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.

APPELLANTS' REPLY BRIEF

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ARGUMENT

There are only two facts necessary to the district court's grant of summary judgment, and neither is disputed: First, Defendants admit that they sold unregistered securities to Plaintiffs. Second, Defendants admit that they engaged in illegal general solicitations and advertising using PPM2 by placing it on the Internet and sending it through the mail. Given those two undisputed facts, the sole issue upon which all else depends is whether the putative offering in which the sales were made to Plaintiffs (using PPM1) is integrated with the putative offering in which Defendants engaged in illegal general solicitations and advertising (using PPM2). If so, then no exemption is available to Defendants and Minnesota is not preempted from enforcing its registration statute.

While the usual summary judgment standard of review applies, it remains the burden of Defendants to establish that an exemption is available to their offering in which they sold unregistered securities to Plaintiffs.[1] As a matter of law, Defendants cannot carry their burden, because they engaged in illegal general solicitations and advertising. Accordingly, this Court should reverse the decision of the court of appeals and reinstate the judgment granted by the district court.

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[1] "[T]he burden of proof for establishing any of the exemptions lies with the person claiming an exemption." Thomas Lee Hazen, *The Law of Securities Regulation* 343 (5th ed. 2005). "A corollary to the burdens of proof and persuasion resting with the person seeking to establish the availability of the exemption is the fact that the exemptions are to be strictly construed." *Id.*

I. THE COURT SHOULD REJECT DEFENDANTS' PREEMPTION ARGUMENTS.

Under the court of appeals' holding, all that is necessary to preempt state registration laws is a simple statement, even a false one, that an issuer intended to comply with Regulation D, 17 C.F.R. §§ 230.501-.508 ("Reg. D"). As the State of Minnesota explains in its amicus brief, that holding "handed unscrupulous issuers of securities a perfect defense to any civil or regulatory action that alleges violations of State securities laws" and, if it is not overturned by this Court, will compromise the State's ability to protect its citizens from such "con artists." Amicus Br. at 9.

Defendants offer a series of preemption arguments in an effort to support the erroneous and overly broad holding of the court of appeals. Nearly all of those arguments are refuted in the corresponding discussions of the preemption issue in the briefs that have already been filed by Plaintiffs and the State. *See* Appellants' Br. at 33-46; Amicus Br. at 7-17. Defendants' additional arguments are briefly addressed below.

A. NSMIA Only Partially Preempts State Regulation and Only When its Conditions are Met.

As explained in the previous submissions of Plaintiffs and the State, NSMIA provides for only *limited* preemption of state Blue Sky Laws. *See* Appellants' Br. at 33-39; Amicus Br. at 8-9. The applicable federal provisions apply preemption only to a "covered security," which is defined as one involving "a transaction that *is exempt* from registration under this subchapter pursuant to . . . Commission rules or regulations issued under section 77d(2) of this title . . . ." 15 U.S.C. § 77r(b)(4) (emphasis added).

It is axiomatic that "the starting point in every case involving construction of a statute is the language itself." *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (quoting *Blue Chip Stamp v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)). Here, the words "*is* exempt" require that an offering actually qualify for exemption under the rules issued pursuant to Section 4(2), such as Rule 506, before a security sold in the offering is deemed a "covered security" as to which state registration requirements do not apply. Had Congress wanted to preempt *all* sales of securities that *purport to* comply with Rule 506, it could have done so. It did not do that, and no such intent can even be considered because the language of the statute is clear.

Furthermore, to the extent that it is even relevant to the present case, the general purpose behind NSMIA is to relieve issuers of the burden of state registration laws *only* when issuers comply with federal law. The idea is that, *when investors are protected by issuer compliance with federal registration law*, the additional burden of state registration laws impairs the market more than it protects investors. Contrary to Defendants' assertions, that purpose will not be frustrated if the decision of the court of appeals is reversed and the judgment of the district court is reinstated. Issuers who comply with federal law will not also need to comply with state law.

If Defendants are correct, NSMIA shifts all registration regulation to the already overburdened SEC, while forcing state regulators to stand idly by, powerless, as unscrupulous promoters sell unregistered, non-exempt offerings in their jurisdictions. As the State of Minnesota has explained in its amicus brief, this is now the law in Minnesota unless and until the decision of the court of appeals in this case is reversed.

B. <u>The Court Should See Through Defendants' Dubious Efforts to Overcome the Increasing Majority of Legal Authorities Rejecting Defendants' Preemption Argument</u>.

In reversing the decision of the district court and adopting Plaintiffs' preemption argument, the court of appeals relied heavily upon a trio of much-criticized federal district court decisions that now represent the minority view that actual compliance with federal law is not required to preempt state registration laws. A.A. 8-9. With little or no analysis, those three decisions essentially hold that an issuer can preempt a state's registration law by merely *saying* that an offering is made "pursuant to" Reg. D, even if the offering fails to actually comply with Reg. D. *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. Am. Family Mortgage Corp.*, 417 F. Supp. 2d 1073, 1087 (D. Minn. 2006).

Ever since the last of those three decisions was issued, however, every court that has considered the issue (with the exception of the court of appeals in the present case) has expressly rejected the holdings of those decisions. *See Brown v. Earthboard Sports USA, Inc.*, 481 F.3d 901, 911 (6th Cir. 2007); *In re Blue Flame Energy Corp.*, 871 N.E.2d 1227, 1243-44 (Ohio Ct. App. 2006); *Hamby v. Clearwater Consulting Concepts, LLLP*, 428 F. Supp. 2d 915, 921 n.2 (E.D. Ark. 2006); *Grubka v. WebAccess Int'l, Inc.*, 445 F. Supp. 2d 1259, 1270 (D. Colo. 2006); *see also Buist v. Time Domain Corp.*, 926 So. 2d 290, 297 (Ala. 2005) (criticizing *Temple* and *Lillard* decisions only, as *Pinnacle* had not yet been issued).

In a desperate attempt to buttress their position, Defendants dubiously assert that the various decisions that are adverse to Defendants' legal position are "factually distinguishable" from the present case. On one level, that assertion is true, since any two cases that do not involve *exactly* the same parties and *exactly* the same factual situation can be said to be "factually distinguishable." In that regard, the present case is just as "factually distinguishable" from the cases on which Defendants rely as it is from the cases on which Plaintiffs rely.[2] From an analytical standpoint, however, the modest factual distinctions raised by Defendants make no difference. Each of the cases cited involves precisely the same legal issue presented in this case -- namely, whether an issuer must first prove that an exemption is, in fact, available to exempt an offering before the state is preempted from enforcing its registration statute concerning that offering.

Moreover, as discussed in the previously-filed briefs of Plaintiffs and the State, the analysis that those later cases give to that legal issue is considerably more detailed and persuasive than the minimal analysis contained in the *Temple* case and its progeny. Presumably, that helps explain Defendants' failure to cite even one commentator who favors the minority view espoused in *Temple*, *Lillard* and *Pinnacle*, over the majority view espoused in cases like *Brown*, *Blue Flame*, *Buist*, *Hamby* and *Grubka*. By contrast, Plaintiffs have cited several legal commentators who have openly rejected the position

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[2] Defendants falsely imply that the cases cited by Plaintiffs all involved "sham" transactions. A review of those cases fails to reveal that any of them clearly involved willful misconduct on the part of the issuer. Instead, they involved such things as an apparently inadvertent failure to file a Form D (*Hamby*), internet advertising of an otherwise exempt offering (*Blue Flame*), and noncompliance with applicable time limitations for an exemption (*Brown*).

adopted by the *Temple* line of cases. *See* Appellants' Br. at 43, 45 and 46. This Court should likewise reject that position.

C. <u>The Fact That the SEC Did Not Take Further Action Does Not Absolve Defendants</u>.

Defendants seek to portray themselves as innocent parties. This Court should see through that ruse and, in particular, should disregard Defendants' frequent suggestion that they must not have done anything wrong or the SEC would have taken action.

It is spurious for Defendants to argue that the SEC "took no action against Defendants with regard to PPM2," when the SEC actually sent a cease and desist letter to Defendants. A.A. 110-111. In fact, it is doubly spurious for Defendants to make such an assertion, because the record reveals that, after the SEC requested information, Defendants failed to advise the SEC of the offering conducted using PPM1 under which they made hundreds of thousands of dollars of sales, including the sales to Plaintiffs. A.A. 112-113. Instead, Defendants led the SEC to believe they had made no sales. *Id.* Had the SEC known about the substantial volume of sales to Plaintiffs and other investors, it may have taken additional action against Defendants.

Furthermore, the fact that the SEC took no steps beyond sending a cease and desist letter does not mean that Defendants were faultless. On the contrary, the SEC has limited resources and may have had any number of reasons for not taking action.

II. ISSUERS MAY NOT SEPARATE A SINGLE OFFERING INTO MULTIPLE OFFERINGS TO MAKE AN EXEMPTION AVAILABLE.

Defendants argue that because the illegal public offers were made by use of separate, though nearly identical, offering documents that *did not* result in sales, the offers cannot be integrated with offers to Plaintiffs that *did* result in sales. Under Defendants' self-serving logic, Defendants made three separate offerings because they used three separate offering documents (referred to as PPM1, PPM2 and PPM3); as if the manner in which an issuer labels its offering documents magically separates a single offering into three separate offerings. By this artifice, Defendants seek to make the sales to Plaintiffs exempt by separating them from the illegal part of the offering for which they admit no exemption is available. By doing this, Defendants hope to gain an exemption that is not otherwise available. As set forth below, the Integration Doctrine prevents such an argument from succeeding.

While the Integration Doctrine does not affect genuinely separate offerings, it does prevent an issuer from obtaining an exemption by splitting a single offering into separate offerings. If the sales to Plaintiffs are otherwise integrated under the Doctrine, they do not become *un*-integrated based on how the offering documents were labeled or because no sales resulted from the illegal activity. Defendants cite no authority for their proposition because there is none. The policy of the Integration Doctrine is to insure investor protection by integrating offerings so that issuers cannot avoid the registration requirement by splitting one offering into multiple offerings. Louis Loss & Joel Seligman, *Securities Regulation* 1231-32 (3d edition, 1999).

A. <u>Though They Did Not Result In Sales, Defendants' Illegal Offers Made By General Solicitations And Advertising Are Part Of An "Offering."</u>

The Securities Act of 1933 (the "Act") and Reg. D do not define the term "offering." But the Act does define the verb "offer," as "every attempt or *offer* to dispose of, or *solicitation* of an offer to buy, a security or interest in a security for value. 15 U.S.C. § 77b(a)(3) (emphasis added). Plainly, that definition encompasses activities that do not result in a sale. Since "offering" is the noun form made from the verb "offer," simple logic dictates that an "offering" can take place without any actual sale taking place.

Here, the offers and sales to Plaintiffs and other investors, as well as the solicitation of offers from investors, provision of offering materials, answering of investor questions, collection of investor funds, provision of stock certificates, and all other activities for which Defendants used the instruments of interstate commerce to "attempt or offer to dispose of, or solicit[] . . . an offer to buy" common stock of funeral.com, inc. are all part of an "offering." Moreover, because Section 5(1) of the Act flatly prohibits the "use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell [unregistered securities] through the use or medium of any prospectus or otherwise," Defendants' general solicitations and advertising using the Internet, email and regular mail are illegal. 15 U.S.C. § 77e.

In short, Defendants' illegal offering activities using PPM2 were part of an "offering" and they violated the Act, whether or not they resulted in sales. Defendants broke the law and eliminated any possibility that an exemption would be available for the putative offering using PPM2 the moment they posted PPM2 on the Internet. They did not un-break it when no sales resulted.

The question upon which this case turns is whether the sales made to Plaintiffs were part of the same offering as Defendants' general solicitations. The answer to that question, based upon the Integration Doctrine, is an unequivocal "yes."

B. The Sales To Plaintiffs Are Part Of The Same Offering In Which Defendants Conducted Illegal General Solicitations And Advertising.

A leading commentator, Professor Hazen, provides this succinct explanation of the Integration Doctrine and how it relates to transactional exemptions such as the one claimed by Defendants here:

> Under the integration doctrine, multiple transactions that may be separate in form [such as PPM1 and PPM2] will be scrutinized as one transaction in order to determine whether an exemption exists. Thus, for example *two transactions that appear to be exempt may be combined and, as a consequence of integration, have both exemptions destroyed.*

Hazen, *supra* at 344 (emphasis added). Furthermore, as Professor Hazen goes on to say, "[o]nce an exemption is destroyed or made unavailable, all offers and sales that purportedly were made under the failed exemption will then be in violation of section 5 of the 1933 Act." *Id.*

Defendants acknowledge that "[t]he five-factor test [of Rule 502]. . . is 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." (Respondents' Br. at 36). In applying the factors, the statements set forth in the securities offering documents, PPM1, PPM2, and PPM3, must be taken to be true, since they are stated by Defendants under a legal duty to be accurate and complete under penalty of securities fraud (*see* 15 U.S.C. §§ 77q(a) *and* 17 C.F.R. § 240.10b-5), and since Plaintiffs have not disputed those statements. There is no question of viewing the facts more or less favorably to either party under the summary judgment standard, since the facts are plainly available to the Court in the filings submitted with this case.

Referring to the five factors, Rule 502 provides that, "[t]he following factors should be considered in determining whether *offers* and *sales* should be integrated for purposes of the exemptions under Reg. D." (emphasis added). It then goes on to restate the five factor test first promulgated by the SEC in Securities Act Release No. 33-4552 (1962) using the term "sales" where the 1962 release had used the term "offerings." Applied to the facts of this case, the term "sales" in the five factors refers to the sales to Plaintiffs. It is these sales that the district court rescinded by finding that they are integrated into the same offering in which Defendants made illegal offers. *Whether the word "offering" or "sale" is used in the five factors, the result is the same — both the "sales" and the putative "offering" in which they were made using PPM1 are integrated with the putative "offering" using PPM2 into the same offering based on the five factor test.* And, because illegal offers were made by placing PPM2 on the Internet and in the mail in that same offering, no exemption is available to any part of it — particularly including the sales made to the Plaintiffs. Therefore, Defendants sold unregistered securities to Plaintiffs for which no exemption is available. Based on that undisputed fact, the district court correctly granted summary judgment to Plaintiffs.

Contrary to Defendants' assertions, the five factors do not consider whether different documents are used in separate putative offerings or whether offers result in sales. They provide a simple, *substance-over-form* framework to determine whether *putative separate offerings* are really the *same single offering* when issuers attempt to separate them in order to obtain an exemption for sales that may be rescinded if the putative separate offerings are really one-and-the-same offering.[3]

Although not all five factors are required for integration, all five factors are fully satisfied in this case.[4] As the factors are examined, it is important to remember that the question posed in Rule 502 is "whether *offers* and *sales* should be integrated for purposes of the exemptions under Reg. D." 17 C.F.R. § 230.502 (emphasis added). The question is answered by the five factors. And those factors do not include whether different PPMs were used or whether sales resulted. Defendants' attempts to escape integration by manipulating the factors does not withstand scrutiny, as detailed below.

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3 Incidentally, the Integration Doctrine is not an element of a cause of action that must be pled affirmatively, as Defendants assert. Indeed, by its nature, the Doctrine only comes into play after an issuer attempts to defend against a claim by alleging that it made separate offerings. Thus, Plaintiffs were not required to include any references to integration in their Complaint. Moreover, even if such an allegation were necessary, the integration issue was plainly litigated by the parties in the district court and that court was free to consider that issue.

4 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 1242.

Factor No. 1. *Whether the sales are part of a single plan of financing.* The sales were part of a plan to finance the start-up capital requirements of the company by the sale of common stock. Contrary to Defendants' claims in their brief that they did not know they would need to raise more money at the time of their sales to Plaintiffs, Defendants not only knew that they would require more financing than PPM1 would supply, they *emphatically* stated that they would in PPM1. The "Use of Proceeds" section of PPM1 includes the statement that the company "will likely need to raise additional capital *immediately*." *See* A.A. 85 (emphasis added). The need to raise more capital is similarly stated in PPM2 and PPM3. *See* A.A. 109 and 117.

Also contrary to Defendants' assertion, the question is not "whether PPM1, PPM2, and PPM3 were spawned from one idea, then split into stages to avoid the need to register." Rather, the question is whether the facts represented by Defendants on the face of the offering documents show that the "offers" and "sales" (including the sales to Plaintiffs) of the common shares using PPM1 and PPM2 are integrated under the Rule 502 five-factor test. It's a question of substance over form. Whether the offers in question were spawned from the same idea, or what might have been the subjective intent of the issuer, is not considered by any of the five factors. All five factors are *objective* tests, and none inquire of the issuer's intent.

The *Livens* decision on which Defendants rely to support their argument regarding the initial factor is factually distinct from the case at hand and should be disregarded. *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, many offers and sales took place in this case over a period of only four months. 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 inapposite. *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 R.A. 58). Unlike this registration case, *Barrett,* was a securities fraud case in which an established mining company in business for years ran short of funds and raised money from six directors who were already investors with a past investment to protect. In *Barrett*, company insiders were simply funding an unexpected cost of a company in which they already owned an interest. The court observes in dicta that this did not constitute a single plan of financing. R.A. 59. In the present case, Defendants conducted a widespread offering of common stock to new investors in order to raise money to pay start-up costs for a new company, including to hire an expensive website consultant. Indeed, this is the plan laid out in all three PPMs -- to raise financing for funeral.com by the sale of its common stock.

Factor No. 2. *Whether the sales involve issuance of the same class of securities.* All of the securities offered and sold by use of PPM1 and PPM2 were of the same class—common stock—with identical rights and preferences.[5] Defendants' assertion that common shares were converted to different classes when they were offered at different prices is patently spurious. The class of a security stays the same regardless of what price it sells for.

At the time that PPM3 was issued, the putative offerings using PPM1 and PPM2 were concluded. Since the illegal acts that make exemption unavailable to Defendants occurred *before* PPM3 was issued. It is not relevant to Plaintiffs' claim whether the putative offering using PPM3 is integrated or not. Therefore, while Plaintiffs believe it is integrated, the point is moot.[6]

Finally, *SEC v. Dunfee*, cited by Defendants, is inapposite. [1966-67 Transfer Binder], Fed. Sec. L. Rptr. (CCH), ¶ 91,970 (W.D. Mo. 1967). There, the court held that two offerings of notes were not integrated, because they had different rights and preferences and were not made at the same time, not merely because they had different interest rates. Here, however, all the common stock offered in PPM1, PPM2, (and

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5 Minn. Stat. § 302A.401 provides that all the common shares of a corporation "shall have *equal rights and preferences* in all matters not otherwise provided for by the board." (emphasis added).

6 For the record, the putative PPM3 offering is not un-integrated because preferred shares were also offered by use of PPM3, as Defendants contend. If the offers and sales of the *common* shares are integrated, it does not matter that other shares that are not integrated were also offered. An issuer cannot obtain exemption by alleging that an offering in which integrated offers and sales were made is, nevertheless, not integrated because the document used also included other offers and sales that were not integrated.

PPM3) provided identical rights (see note 5, *supra*) and, as discussed in the following paragraph, was offered at the same time.

<u>**Factor No. 3.**</u> *Whether the sales have been made at or <u>about</u> the same time.* Plaintiffs do not argue that time alone determines integration, as Defendants suggest. Rule 502 is a safe harbor that provides that certain offers and sales made more than six months before the *beginning* or six months after the *end* of an offering will not be integrated into the offering. 17 C.F.R. § 230.502(a). Six months did not pass between the end of the PPM1 offering and the beginning of the PPM2 offering, so the safe harbor does not apply. Rather, the putative offerings by PPM1 and PPM2 were virtually back-to-back — with only 19 days between the date of the last sale to a Plaintiff and the offering date on the front cover of PPM2. Under the circumstances, the putative offerings occurred at about the same time.

<u>**Factor No. 4.**</u> *Whether the same <u>type</u> of consideration is being received.* Contrary to Defendants' assertions, price differences between putative offering are also irrelevant. Rule 502 considers the *type* of consideration, *not the price*. Here, cash was received or was expected to be received in exchange for the stock offered in each of the three putative offerings.

<u>**Factor No. 5.**</u> *Whether the sales are made for the same general purpose.* On its face, this factor looks to a "general" purpose rather than to detailed specific purposes that come within the general purpose. 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).

The general purpose of all three putative offerings was to pay start-up costs of funeral.com, inc. Indeed, the "Use of Proceeds" statements in 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.*

Defendants contend that the purpose of putative offering PPM1 differed from the purpose of putative offering PPM2, since one-half the proceeds of the PPM1 offering was used to reimburse Defendant Brown for start-up costs that he had previously paid for the company. PPM1 states that Brown will be reimbursed for "the development of the site design, maintenance of the site and associated costs over the past four years." *See* A.A. 80. The rest of the "Use of Proceeds" section states that funds would be used to "increase marketing and promotional expenses, web-site development, purchase equipment, salaries and general working capital." *Id.* These are all the same general purpose—they are start-up costs of the Internet-based business of funeral.com, inc. The fact that half the money would be used to pay those expenses retrospectively by reimbursement while the other half would be used to pay them prospectively has no bearing on the fact that they would be used for the same purpose.

Professor Loss observes:

> "The purpose of an offering normally refers to the use of proceeds. Often, when the Commission [the SEC] staff or a court finds a 'single plan of financing,' the discussion will not be analytically distinct from a finding of the same general purpose."

Loss & Seligman, *supra* at 1235-36. Here, there was a single plan of financing to sell common stock to raise capital to pay start-up costs of funeral.com., inc.

C. <u>**By Changing The Wording In The Five-Factor Test, The SEC Did Not Change Traditional Integration Analysis.**</u>

The reason for the change in wording is not relevant to this case because using either the word "offering" or "sales" the result is the same. The word "sales" (as it presently appears in Rule 502) integrates the *sales* to Plaintiffs (made by use of PPM1) into the same offering with the illegal *offers* (made by use of PPM2). Use of the word "*offering*" (as previously appeared in Rule 502) yields the same result. Defendants' putative *offering* using PPM1 to make sales to Plaintiffs is integrated with Defendants' putative *offering* using PPM2, in which they made illegal offers.

Furthermore, as detailed in Appellants' Brief, the SEC did not change its traditional integration analysis by shifting from the use of the word "offering" to the use of the word "sales" in setting forth the five factors in 1982. *See* Appellants' Br. at 28-33. To this day, more than 25 years later, the SEC continues to apply the five-factor integration analysis in the same way that it did before the change. *Id.* at 30-31. Thus, *Defendants are unable to cite a single case or other legal authority in their brief to* *support the proposition upon which their whole case depends — i.e., that offers that do not result in sales cannot be integrated.*

The SEC, commentators, and the courts continue to view "offers" that are integrated by the five-factor test as part of the same "offering," whether or not they result in sales. Regulators can regulate them. And purchasers who purchase stock in offerings for which no exemption is available can sue for rescission, as Plaintiffs have done.

III. DEFENDANTS HAVE INCORRECTLY INTERPRETED RULES AND AUTHORITIES AND HAVE PROVIDED MISLEADING FACTS.

Defendants' brief includes numerous misleading arguments and citations. It is not practical to address them all, but the following section addresses several of them.

A. The Term "Transaction" Does Not Refer Only To Sales.

Contrary to Defendants' assertion that a "transaction" must involve an actual "sale" (Respondents' Br. at 39), a "transaction" under the Act is the same thing as an "offering." *Compare SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953) (giving the term "offering" an expansive interpretation to include a series of proposed sales) *and SEC v. Chinese Consol. Benevolent Ass'n*, 120 F.2d 738, 741 (2d Cir. 1941) (explaining that a "transaction" includes "offers" and "the transmission of offers"). Defendants' attempt to provide a completely different dictionary definition in order to narrow the meaning of "transaction" to include only sales is an extreme and self-serving distortion of the law.

B. <u>Rule 155 is Inapposite Authority</u>.

Contrary to Defendants' assertion, the SEC's new Rule 155 (17 C.F.R. § 230.155) does not serve as authority that integration should *not* apply in the present case. Instead, Rule 155 actually supports Plaintiffs' integration argument.

In Rule 155, the SEC states that an abandoned private offering and a registration statement will not be integrated (or vice-versa) into the same offering if the issuer waits at least 30 days between the abandoned offering and the new one. *See* 17 C.F.R. § 230.155(b)(4) and (c)(3). Rule 155 is designed to protect issuers who file proper registration statements and attempt legal public offerings.

In this case, Defendants did not file a registration statement and they conducted an illegal public offering. To apply Rule 155 to prevent integration of Defendants' illegal offering so that an exemption would become available to it would undercut the policy implemented by the Act and make a mockery of the Rule. But, even if it were applied by analogy, the Rule would not alter the result in the present case. Rule 155 requires that at least 30 days elapse between two offerings to avoid integration. Here, only 19 days passed between the last sale to a Plaintiff and the beginning of Defendants' putative PPM2 offering.

C. <u>The *Circle Creek* No-Action Letter Supports Integration</u>.

Contrary to Defendants' assertion, the *Circle Creek* No-Action letter is good precedent supporting the integration of an offering by general solicitation in which no sales had been made with one in which sales were made under Reg. D. *See Circle Creek Aquaculture V*, SEC No-Action Letter, 1993 WL 93583 (Mar. 26, 1993) (copied at A.A.

166). In *Circle Creek*, an issuer who had aborted a registered public offering in which it had conducted *legal* general solicitations (because a registration statement had been filed) wanted to make offers and sales under the Reg. D exemption in what it claimed would be a separate transaction. The SEC's staff, however, advised that if the sales were made under Reg. D they would be integrated with the aborted offering that included general solicitations and this would make exemption un-available.

D. <u>The SEC Was Misled About the Offering.</u>

Defendants' suggestion that they properly informed the SEC about the relevant facts in the letter that their lawyer sent to the SEC is misleading. Upon discovering the illegal offers on the Internet, the SEC demanded that Defendants "outline all *relevant details concerning any applicable exemptions* from federal registration upon which the offerings are relying." *See* A.A. 110 (emphasis added). Defendants' attorney acknowledged only that PPM2 had been used to conduct illegal offers and then said that "[t]he company's *initial* private placement did not result in the receipt of any subscription agreements or the sale of any shares of common stock." *See* A.A. 113 (emphasis added). Of course the company's "initial" private placement was the one using PPM1 and, in fact, it *did* result in the receipt of the subscription agreements and funds that led to this case. Had the SEC been advised of this "relevant detail concerning applicable exemptions," it likely would have raised the same questions raised in this case. And Plaintiffs might have been better protected than they have been from the high cost and risk involved in the years of litigation it has taken to get to this Court.

IV. NO EXEMPTION IS AVAILABLE TO DEFENDANTS, EVEN THOUGH THE VIOLATION TOOK PLACE AFTER THE SALES TO PLAINTIFFS.

A. <u>No Matter How They Slice It, It Is Still the Same Salami</u>.

An offering is like a salami. No matter how the issuer attempts to slice it up into separate parts (by separating a single offering into multiple offerings), its still the same salami. The exemption claimed by Defendants is either available or not to the *whole* offering. For example, another requirement of the Rule 506 exemption claimed by Defendants is that sales cannot be made to more than 35 non-accredited investors. When a thirty-sixth sale is made to a non-accredited investor, the exemption becomes unavailable to the whole offering; *including all previous sales.*

B. <u>Defendants' Violations Were Not Merely "Technical</u>."

Defendants' repeated reference to their supposedly inadvertent illegal general solicitations and advertising as a "technical" violation is not in agreement with the SEC. Rule 508 of Reg. D forgives truly insignificant technical violations. *See* 17 C.F.R. § 230.508. But Rule 508(a)(2) provides that violation of the prohibition against general solicitations and advertising is *never* insignificant. *Id.* Thus, Defendants' violations are considered under the Act to be serious, not merely "technical."

V. PLAINTIFFS WERE DAMAGED BY DEFENDANTS' ILLEGAL OFFERS MADE AFTER THEY INVESTED.

A. Paintiffs' Investment Was Impaired.

From the first moment that Defendants began their illegal general solicitations and advertising, Defendant funeral.com, inc., the company into which Plaintiffs invested, lost any hope of establishing that an exemption is available covering its sales of common stock before or after the violation. All investors to whom common stock had been sold became entitled to sue the company. Investors may have obtained judgment for the amount of their investments, interest, fees, and costs, just as the district court awarded in this case. Furthermore, the company became legally barred from offering more unregistered common stock to raise much needed capital.

B. Public Policy Encourages Private Enforcement Actions.

Even if the SEC had learned of Defendants' illegal offering when it inquired about it, the SEC may not have acted because it lacks the resources to fully enforce registration laws in small, local offerings like the one in this case.[7] Strict liability is imposed on issuers of unregistered securities, and private investors are given strong remedies not only to protect their own interests but to encourage protection of the public interest as well.

> "The registration requirements are the heart of the Act [The Securities Act of 1933], and Sec. 12(1) [an investor's right to rescind for the sale of unregistered securities] imposes strict liability for violation of those requirements. Liability under Sec. 12(1) is a particularly important enforcement tool, because in many instances, *a private suit* is the only effective means of detecting and deterring a seller's wrongful failure to register securities before offering them for sale."

Pinter v. Dahl, 486 U.S. 622, 638 (1988). (emphasis added.)

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[7] Gretchen Morgenson, *Quick, Call Tech Support for the S.E.C.*, N.Y. Times, Dec 16, 2007, at BU1 ("It's no secret that the Securities and Exchange Commission is terrifically understaffed and wildly underfunded compared with the populous and wealthy Wall Street world it is supposed to police.").

VI. THE LOWER COURTS PROPERLY IGNORED THE ARGUMENT THAT PLAINTIFFS' CLAIMS ARE EQUITABLY BARRED.

As explained in detail in Plaintiffs' initial brief to this Court, the Minnesota Blue Sky Laws explicitly provide that "[a]ny person who sells a security in violation of [the registration requirement] *is liable* to the person purchasing the security, who may sue either in *equity* for rescission . . . or at law . . ." Appellants' Br. at 46-48 (quoting Minn. Stat. § 80A.23, subd. 1; emphasis added). Thus, Plaintiffs are specifically entitled, by statute, to the equitable relief granted by the district court. Defendants' arguments to the contrary must be rejected.

In particular, the Court should reject Defendants' assertion that the *Panuska* and *Adams* cases bar Plaintiffs' statutory rescission claims. *See Logan v. Panuska,* 293 N.W.2d 359 (Minn. 1980); *Adams v. Resolution Trust Corp.*, 731 F. Supp. 352 (D. Minn. 1990), *aff'd*, 927 F.2d 348 (8th Cir. 1991), *cert. denied*, 502 U.S. 815 (1991). The facts of the present case are materially distinct from the facts that led the courts to refrain from enforcing an equitable remedy in those two cases.

As the State has detailed in the Amicus Brief, Plaintiffs were merely passive investors who did not participate in the management of funeral.com, inc. *See* Amicus Br. at 17-18. By contrast, the plaintiffs in *Panuska* were members of the management group for the defendant-issuer and the court concluded that they should not be allowed to rescind their investments in their own company. 293 N.W.2d at 363-64.

The situation in *Adams* is similarly distinct from the situation in the present case. In *Adams*, the plaintiff borrowed funds from the defendant and immediately loaned those same funds back to the defendant. 731 F. Supp. at 357. The court held that such a transaction could not be rescinded because "it could not be regarded as one conducted in the regular course of business." *Id.* That is, unlike Plaintiffs, the plaintiff in *Adams* was not an innocent purchaser. *Id.*

Finally, as noted earlier, Plaintiffs were plainly damaged by Defendants' illegal activities and the Court should reject Defendants' misguided contentions to the contrary. *See* Argument, *supra*, at 21-22. To briefly reiterate, the company in which Plaintiffs invested became liable to *all* investors when Defendants' illegal acts made exemption unavailable. That liability exposure diminished the value of the company and, by extension, the value of Plaintiffs' stock. In addition, Plaintiffs' investments were further threatened because the company could no longer legally sell common stock to raise much-needed capital. Indeed, at the end of the day, Plaintiffs lost their entire investment in the company when it went out of business, and there is nothing inequitable about the relief that was granted by the district court.

VII. THE COURT OF APPEALS DECISION PROVIDES UNSCRUPULOUS ISSUERS WITH A "ROADMAP" FOR DEFRAUDING THE PUBLIC.

The State rightly asserts in its amicus brief that a holding here for Defendants would create a "roadmap" for fraud. Amicus Br. at 3 and 9. An unscrupulous promoter could avoid registering his securities by first selling them only to a few wealthy investors and then offering them almost immediately for sale to the public. No state registration violations could be pursued in that case, even if the promoter failed to comply with a federal exemption, so long as the promoter alleged some attempt at compliance, however imperfect.

Additionally, the private sales and public offering of the same securities to finance the same operations would be seen as a separate transaction, even if (as in the present case) they were staged virtually back-to-back. As the State points out, that sorry state of affairs will be lawful in Minnesota, and possibly a number of other states, if this Court does not reverse the decision of the court of appeals and reinstate the summary judgment ruling in favor of Plaintiffs.

CONCLUSION

Because Defendants have failed to prove that the exemption they claimed is available to the offering in which they sold funeral.com stock to Plaintiffs, Minnesota is not preempted from enforcing its registration statute. Furthermore, because no exemption is available, Defendants are guilty of selling unregistered securities to Plaintiffs in violation of that registration statute, and are, therefore, strictly liable to pay the relief granted by the district court. Accordingly, the decision of the court of appeals should be reversed, and the judgment of the district court should be reinstated.

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 6,888 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: December 17, 2007.

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