiffs Charles Risdall and Len Dozier invested \$70,000 and \$100,000, respectively, on March 13 and 15, 2000; and Plaintiff Mary Risdall invested \$50,000, on April 28, 2000. *Id.*

Having raised only \$760,006 under PPM1, including the \$220,000 invested by Plaintiffs, (A.A. 124), Defendants issued a second private placement memorandum (PPM2), on May 17, 2000, which quadrupled the number of common shares offered to 2,400,000 and cut the price by half, to \$3 per share, seeking \$7,200,000 from investors. A.A. 107. PPM2 stated that the stock was being offered to raise more funds for the same purposes funds were raised under PPM1—"*to fund marketing and promotional expenses, web-site development, equipment purchases, salaries and general working capital.*" A.A. 108. 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." A.A. 109.

Before the month ended, Brown was conducting a public offering by advertising the stock for sale and soliciting sales of stock over the Internet, by regular mail, and by email. He posted PPM2 on two separate websites (funeral.com and vfinance.com, a venture capital website) and mass mailed it (both in hard copy and via email) to a large number of funeral home owners and venture capital investors. A.A. 114, 125-26, and 129.[3]

On July 20, 2000, while PPM2 remained available on the Internet, Defendants issued yet another private placement memorandum (PPM3), again halving the price, to $1.50 per share, but this time only doubling the number of shares offered, to 4,800,000. A.A. 115. 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. 76, 107 and 115. Like PPM1 and PPM2, the summary of "The Offering" in PPM3 states that funds raised will be used "*to fund marketing and promotional expenses, web-site development, equipment purchases, salaries and general working capital.*" A.A. 116. Inside, it adds one more purpose—that people who already own preferred stock may receive some of the proceeds. A.A. 117. Even PPM3, after two previous PPMs, still repeats that the company "will likely need to raise *additional capital* in the future." *Id.*

In a letter dated August 3, 2000, the SEC sent a cease and desist letter to funeral.com's CFO directly the company and "persons affiliated" to stop offering the stock for sale over the Internet and by emails. A.A. 110-111. (It is not clear whether the SEC knew about the hard copy mass mailings.) The SEC also directed Defendants to "*specify if you have received any funds . . . from your <u>offerings</u> to date.*" A.A. 110 (emphasis added).

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[3] Defendants claim to have made no sales by this public offering and Plaintiffs do not dispute this because it is not relevant to Plaintiffs' claims.

Defendants received the letter from the SEC 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. 112–114. Defendants' response contains an admission that they conducted the public offering. *Id.* But, despite the specific request from the SEC described above, *the response does not inform the SEC that Defendants had received funds to date in the amount of $760,006, including $220,000 invested by Plaintiffs. Id.*

Defendant funeral.com never got off of the ground and eventually "quit trying to raise money." A.A. 121.

INTRODUCTION TO ARGUMENT

A. Standard of Review

On 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). The interpretation of statutes and regulations presents an issue of law that is likewise subject to *de novo* review. *Denelsbeck v. Wells Fargo & Co.*, 666 N.W.2d 339, 346 (Minn. 2003); *Houston v. Int'l Data Transfer Corp.*, 645 N.W.2d 144, 149 (Minn. 2002).

When reviewing a summary judgment ruling, the Court views the evidence in the light most favorable to the non-moving party. *Gradjelick v. Hance*, 646 N.W.2d 225, 231

(Minn. 2002).[4] Summary judgment is appropriate if the nonmoving party has the burden of proof on an issue and fails to present sufficient evidence to permit reasonable persons to draw different conclusions. *Id.*

B. Summary of Argument.

Defendants sold $220,000 worth of unregistered securities to Plaintiffs in violation of both federal and state laws that prohibit the sale of unregistered securities unless the seller proves that the sales were made in an *offering* that is exempt from those laws. Minnesota law *exempts* offerings that are exempt under federal law. Federal law *preempts* Minnesota from enforcing its registration statute if a federal exemption applies to an offering. If the sales are not exempt under federal law, then Minnesota is not preempted from enforcing its registration statute.

Defendants offered and sold the same securities to Plaintiffs and others over a short period of time in the course of a single offering. No exemption is available to the offering because Defendants engaged in illegal advertising and general solicitations prohibited by both federal and state law. Defendants contend that they conducted three separate offerings by using three separate offering documents and claim exemption for the one in which they made the sales to Plaintiffs. Under the SEC's Integration Doctrine,

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4 Where parties have brought cross-motions for summary judgment, each party is only entitled to have 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 asking the Court to affirm the judgment ordered by the court of appeals, *Plaintiffs* are entitled to a favorable view of the evidence.

the whole of an offering is either exempt or not. It cannot be separated into parts to gain exemption for a part if the whole is not exempt. Therefore, no federal exemption is available to any part of the three purported offerings.

Since no federal exemption is available, (1) Minnesota is not preempted from enforcing its registration statute, and (2) Defendant's offering is not exempt under that statute since state exemption depends upon federal exemption. Therefore, Plaintiffs are entitled to the relief ordered by the district court under Minn. Stat. 80A.23 (*i.e.*, rescission, restitution, interest, fees, and costs) and this Court must reverse the decision of the court of appeals to reinstate that relief.

ARGUMENT

I. UNLESS DEFENDANTS PROVE THAT AN EXEMPTION IS AVAILABLE, THEY ARE STRICLY LIABLE FOR SELLING UNREGISTERED SECURITIES TO PLAINTIFFS.

It is undisputed that the securities that Defendants sold to Plaintiffs were not registered with either the SEC or the State of Minnesota. The offer or sale of unregistered securities was made illegal in the United States by the Securities Act of 1933 (the "Securities Act" or the "Act").[5] Registration of securities with the Securities and Exchange Commission ("SEC" or "Commission") before they may be offered or sold is a key requirement of this landmark legislation, which was passed by Congress during the Great Depression that followed the stock market crash of 1929. *See generally* Louis Loss

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[5] Securities Act of 1933, Section 5 — Prohibitions Relating to Interstate Commerce and the Mails

a. Sale or delivery after sale of unregistered securities. Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

1. to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to *sell* such security through the use or medium of any prospectus or otherwise; or

2. to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of *sale* or for delivery after sale.

* * *

c. Necessity of filing registration statement. It shall be unlawful for any person, directly or indirectly, to make 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* [e.g. advertising] any security, unless a registration statement has been filed as to such security....

15 U.S.C. § 77e (a) and (c). (emphasis added).

and Joel Seligman, *Fundamentals of Securities Regulation*, 25-29 (2001). Minnesota also prohibits the offer or sale of unregistered securities. *See* Minn. Stat. § 80A.08.[6]

The primary purpose of registration is to prevent fraud by guaranteeing that prospective purchasers of securities receive full disclosure of information that is material to their investment decisions.[7] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953); *see also* C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 Emory L.J. 591, 599-600 (1996). To tip the balance in favor of strong investor protection, both federal and Minnesota law make issuers who offer or sell unregistered securities *strictly* liable to their purchasers by granting to investors the right

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6 Minn. Stat. § 80A.08 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.

NOTE: The Minnesota Blue Sky Statute under which Plaintiffs' claim was brought has been superseded by Minn. Stat. § 80A.40 *et. seq*. However, the new lawexpressly provides that "[t]he predecessor act exclusively governs all actions or proceedings that are pending on the effective date of this chapter.," *See* 2006 Minn. Laws ch. 196, art. I, § 50. This case was pending as of the effective date, August 7, 2007, so it is still governed by sections §§ 80A.01 to 80A.31. *Id.* at § 52.

7 The SEC has promulgated specific regulations and forms to that effect. Regulation S-K governs the narrative disclosure required in a prospectus, the heart of the registration statement, 17 C.F.R. § 229.10 *et. seq*., and Regulation S-X governs disclosures relating to the financial statements, 17 C.F.R. § 228.10 *et. seq*.

to rescission and restitution simply because the securities sold to them were not registered. 15 U.S.C. § 77l(a)(1); Minn. Stat. § 80A.23.[8]

Imposing strict liability against issuers who cannot establish that an exemption from registration is available has been said to "give teeth" to the registration provision. Marc. I. Steinberg, *Understanding Securities Laws* 207 (4th ed. 2007). Making protection stronger still, *the burden is placed on the issuer to establish that its offering actually qualifies for the exemption. See Ralston Purina,* 346 U.S. at 126 (holding, based on the "broad remedial purpose of federal securities legislation," that an issuer of unregistered securities has the burden to prove its compliance with the private placement exemption); *see also Mark v. FSC Sec. Corp.*, 870 F.2d 331, 337 (6th Cir. 1989); *Pennalumna & Co. v. SEC*, 410 F.2d 861 (9th Cir. 1969).

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[8] Section 12 of the Securities Act provides as follows:

> a. In general
>
> Any person who—
>
> 1. offers or sells a security in violation of section 5, . . .
>
> shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77l(a)(1).

Minn. Stat § 80A.23 states that "[a]ny person who sells a security in violation of sections 80A.08 [prohibiting the sale of unregistered securities] . . . 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."

Because strict liability follows automatically as a matter of law from sales of unregistered securities, lack of intent to evade registration is not a defense. Except in situations not pertaining to this case,[9] compliance *in fact* is strictly required. Without strict liability, victims of fraud would be put to greater expense and risk to recover. And, since fraud can be more easily committed by issuers who fail to register their securities,. the Act deliberately puts issuers at greater risk if they fail to register their securities. It does that so investors will be at lesser risk of being deceived in the securities transactions.[10]

Of course, issuers can shift risk from themselves to investors by (a) simply complying with the registration requirement or (b) establishing that their securities offerings are exempt from that requirement. In this case, because Defendants admittedly sold unregistered securities to Plaintiffs, only the second option is available to Defendants. That is, Defendants must carry the burden to establish that an exemption is available to cover those sales of unregistered securities.

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9 Regulation D, Rule 508—entitled "Insignificant Deviations from a Term, Condition or Requirement of Regulation D"—makes certain exemptions available to issuers who deviate insignificantly from Regulation D exemption requirements, but specifically provides that "any failure to comply with paragraph (c) of Rule 502 [prohibiting general solicitations and advertising of securities as occurred in this case], . . . shall be deemed to be significant to the *offering as a whole*." (Emphasis added).

10 Never has this regulatory scheme been more important to investor protection than it is now. The SEC reports that 5 million senior citizens are victims of financial abuse and fraud *each year*. *See* U.S. Sec. and Exch. Comm'n, homepage. www.sec.gov/investor/seniors.shtml. (last visited Oct. 11, 2007).

A. <u>The Exemption Claimed by Defendants is not Available to Exempt Their Sales of Unregistered Securities from the Registration Requirement.</u>

Under the Securities Act, Congress authorized the SEC to set terms and conditions for exemptions from the registration requirement where it deems that registration is not necessary to investor protection. 15 U.S.C § 77bb. An issuer, therefore, may relieve itself of liability for the sale of unregistered securities by carrying the burden to establish that it complied with the terms and conditions of the particular exemption of an SEC "safe-harbor" rule made pursuant to that authority. 15 U.S.C. § 77s(a)

In this case, Defendants claim reliance upon the exemption authorized under Rule 506 of Regulation D ("Reg. D") promulgated by the SEC under Section 4(2) of the Securities Act, 15 U.S.C.§§ 77d(2). Section 4(2) provides: "[t]he provisions of Section 5 [prohibiting the offer or sale of unregistered securities] shall not apply to…transactions by an issuer *not involving any public offering*." *Id.* (emphasis added).[11] Therefore, no rule promulgated under Section 4(2) may permit issuers to conduct public offerings (*i.e.*, general solicitations and advertising) of unregistered securities.

Rule 506 (17 C.F.R. 230.506), promulgated under the Section 4(2), permits an issuer to make otherwise prohibited offers and sales of unregistered securities to qualified investors providing, however, that the issuer *does not engage in general solicitations or advertising of the securities—i.e.*, that it does not conduct a public offering in violation of Rule 502(c) (17 C.F.R. 230.502(c)). Defendants admit, however, that they *did* conduct

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11 A "transaction" refers to a range of activities, including offers that do not result in sales, that comprise an offering. *SEC v. Chinese Consol. Benevolent Ass'n*, 120 F.2d 738, 741 (2d Cir. 1941).

prohibited general solicitations and advertising of securities by their use of the Internet, regular mail, and email. Therefore, Defendants cannot carry the burden to establish that the Rule 506 exemption that they claim to have relied upon is available to them, unless they can prove that the offering in which they committed these violations was not the same offering in which they sold securities to Plaintiffs. This case thus turns on whether or not there was more than one offering. The answer is clear, there was not. Under the SEC's long standing Integration Doctrine, there was *only one offering*.

B. <u>The Sales to Plaintiffs were part of the Same Offering in which Defendants Conducted Illegal Solicitations and Advertising for which No Exemption is Available</u>.

1. *An "offering" includes offers that don't result in sales as well as offers that do result in sales.*

The court of appeals held that Defendants' illegal offers made by use of the Internet, mail, and email using PPM2 are not part of the same offering in which sales were made to Plaintiffs using PPM1, because none of the illegal offers made using PPM2 resulted in sales. This can be true only if securities offers that do not result in sales are never part of an "offering." In other words, under the approach adopted by the court of appeals, "offerings" (as that term is understood in the federal securities laws) do not include offers that do not result in sales. In other words, in the eyes of the court of appeals, mere "offers" are not part of an "offering."

The court of appeals erred by applying such a "resulting sales" requirement that does not exist in the law. The notion that offers that do not result in sales are not part of an offering is facially incongruent with the large body of securities law that regulates offers as well as sales under made in offerings.

Rather than attempting to draft an all-encompassing definition of the term "offering" that would establish exactly what offers, sales, and other activities are included in the same offering, the SEC states that what comprises an offering depends upon the particular facts and circumstances.[12] In this case, application of the Integration Doctrine to the undisputed facts reveals that the *sales* made to Plaintiffs are part of the same *offering* in which Defendants engaged in illegal general solicitations and advertising to the public—including *offers* made by these illegal means—even though those offers did not result in sales.

The Securities Act interprets the term "offer" broadly to include "every attempt or *offer* to dispose of, or solicitation of an *offer* to buy, a security or interest in a security, for value." Section 2(a)(3) of the Securities Act, 15 U.S.C. § 77b(a)(3) (emphasis added). Thus, an "offering" clearly includes, among other things, a series of "attempts or offers to dispose of" (*i.e.*, attempted sales) and "solicitations of offers to buy" securities. Section 5(c) of the Securities Act, which prohibits any offers of securities unless the securities are registered with the SEC, echoes this expansive interpretation of an "offering," providing that: "It shall be unlawful for any person, directly or indirectly ... to *offer* to sell or *offer*

12 A "NOTE" included in Rule 502(a) explains: "The term *offering* is not defined in the Act or in Regulation D. If the issuer *offers* or *sells* securities for which the safe harbor rule in paragraph (a) of this Rule 502 is unavailable, the determination as to whether separate sales of securities are part of the same offering [*i.e.*, are considered *integrated*] *depends on the particular facts and circumstances*. . . ." 17 C.F.R. §§230.502 (emphasis added).

to buy [an unregistered security] through the use or medium of any prospectus *or otherwise* [unless the securities are first registered]." 15 U.S.C. § 77 b(c) (emphasis added). Offers of securities may thus be included in an offering even though those offers do not result in sales.

In its seminal case on the private placement exemption, the Supreme Court gave an expansive interpretation to the term "offering," holding that it would apply to a series of proposed sales to the employees of a corporate issuer. *Ralston Purina*, 346 U.S. at 125. Likewise, in a case involving the sale of unregistered war bonds during World War II, the Second Circuit held that "[*t*]*he complete transaction included not only solicitation by the defendant of offers to buy, but the offers themselves, the transmission of the offers* and the purchase money through the banks to the Chinese government, the acceptance by that government of the offers and the delivery of the bonds to the purchaser or the defendant or his agent." *Chinese Consol. Benevolent Ass'n*, 120 F.2d at 741 (emphasis added). Meanwhile, Reg. D, Rule 502(c) prohibits not only sales, but also *offers* made by general solicitation or advertising.

None of the statutes, rules, and cases applies a "resulting sales" requirement as did the court of appeals in this case. On the contrary, offers are clearly included in offerings, regardless of whether or not they result in sales.

2. ***The sales made to Plaintiffs are part of the same offering in which Defendants conducted illegal general solicitations and advertising for which the Rule 506 exemption relied upon by Defendants is not available.***

What offers, sales, and other activities of an issuer are part of the same offering is determined by the Integration Doctrine adopted by the SEC in 1933. Applying the doctrine, as set forth in Reg. D., Rule 502(a), the district court properly held that Defendants' sales of its securities to Plaintiffs (using PPM1) are integrated into the same offering in which Defendants (using PPM2) conducted prohibited general solicitations and advertising. Inexplicably, the court of appeals reversed, holding that the sales made to Plaintiffs were made in an earlier offering and that Defendants engaged in the illegal general solicitations and advertising in a separate later offering. Because the court concluded that the illegal acts were part of a separate offering, the court held that a Regulation D exemption remained available to Defendants with regard to the sales to Plaintiffs.

The court of appeals based its holding solely on the fact that no sales were made in the later offering, concluding that an offering in which no sales were made cannot be integrated with an offering in which sales were made. In doing so, <u>the court of appeals imported into the Integration Doctrine a new sales requirement that is contrary to the Act, Reg. D. and case law</u>. No court, anywhere, has ever applied such an analysis. Using this unprecedented new rule, the court of appeals held that Reg. D remained available to Defendants to exempt the sales to Plaintiffs and that, on that basis, Plaintiffs were entitled to a judgment of dismissal. As set forth below, the court of appeals was mistaken.

a. Background of the Integration Doctrine.

The legal standard that determines when offers, sales, and other activities that comprise an offering are part of one-and-the-same offering is known as the Integration Doctrine. The standard was set down in 1933, during the first year after Congress passed the Securities Act. SEC Release No. 33-97 (Dec. 28, 1933). Since then, the standard has enforced the basic principle of statutory construction that substance should apply over form.

The doctrine holds that activities such as offers, solicitations of purchase orders, and sales by an issuer of the same or similar securities, are all part and parcel of the same offering for purposes of determining whether an exemption from registration is available to the whole offering. Specifically, it prevents issuers from dividing a single offering into multiple offerings where doing so would make an exemption available for part of an offering when it is not, in fact, available to exempt the whole of the offering. In essence, such offerings are like a whole salami that hangs in a butcher shop. No matter how you later slice it, it is still the same salami.

In this case Defendants *purport* to have conducted three separate offerings using three separate private placement memoranda—PPM1, PPM2, and PPM3—as if an "offering" consists of the documents used in conducting it rather than in the wide sweep of all the activities that the SEC and case law have held to be included in an offering. *See* Argument *supra* at n. 11 and at p. 18. Defendants asserted that Rule 506 of Reg D was available to exempt the sales it made to Plaintiffs by use of PPM1 as of the time they were made. Plaintiffs agree that, had Defendants stopped there, Reg D would be available to exempt the sales to Plaintiffs.

But Defendants did not stop there. After the sales to Plaintiffs, Defendants went on to offer and sell the same securities to many others using PPM2 and PPM3. And Defendants admit to engaging in prohibited general solicitations and advertising in what they purport to be the second offering using PPM2. It is the general solicitations and advertising they admit to have conducted in this second purported offering that makes the Reg. D exemption claimed by Defendants un-available to cover *any* sales made in the course of *any* of the three purported offerings. That is so because the Integration Doctrine considers all of the offers and sales made by Plaintiffs in all three purported offerings, along with the illegal advertising and solicitations, to be part of a single offering. The fact that the violations occurred after the sales were made to Plaintiffs is not relevant. An exemption is either available or not for the whole offering.

From its earliest days, the SEC has been concerned that the Act's exemptions not be applied in a way that would negate the Act's strict prohibition against the offer and sale of unregistered securities. The Commission's concern was that issuers would claim exemptions for non-exempt sales by breaking up an offering into parts and claiming exemption for a part when the offering as a whole is not exempt. *See In re Unity Gold*, 3 S.E.C. 618 (1938). Likewise, it has long been recognized that an issuer might claim an exemption for sales made in an offering in which prohibited acts occurred, such as general solicitations and advertising. Such an issuer would argue, as Defendants did here, that the prohibited acts occurred in a different offering than the one on which sales were made. It was to prevent just this type of abuse of the Act's carefully designed exemptions that the SEC adopted the Integration Doctrine.

In 1962, the SEC promulgated an important interpretative release delineating the Sec. 4(2) "Nonpublic Offering Exemption." SEC Release No. 33-4552 (Nov. 6, 1962) (copied at A.A. 138). After addressing a number of issues germane to this exemption, the SEC concluded with a section entitled "Integration of Offerings." The release states:

> A determination whether an offering is public [such as the one Defendants made using PPM2] or private [such as the previous one Defendants made to Plaintiffs under PPM1] would also include consideration of the question whether it should be regarded as part of a larger offering made *or to be made*.
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> * * *
>
> What may appear to be a separate offering to a properly limited group will not be so considered if it is one of a related series of offerings. A person may not separate parts of a series of related transactions, the sum total of which is really one offering, and claim that a particular part is a nonpublic transaction.

SEC Release No. 33-4552 (emphasis added).

Ever since the doctrine was first delineated, it has been true that a purported offering to which Reg D may be available (*e.g.*, PPM1) may be integrated with a subsequent purportedly separate offering to which Reg. D, may not be available (*e.g.*, PPM2). Moreover, the purportedly separate offerings may be integrated even where the subsequent offering is yet "to be made" (*e.g.*, when no offers or sales have yet been made but the securities have been illegally advertised). A purported offering for which an exemption may be available at one point in time may subsequently lose the availability of that exemption when integrated with a *subsequent* purported offering that included *subsequent* prohibited general solicitation and advertising, as took place in this case. *See* John C. Coffee, Jr., Joel Seligman, Hillary A. Sale, *Securities Regulation* 470 (10th ed. 2007) (explaining that "for an exemption to be available, each transaction must satisfy all of the conditions of a single exemption" and that "every proposed unregistered offering . . . may be linked with a prior or subsequent offering . . . to comprise a single transaction").[13]

This concept of an exemption being lost through subsequent conduct can also be seen in an Alabama case where the violation took place after initial compliance with Reg D requirements. *See Buist v. Time Domain Corp.*, 926 So. 2d 290 (Ala. 2005). In that case, the Alabama Supreme Court held that "a failure to comply with a requirement of Rule 506 '*voids*' the exemption," even if the issuer initially complied with applicable requirements. 926 So. 2d at 297-98 (emphasis added). In other words, the court in *Buist* held that a Reg D exemption could be lost "retroactively." *Id.*

b. Applying the Integration Doctrine to the facts of this case.

Simply put, if the sales made to Plaintiffs using PPM1 are part of the same offering in which Defendants engaged in illegal solicitation and advertising using PPM2, then the exemption claimed by Defendants is not available to cover the sales to Plaintiffs. Whether these illegal acts took place in the same offering in which sales were made to

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[13] As noted earlier, the word "transaction" in the securities area refers to a range of activities that make up an "offering" and, as such, is synonymous with the word "offering." *See Chinese Consol. Benevolent Ass'n*, 120 F.2d at 741.

Plaintiffs is determined by the Integration Doctrine, which uses the five-factor test developed by the SEC. That test asks whether:

1. the different offerings are part of a single plan of finance,
2. the offerings involve issuance of the same class of security,
3. the offerings are made at or about the same time,
4. the same type of consideration is received, and
5. the offerings are made for the same general purpose.

See SEC Release No. 33-8828 at 57 (Aug. 3, 2007) (excerpted at A.A. 133) (citing SEC Release No. 33-4552).

Applied to the particular undisputed facts and circumstance of this case, the five factors show that purported offering PPM1 is integrated into purported offering PPM2.[14]

(1) *Single Plan of Financing*. All offers and sales of securities, made by means of all three PPMs, and including the use of general solicitations and advertising, were made pursuant to the same plan of financing—the continuous sale of common stock to fund the start-up costs and operations of funeral.com. Defendant Brown's claim that he expected each offering to be the last—that there was no plan to conduct more than the first offering—in his affidavit below (A.A. 120) is disingenuous at best and is belied by the language of the PPMs.

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14 Since Reg. D became un-available to the entire offering as of the date that the first violation took place in the course of the purported offering using PPM2, nothing that happened in the course of the offering using PPM3 could affect this case. Nevertheless, the purported offering using PPM3 is integrated with the other two into the one single offering.

The cover page of PPM1 states that Defendant funeral.com sought to raise a minimum of $700,000 and a maximum of $3,600,000, reflecting a need for the maximum and a readiness to accept the minimum—less than one-fifth of the amount needed. In fact, the "Use of Proceeds" section of PPM1 states, "We will likely need to raise additional capital *immediately* in order to fund our expansion, to develop new or enhanced existing services or products, to respond to competitive pressures or to acquire complementary products, businesses or technologies." A.A. 85 (emphasis added). And, indeed more money was needed, much more. On May 17, only three weeks after funeral.com made the last sale to one of Plaintiffs using PPM1, and after raising only $760,006 using PPM1, Defendants started using PPM2, offering 2,400,000 common shares at a price of $3.00 per share — up to $7,200,000 — reflecting that Defendants original expectation that more common stock would need to be sold immediately to raise money for start-up costs and operations was well placed. A.A. 107. Then, on July 20, only ten weeks later, Defendants started using PPM3, planning to sell exactly twice as many shares as PPM2 at half the price to raise the exact same amount of money — $7,200,000. A.A. 115.[15] Clearly, all the offers and sales using all three PPMs were part of the same plan of financing. All totaled, Defendants raised $931,006 dollars by use of the three PPMs to sell common stock before the company went under.

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15 It is worth noting that Defendants, through their attorney, stated to the SEC that no shares were or would be sold under PPM2 (the one that was used to make illegal solicitations), but went on to sell $171,000 in common stock using PPM3, which is identical in every respect to PPM2, except for the price and a separate offer of preferred stock. A.A. 113 and 125.

(2) *Issuance of the Same Class of Security.* All of the purported offerings involved issuance of the same class of security—*common stock.* PPM1 and PPM2 exclusively offered common stock. PPM3 offered mostly common stock, plus a lesser amount of preferred stock.[16]

(3) *Made About the Same Time.* The three purported offerings were conducted virtually back-to-back. Only 19 days separated the date of the last sale to a Plaintiff, Mary Risdall—April 28—from the date on which Defendants started using PPM2—May 17. A.A. 125 and 107. Barely 60 days later, Defendants began using PPM3. A.A. 115. Rule 502(a) creates a safe harbor ensuring that sales that occur more than 6 months preceding an offering or more than six months after an offering period ends will not be integrated. The purported offerings in the present case were back-to-back. One started about when the prior one ended. As such, they were one continuous offering of the same securities.

(4) *Type of Consideration.* The same type of consideration—*i.e.*, cash—was sought in each purported offering and received for all sales that were made. Whether the price differs for the sale of the same securities is not relevant. The Integration Doctrine asks only whether the "type" of consideration was the same. Here, the consideration required and received for all offers and sale of the common shares was U.S. Dollars paid in cash.

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16 Plaintiffs agree that the offering of preferred stock also made by means of PPM3 during the time that the offering of common stock was made is not integrated into the same offering as the common stock, because it involved a different class of security.

(5) *Same General Purpose.* Each of the three PPMs that Defendants utilized to offer funeral.com common stock includes the same statement that the stock was being sold to raise funds to pay for "marketing and promotional expenses, web-site development, [equipment], salaries and general working capital." A.A. 80, 108 and 116. Indeed, the "Use of Proceeds" language in the PPMs is identical, except that PPM1 uses the words "purchase equipment" while PPM2 and PPM3 use the words "equipment purchases." *Id.*

Below, Defendants argued that additional language in PPM1 stating that $375,000 of the proceeds would be used to pay a promissory note owing to Defendant Brown, establishes that the purpose at the time of PPM1 (under which the sales were made to Plaintiffs) was different from the purpose at the time of PPM2 (in connection with which Defendants conducted illegal general solicitations and advertising). A careful reading of the language in PPM1, however, makes plain that these funds were to be used to "repay" Brown for costs incurred "for the development of the site design, maintenance of the site and associate costs" previously paid by him for the benefit of the company. A.A. 80. Those purposes are squarely within the purposes described by all three PPMs.

In summary, all three purported offerings involved the same plan of financing, the issuance of common stock, for the same type of consideration, for the same purpose and took place about the same time. Therefore, under the Integration Doctrine, *all of the purported offerings are actually one-and-the-same offering* for purposes of determining whether the Rule 506 exemption claimed by Defendants is available to exempt their sales of stock to Plaintiffs from the prohibition against the sale of unregistered securities.

3. *The Court of Appeals Erroneously Imported a "Sales" Requirement into the Integration Doctrine analysis.*

After reviewing the arguments on both sides, the district court correctly held that the *sales* made to Plaintiffs by use of PPM1, and the *offers* made by means of general solicitation and advertising using PPM2, were "part of a common plan to raise funds to start up funeral.com and are deemed integrated as part of the same offering." A.A. 10. That holding was properly based on the Integration Doctrine. *Id.* The district court then appropriately concluded that "it is inconsequential that the second offering was withdrawn before any sales [were made], as the entire offering was tainted . . . [by Defendants'] general solicitations of unregistered securities." A.A. 111.

In reversing the district court, the court of appeals based its holding on an unexplained 1981 change in the language of the five-factor integration test. That change appears in a "NOTE" that accompanies Rule 502(a). That "NOTE" first refers to the integration of "offerings," "offers," "sales" and "transactions," before introducing a slightly reworded version of the usual five-factors. Although the "NOTE" lists what it states are the "factors [that] should be considered in determining whether *offers* <u>and</u> *sales* should be integrated for purpose of the exemptions under Regulation D," the list itself inexplicably substitutes only the word "sales" for the word "offerings" in the various factors. 17 C.F.R. §§230.502 (*emphasis added*).[17] Ignoring the earlier references in Rule 502 to "offerings" and to "offers *and* sales," the court of appeals seized upon the use of the word "sales" in the reworded listing of the five-factors:

> Under the plain language of the federal regulation, an offering under which no sales are made cannot be integrated with another offering under Regulation D.

A.A. 11-12.

The court of appeals construed the change from the use of the word "offerings" to the use of the word "sales" in the reworded five-factor test to mean that offers that do not result in sales, or offerings that do not include sales, cannot be integrated under the Integration Doctrine—*i.e., that only "sales" are integrated.* In doing so, it imported a new *resulting sales* requirement into the Integration Doctrine. And that turns the Integration Doctrine on its head, because it permits issuers who conduct prohibited public solicitations and advertising of securities for sale to have the benefit of the Non-public Offering Exemption. They need merely use different offering documents to conduct the

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[17] The reworded five-factor test first appeared in a rule-making proposal the SEC published in 1981, seeking public comments on its plan to change the safe harbor rules for small, limited offerings and private placements, (*see* SEC Release No. 33-6639 (Aug. 7, 1981)) and became part of Rule 502(a) the following year (*see* SEC Release No. 33-6389 (March 8, 1982)). The reworded list reads as follows:

> (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.

Id. (emphasis added). As noted earlier, the previous version used the word "offerings" instead of "sales." *See* SEC Release No. 33-4552.

illegal general solicitations and advertising (*e.g.*, PPM2) than the ones they use to make sales (*e.g.*, PPM1). Though the purportedly different offerings are part of a single plan of financing, involve the issuance of the same class of security, are made at or about the same time, for the same type of consideration, and for the same general purpose, the court of appeals held that they will not be integrated so long as no sales are made using the same offering document used to conduct illegal general solicitations and advertising. This result creates a serious threat to the investing public and must be reversed.

The court of appeals did not cite any legal authority in support of its new and dangerous interpretation of the Integration Doctrine. That is not surprising, as no such authority appears to exist, even though language on which the court of appeals relied has existed for more than 25 years. By contrast, there is ample support for the proposition that the SEC did not mean to change the interpretation of the five integration factors when it changed the word "offerings" to the word "sales."

As recently as August of this year, referring to the five factors it first promulgated in its 1962 release, the SEC stated that:

> In 1982 [the year Reg. D was adopted with the new language] we included the five factors and established an integration safe harbor in Rule 502(a). We stated that the five factors relevant to the question of integration are:
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> > Whether (1) the different *offerings* are part of a single plan of financing, (2) the *offerings* involve an issuance of the same class of security, (3) whether the *offerings* are made at or about the same time, (4) the same type of consideration is to be received, and (5) the *offerings* are made for the same general purpose."

SEC Release No. 33-8828 at 57 (Aug. 3, 2007) (A.A. 133) (emphasis added). Nowhere does that release refer to any "sales" requirement. Furthermore, the SEC has expressly indicated that two "offers" could be integrated where no sales occurred under one of the offers. *See Circle Creek Aquaculture V*, SEC No-Action Letter, 1993 WL 93583 (Mar. 26, 1993) (copied at A.A. 166). Thus, the SEC itself has not placed any significance upon the use of the word "sales" in the "NOTE" accompanying Rule 502(a).

Learned commentators writing on the Integration Doctrine also continue to utilize the "offerings" language of the SEC's 1962 release in discussing Rule 502(a). *See, e.g.*, William M. Prifti, *Securities: Public and Private Offerings*, § 6:18 (2d ed. 2007); Louis Loss And Joel Seligman, *Fundamentals of Securities Regulation* §3-C-1 (3d ed. 1995); Perry E. Wallace, Jr., *Integration of Securities Offerings: Obstacles to Capital Formation Remain for Small Businesses*, 45 Wash. & Lee L. Rev. 935, 950 (1988); Todd Taylor, *Securities Law Primer for Non-Securities Lawyers*, Hennepin Lawyer (Oct./Nov. 2003).

Similarly, various courts continue to use the word "offerings" (rather than the word "sales") in stating the five-factor integration test. *See, e.g., SEC v. Cavanagh*, 445 F.3d 105, 113 n. 17 (2nd Cir. 2006); *Kunz v. SEC*, 64 Fed. Appx. 659, 666 (10th Cir. 2003); *Donohoe v. Consol. Operating & Prod. Corp.*, 982 F.2d 1130, 1140 (7th Cir. 1992).

Meanwhile, the apparent confusion raised by the change in language can be easily remedied in the context of the present case. The question raised by Plaintiffs' lawsuit is whether the "sales" made to them are integrated into the same "offering" in which Defendants committed the illegal acts. The "NOTE" that accompanies Rule 502(a) and introduces the new language states that the five factors "should be considered in determining whether offers *and* sales should be integrated for purposes of the exemptions under Regulation D." (*emphasis added*). The "offers" are the ones that Defendants made by illegal general solicitation and advertising. The "sales" to be integrated (along with those "offers") into a single "offering" are the sales to Plaintiffs. Under both the old language and the new, because the offers and sales were part of a single plan of financing, involved issuance of the same class of securities, were made at or about the same time, for the same type of consideration, and for the same general purpose, they are integrated into a single offering.

Finally, it is hornbook law that an administrative agency cannot in its rule-making go beyond the authority it is given in a statute. Agency regulations therefore must be construed to make them consistent with the legislative enactment under which they are promulgated. Section 4(2) exempts not "sales" but "*transactions*" and provides that the "transactions" must not involve "*any* public *offering*." 15 U.S.C. §§ 77d(2) (emphasis *added*).[18]

As the SEC rightly observed in its 1962 release, the whole concept of integration is premised on the common sense belief that one cannot artificially divide up an "offering" by contrived distinctions. SEC Release No. 33-4552. And the five factors remain the classic criteria to determine whether purportedly separate offerings are part of the same "transaction." As set forth above, those factors require that all of Defendants'

18 As noted previously, a "transaction" refers to the whole range of activities, including offers that do not result in sales, that can be part of an offering. *See* Argument *supra* at n. 11 and at p. 18.

purported offerings of common stock be treated as parts of a single offering for purposes of determining whether the Rule 506 exemption claimed by Defendants is available to exempt their sales of unregistered securities to Plaintiffs. When Defendants' purported offerings are properly treated as a single offering, no Reg D exemption is available to that offering.

II. THE MERE FACT THAT DEFENDANTS PURPORTED TO OFFER AND SELL SECURITIES TO PLAINTIFFS "PURSUANT TO REGULATION D" DOES NOT PREEMPT ENFORCEMENT OF MINNESOTA'S REGISTRATION STATUTE, WHERE DEFENDANTS DID NOT COMPLY WITH ALL OF THE REQUIREMENTS OF REGULATION D.

As the district court correctly concluded, it is irrelevant that, at the time of the actual offers and sales to Plaintiffs, Defendants were purporting to sell 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 solicitation or general advertising" imposed by Regulation D, Rule 502(c), which exempts *private* offerings. A.A. 114, 125 and 129. 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. Accordingly, the district court correctly rejected Defendants' federal preemption argument. The court of appeals erred when it reversed that ruling.

By holding that state securities registration laws are preempted by federal law when an issuer of securities merely "purports" to offer an exempt "federal covered security" under Regulation D without actually complying with the requirements of Regulation D, the court of appeals overlooked relevant statutory language and ignored the fact that an increasing majority of jurisdictions have rejected the position that the court of appeals adopted. Instead of following the well-reasoned rulings of the only U.S. Court of Appeals to consider the issue and the only two state-level appellate courts that have done so, the court of appeals erroneously chose to blindly embrace the much-criticized minority position contained in a trio of federal district court decisions. To preserve the important federal and State interest in protecting investors, this Court must reverse the decision of the court of appeals and reinstate the judgment ordered by the district court.

A. **<u>The Relevant Statutory Provisions Limit Preemption to "Covered Securities" that Comply with All Applicable Requirements</u>.**

The states and the federal government have shared a common interest in regulating securities transactions.[19] Thus, under both state and federal law, a security must either be registered with the appropriate regulatory body or must be exempt from registration, before it can be offered and sold to the public.

In 1996, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA"), 15 U.S.C. § 77r, to address problems arising out of overlapping federal and 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). To relieve issuers of securities from having to comply with multiple, inconsistent state registration requirements, NSMIA preempts *state* securities registration requirements where the issuer of a security has complied with *federal* securities registration requirements or has established that an exemption (*e.g.*, Rule 506) is available to exempt an unregistered offering.

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[19] Every state has enacted a securities statute. Allen R. Palmiter, *Securities Regulation* § 1.4 (2d ed. 2002). When federal securities laws were enacted in the 1930s, they were viewed to be a supplement to existing state laws, rather than a substitute for those laws. Richard H. Walker, *Evaluating the Preemption Evidence: Have the Respondents Met Their Burden?*, 60 Law & Contempt. Probs. 237 (Summer 1997). Indeed, both the Securities Act of 1933 and the Securities Exchange Act of 1934 contain express provisions preserving state law rights and remedies. *See* 15 U.S.C. §§ 77p and 78bb.

However, the states continue to have an interest in regulating Regulation D, Rule 506 offerings where, as here, issuers fail to actually comply with *all* of the relevant requirements of Rule 506. Under such circumstances, NSMIA simply does not preempt state authority. In short, Congress did not intend to preempt states like Minnesota from protecting their citizens against issuers who fail to comply with both federal and state law.

One of the basic elements of securities regulation is the registration requirement. Thus, while NSMIA provides that, under specified conditions, state laws requiring registration are preempted (15 U.S.C. § 77r(b)(4)), preemption is limited to "covered securities" (15 U.S.C. § 77r(a)(1)(A)-(B)). The plain language of the statute indicates that if, and only if, a security falls within the category of a "covered security," it is exempt from state registration requirements and states are preempted from reviewing any such offering or requiring that the offeror file any documents beyond what is required under federal law. *Id.*

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).[20] 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

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20 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.

Minnesota law in the present case 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 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. Because a Rule 506 exemption is available only to all or none of the offering, 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.

Significantly, subsection (D) of Section 18 of NSMIA squarely contradicts any notion that an offeror may qualify an offering as a "covered security" by invoking Regulation D without actually complying with the requirements of that regulation. *See* 15 U.S.C. § 77r(b)(4)(D). That subsection clearly states that an offering is a "covered security" only if "the offer or sale of such security *is exempt* from registration . . . pursuant to Commission rule or regulation . . . ." *Id.* (emphasis added). It does not say that an offering is exempt from state registration if the security "purports to be exempt," or "is claimed by the issuer to be exempt." Thus, the language of NSMIA itself indicates that a securities offering will only qualify as a "covered security" if it is actually "exempt" pursuant to the applicable SEC rules and regulations.

In addition, the wording and structure of Regulation D provides further proof that Regulation D is not available unless an offering actually satisfies all of the relevant requirements of Regulation D. Part (a) of Rule 506 grants an exemption to "offers and sales of securities by an insurer *that satisfy the conditions*" set forth in that rule. *See* 17 C.F.R. § 230.506(a) (emphasis added). With regard to the general conditions, the rule further declares that "[t]o qualify for exemption under this section, offers and sales *must satisfy all the terms and conditions of §§ 230.501 and 230.502*," which include the prohibition on general solicitation or general advertising. *See* 17 C.F.R. § 230.506(b) (emphasis added).

Finally, it is noteworthy that NSMIA not only preserves the states' antifraud power over otherwise exempt offerings, but also preserves the states' authority to suspend any offerings where a required "filing or fee" has not been submitted. *See* 15 U.S.C. § 77r(c)(3). With regard to Regulation D offerings, the required filing is the Form D. It is anomalous to suggest that Congress would authorize states to enjoin an offering where the issuer simply fails to file the Form D, but would preclude states from taking any action at all where the issuer files a false Form D or fails to satisfy the very conditions that are necessary to qualify for an exemption under Regulation D.

B. <u>An Increasing Majority of Courts and Commentators have Concluded that Preemption can only be Triggered by Actual Compliance with the Requirements for a Claimed Exemption</u>.

The only appellate courts to yet address the issue, together with a majority of the federal district courts that have 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 Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901, 909-912 (6th Cir. 2007); *Buist v. Time Domain Corp.*, 926 So. 2d 290, 298 (Ala. 2005); *In re Blue Flame Energy Corp.*, 2006 WL 3775856 at *11 (Ohio Ct. App. 2006) (copied at A.A. 140); *Hamby v. Clearwater Consulting Concepts, LLLP*, 428 F. Supp. 2d 915, 921 (E.D. Ark. 2006); *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006); *see also Myers v. OTR Medica, Inc.*, 2005 WL 2100996 at *5 (W.D. Ky. 2005) (copied at A.A. 152); *AFA*

Private Equity Fund 1 v. Miresca Inv. Servs., 2005 WL 2417116 at *9 (E.D. Mich. 2005) (copied at A.A. 157). 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 the first federal appeals court decision to address the issue, the court in *Brown* expressly rejected the idea that federal preemption can be triggered by a mere assertion that securities were offered and sold "pursuant to" Regulation D. 481 F.3d at 909-912. Like Defendants, the party that issued the securities in *Brown* claimed that the securities in question were offered "pursuant to" an exemption and that state registration laws were thereby preempted. *Id.* at 909. The Sixth Circuit flatly rejected that argument, observing that such an approach "would effectively eviscerate state registration requirements." *Id.* at 911-12. After noting that Congress undoubtedly has the power to pass such a law, the Sixth Circuit concluded that, "[h]ad Congress possessed the political will to preempt state Blue Sky laws in their practical entirety, it would have expressed that decision in the statute's plain text." *Id.* at 912. Instead, however, Congress limited preemption to "securities that actually qualify as 'covered securities' under federal law." *Id.*

In *Buist*, the Alabama Supreme Court similarly 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.[21]

In another recent appellate level decision, the Ohio Court of Appeals joined the Alabama Supreme Court in holding that a security is a "covered security" (thereby triggering federal preemption) only if it actually meets the requirements under Rule 506 for exemption from registration, not if it is merely sold "pursuant to" Rule 506. *See Blue Flame*, 2006 WL 3775856 at *11. Like Defendants Brown and funeral.com, the defendants in *Blue Flame* claimed that they offered the securities in question in compliance with Regulation D but they had actually made prohibited general solicitations via the Internet. *Id.* at *2. Under the circumstances, the appellate court in *Blue Flame* held that Ohio was not preempted from regulating the securities in question. *Id.* at 11.

The federal district court in *Hamby* recently reached the same conclusion that the appellate courts reached in the foregoing cases. 428 F. Supp. 2d at 921. Specifically, the court in *Hamby* denied the summary judgment motion of issuers who had claimed that

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21 The court in *Buist* noted that the defendants had the burden of proof with regard to the affirmative defense of preemption. 926 So.2d at 293. The court also noted that "the burden of establishing an exemption [under the securities laws] is on the party who claims it." *Id.* (citing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 126 (1953)).

their "mere statement" that a sale of securities "was made pursuant to an exemption from federal registration" was all that was 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 federal district court in *Grubka* likewise 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. 445 F. Supp. 2d at 1269-70. After expressly noting its agreement with "the *Hamby* court's reasoning," the court in *Grubka* went on to explain:

> <u>Nowhere does the [federal exemption] statute indicate that a security may satisfy the definition if it is sold pursuant to a putative exemption</u>. 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; <u>that a defendant could avoid liability under state law simply by declaiming its alleged compliance with Regulation D is an unsavory proposition and would eviscerate the statute</u>.

Id. at 1270 (emphasis added).

Two other federal district courts have also held that an issuer must actually prove that an exemption applies in order to trigger federal preemption. *See Myers*, 2005 WL 2100996 at *5 *and Miresca*, 2005 WL 2417116 at *9. In *Myers*, by noting that the defendants had raised a question of fact "as to whether they are exempt under Rule 506," the court implicitly recognized that a party asserting preemption under NSMIA must prove that the securities in question are, in fact, "covered securities." 2005 WL 2100996 at *5. Similarly, in *Miresca*, the court held that the party claiming a registration exemption under NSMIA has the burden of establishing that the exemption applies and that all the requirements of the exemption have been satisfied. 2005 WL 2417116 at *9.

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. Hugh H. Makens, *Blue Sky Practice - Part I: Doing it Right*, SL075 ALI-ABA 549, 554 (March 16, 2006) ("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 561.

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. Thus, this Court must overturn the preemption ruling issued by the court of appeals and must reinstate the judgment ordered by the district court.

C. <u>The Cases on which the Court of Appeals Based its Preemption Ruling are Unsupported and Unpersuasive.</u>

In setting aside the well-reasoned decision of the district court, the court of appeals rejected the majority position adopted by the courts and commentators discussed above. Instead, the court of appeals erroneously chose to follow a trio of discredited federal district court cases in holding 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). This court must correct that error.

Temple is the first of this minority 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.[22] Reading the words "pursuant to" into the text of NSMIA, the federal district court judge in *Temple* ruled that state law is preempted whenever an issuer invokes the exemption for "covered securities" provided in NSMIA, regardless of

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22 Neither *Pinnacle* nor *Lillard* contains any significant discussion of the preemption issue. Instead, the courts in those cases seem to have blindly followed the *Temple* decision, with little consideration of the countervailing position. Indeed, the court in *Lillard* noted that the plaintiffs in that case entirely failed to address the preemption issue in their briefs and at a court hearing, so it is not surprising that the court did not give much consideration to that issue. 267 F. Supp. at 1116. Accordingly, the precedential value of that case is particularly suspect. Curiously, however, that did not stop the court in *Pinnacle* from relying on *Lillard*. 417 F. Supp. 2d at 1087

whether the issuer actually complies with the applicable exemption requirements. 201 F. Supp. 2d at 1244.

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*, 445 F. Supp. 2d at 1270. "In order to reach its holding, the *Temple* court supplanted the plain language of [NSMIA] with its own reading of the statute." *Blue Flame*, 2006 WL 3775856 at *11. Indeed, as the Sixth Circuit noted in *Brown*, the court in *Temple* "read language into the statute that does not appear there." 481 F.3d at 911 (quoting *Grubka*, 445 F. Supp. at 1270). Moreover, the *Temple* decision cannot be justified by claiming (as the court in that case did) that Congress had the "legislative intent" to preempt all state registration laws where an issuer simply claims a federal exemption applies, since legislative intent is irrelevant where, as here, the statute is unambiguous. *Id.*; *see also Blue Flame*, 2006 WL 3775856 at *11.

For each of the foregoing reasons, numerous courts have expressly rejected *Temple* and its progeny. *Brown*, 481 F.3d at 911; *Blue Flame*, 2006 WL 3775856 at *11; *Buist*, 926 So.2d at 297; *Hamby*, 428 F. Supp. 2d at 921 n. 2; *Grubka*, 445 F. Supp. 2d at 1270. In addition, several commentators in the field of securities law have harshly criticized the *Temple* holding. *See, e.g.*, 1 Thomas Lee Hazen, *Law of Securities Regulation* § 4.24[4] (5th ed. 2005) (describing the *Temple* holding as "highly suspect"); Joseph C. Long, *A Hedge Fund Primer*, 1503 PLI/Corp. 233 (Aug. 2005) (stating that *Temple* was "incorrectly decided"); 12 Joseph C. Long, *Blue Sky Law* § 3:81 (2005) ("If all that is required for preemption was a bald-face statement that the offering was made under Rule 506, then any con artist could avoid state regulation by telling the investor that the offering was a private placement under Rule 506"); Stuart R. Cohn, *Securities Counseling for Small and Emerging Companies* § 6:24.50 (2006) ("Unless courts require at a minimum a bona fide effort to comply with [R]ule 506, the mere assertion of form would control, and sham Rule 506 offerings would be exempt from state registration or exemption laws").

Without addressing any of the pointed criticisms set forth above, the court of appeals inexplicably chose to follow the holding in *Temple* (by following the holding in *Pinnacle*). This Court must reverse that indefensible decision on the part of the court of appeals and, instead, should follow the numerous courts and commentators that have concluded that preemption is only appropriate when an issuer actually satisfies all of the conditions that are necessary for an exemption from state securities laws.

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

Similarly to the federal registration statute, Minnesota's registration statute also prohibits the offer or sale of unregistered securities unless an exemption is available:

> <u>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</u> or (b) the security or transaction is exempted under section 80A.15 or (c) it is a federal covered security.

Minn. Stat. § 80A.08.

Securities are not Registered. It is not disputed that the securities sold to Plaintiffs were not registered with the State of Minnesota. Accordingly, Defendants violated Minnesota's registration statute and are liable to Plaintiffs unless (a) they carry the burden to prove that an state exemption is available, or (b) Minnesota is preempted from enforcing its statute.

Securities are not Exempt. Defendants claim the state exemption provided by Minn. Stat. § 80A.15(2)(h), which provides that "the following transactions are exempted from sections 80A.08 . . ."

> An offer or sale of securities by an issuer made in reliance on the exemptions provided by Rule 505 or *506 of Regulation D* promulgated by the Securities and Exchange Commission, Code of Federal Regulations, title 17, sections 230.501 to 230.508, *subject to the conditions* and definitions *provided by Rules 501 to 503* of Regulation D, . . .

Minn. Stat. § 80A.15(2)(h) (emphasis added).

As explained above, Defendants engaged in general solicitations and advertising in the course of offering the securities, they violated Sec. 5 of the Act, as well as the conditions of exemption set forth in Sec. 4(2) of the Act and Rules 502 and 506 of Regulation D. The Rule 506 exemption claimed by the Defendants is, therefore, not available to them. Moreover, because the state exemption on which Plaintiffs rely is dependant upon the federal exemption, *the state exemption is also not available.*

Minnesota is not Preempted. The statute preempts the State from requiring registration of "federal covered securities," which are defined for purposes of this case as securities for which exemption is available under Rule 506 of Regulation D. Since that exemption is not available, the securities sold to the Plaintiffs are not "federal covered securities" Therefore, Minnesota is *not preempted* from enforcing its registration statute.

Since the securities are not registered nor exempt, and Minnesota is not preempted from enforcing its registration statute, the district court properly exercised its authority to enter judgment ordering relief for Plaintiffs under Section 80A.23.

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

> <u>Any person who sells a security in violation of sections 80A.08</u> or 80A.18, . . . <u>is liable to the person purchasing the security, who may sue</u> either <u>in equity for rescission</u> 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 reinstated.

CONCLUSION

For all of the foregoing reasons, Plaintiffs respectfully request that the Court reverse the decision of the court of appeals and reinstate the judgment of the district court in all respects.

Respectfully submitted,

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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 13,137 words, exclusive of the cover page, table of contents, table of authorities, and signature block, and complies with the typeface requirements of Minn. R. Civ. App. P. 132.01.

Dated: October 18, 2007.

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