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North Dakota Securities Law

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NORTH DAKOTA SECURITIES LAW

CAL HOOVESTOL*

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I. INTRODUCTION

Some attorneys avoid the arcane web of securities law. Malpractice insurance rates are high and botched securities transactions are expensive for companies, investors, accountants, and attorneys. However, by ignoring securities law, non-securities attorneys sometimes overlook basic strategies of client protection. Business clients who collect money from investors should register securities to protect themselves against potential allegations that they did not disclose material facts or risks. Investors who lose money with fraudulent or unregistered securities can recover their investments and pursue other legal and equitable remedies.

Companies that sell securities need to register with state and federal regulators unless they are exempt. As a matter of public policy, people who collect and spend other investors' money should disclose honest financial information that will protect consumers against investment fraud and promote economic development through efficient capital formation in public markets. Bogus securities are like counterfeit money because they represent financial value and can be produced in almost unlimited quantities. Accordingly, securities violations involve serious sanctions. A willful violation of any North Dakota securities law is a Class B felony¹ that carries a maximum sentence of ten years in jail and a \$10,000 fine per violation.² Civil violations can trigger a \$10,000 civil penalty per violation,³ full refund to the investors, and payment of interest, attorney fees, and court costs.⁴

Attorneys who are not securities specialists can use securities law to protect clients in transactions involving corporate debt and equity, promissory notes, transfer or sale of a business, real estate financing, limited partnerships, oil and gas leases, estate planning, limited liability companies, and many other investment contracts. Attorneys should analyze at least three main questions for investments: (1) Is the investment a security? (2) If the investment is a security, is it exempt from registration? (3) What investor remedies are available for securities violations?

This article describes fundamental securities definitions and judicial interpretations, illustrates state and federal exemptions from registration, and suggests practical investor remedies for attorneys who do not specialize in securities law.

1. N.D. CENT. CODE § 10-04-18(1) (1995).

2. *Id.* § 12.1-32-01(3).

3. *Id.* § 10-04-16(1).

4. *Id.* § 10-04-17.

II. WHAT IS A "SECURITY?"

The North Dakota Securities Commissioner regulates securities,⁵ pre-need funeral contracts,⁶ franchises,⁷ and commodities⁸ to maintain the public integrity of financial markets. Securities are financial contracts of investors who do not manage or control the investment. The broad definition of a "security" in North Dakota includes stocks, bonds, limited partnerships, oil and gas leases, promissory notes, certificates, and other investment contracts.⁹ Defining a "security" often is the primary issue in securities cases for civil litigation or regulatory action. If the case involves a security, then registration requirements and enforcement remedies are defined by law. If the case does not involve a security, then securities requirements and remedies are moot.

A. FOUR ELEMENTS

Most state and federal statutes and many court decisions in recent years have developed various definitions of a "security" that include four main elements of (1) an investment (2) in a common enterprise (3) where investors reasonably expect profits (4) from the managerial efforts of others.¹⁰ Most modern definitions of a "security" evolved from a four-part test the United States Supreme Court outlined in *SEC v. W. J. Howey Co.*¹¹ In *Howey*, the Supreme Court ruled that citrus groves, sold

5. *Id.* § 10-04-03.

6. N.D. CENT. CODE § 43-10.1-07.1 (Supp. 1995).

7. *Id.* § 51-19-13.

8. *Id.* § 51-23-20.

9. *Id.* § 10-04-02(13). This section defines "security" as:

[a]ny note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; collateral trust certificate; preorganization certificate or subscription; transferable share; investment contract; program, contract, or other arrangement in which persons invest in a common enterprise the returns of which depend to any extent upon inducing other persons to participate or invest in the enterprise; investment of money or money's worth including goods furnished or services performed in the risk capital of a venture with the expectation of profit or some other form of benefit to the investor where the investor has no direct control over the investment or policy decisions of the venture; voting-trust certificate; certificate of deposit for a security; or beneficial interest in title to property, profits, or earnings; or, in general, any interest or instrument commonly known as a "security"; or any certificate of interest or participation in; temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Id. The federal definition of a "security" is described in 15 U.S.C. § 77(b)(1) (1988).

10. *See, e.g., United Housing Found., Inc. v. Forman*, 421 U.S. 837, 846-56 (1975) (describing securities elements for the common stock of a cooperative housing corporation).

11. 328 U.S. 293, 299-300 (1946) (determining an investment contract was within the scope of the Securities Act).

to non-managerial investors, were securities because the real estate sales were linked with ten-year farming "investment contracts."¹² Although nine of 51 purchasers during a three-year period bought land without lease-back farm service contracts, the Supreme Court found the real estate contracts were "purely incidental" to the investment contracts.¹³ The Court emphasized "economic reality" and defined "security" with "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."¹⁴ The *Howey* Court described a "security" as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."¹⁵

Following the *Howey* decision, federal courts expanded the fourth element to include securities protection for investors who expect profits "primarily" from the managerial efforts of others rather than "solely" from the efforts of others.¹⁶ For example, in *SEC v. Turner*,¹⁷ Glenn Turner marketed "Dare to Be Great" seminars, trips, tapes, records, and other materials.¹⁸ Turner claimed his programs were not securities because investors expected profits from their own efforts of attending meetings and studying materials rather than solely from the efforts of Turner and others. Turner lost the argument when the Ninth Circuit held that Turner controlled "the essential managerial efforts" of the program.¹⁹

The United States Supreme Court denied certiorari in *Turner*, but cited *Turner* in *United Housing Foundation, Inc. v. Forman*.²⁰ The *Forman* Court described a "security" as "(1) an investment (2) in a common venture (3) premised on a reasonable expectation of profits (4) to be derived from the entrepreneurial or managerial efforts of others."²¹ The North Dakota definition of a "security" includes investments like the Turner program, where the returns depend to any extent upon inducing other persons to participate or invest.²²

12. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 296 (1946).

13. *Id.* at 300.

14. *Id.* at 299.

15. *Id.* at 298-99.

16. *See, e.g.*, *SEC v. Turner*, 474 F.2d 476, 482 (9th Cir. 1973); *cert. denied*, 414 U.S. 821 (1973) (noting that the definition of securities should be interpreted broadly).

17. 474 F.2d 476 (9th Cir. 1973).

18. *Id.* at 484.

19. *Id.* at 483.

20. 421 U.S. 837, 852 n.16 (1975).

21. *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 852 (1975) (finding that cooperative housing shares for low-rent apartments were not securities).

22. *See* N.D. CENT. CODE § 10-04-02(13) (1995) (defining security).

Investments also are securities when the investor has no direct control over the investment or policy decisions of the venture.²³

The first three elements rarely are disputed in securities cases, because investors normally can prove (1) an investment (2) in a common enterprise (3) where investors expect profits. However, the fourth element of managerial control by others often is critical in defining a "security." In disputed cases, the investor who lost money and the promoter who sold the bad investment typically claim that they are not liable for the loss because the other party exercised managerial control over the investment. Therefore, in many cases the investors who seek contract or tort damages in civil litigation for failed or unregistered investments, the defendants who deny liability, and the regulators who enforce securities laws all collide at the same intersection of managerial control when they dispute the fourth element of defining a security. North Dakota statutes and North Dakota Supreme Court interpretations of managerial control provide helpful guidelines to define a "security" and ultimately to resolve most securities disputes.

B. NORTH DAKOTA SUPREME COURT CASES

The United States Supreme Court has emphasized substance over form²⁴ and the North Dakota Supreme Court has stated that "labels are not ordinarily conclusive" in defining a security.²⁵ The North Dakota Securities Act defines stocks, bonds, debentures, corporate offerings of debt and equity, limited partnership interests, warrants, promissory notes, certificates, assignments of money contracts, and other investment contracts involving non-managerial investors as securities.²⁶ Regardless of document labels, the transfer of managerial control over risk capital from investors to another party usually is the fundamental issue that determines whether or not a financial contract is a security.

1. *Investment Contracts*

The North Dakota Supreme Court has ruled that investment contracts for ownership certificates,²⁷ investment certificates,²⁸ advance fees to help customers obtain loan commitments,²⁹ oil and gas leases,³⁰

23. *Id.*

24. *Reves v. Ernst & Young*, 494 U.S. 56, 60-61 (1990).

25. *State v. Gates*, 325 N.W.2d 166, 168 (N.D. 1982).

26. N.D. CENT. CODE § 10-04-02(13) (1995).

27. *Rossen v. Welch*, 172 N.W. 234, 235 (N.D. 1919).

28. *State v. Hastings*, 211 N.W. 816, 816 (N.D. 1926).

29. *Gates*, 325 N.W.2d at 169.

30. *Hummel v. Kranz*, 126 N.W.2d 786, 788 (N.D. 1964).

promissory notes,³¹ and financial promises³² are securities. Similarly, the Eighth Circuit has held that demand notes for loan deposit agreements involving personal credit cards,³³ partial assignments of mortgages,³⁴ and assignments of voting trust certificates³⁵ are securities. Considering the broad statutory definition of a security³⁶ and the wide scope of judicial interpretations, what boundaries limit the definition of a security? An assignment of a financial contract is not a security if the investor retains managerial control over the investment,³⁷ but an investment contract or financial assignment is a security if managerial control is transferred from the investors to a fund or company not managed by the investors.

2. *Stocks, Bonds, and Debentures*

Stocks,³⁸ bonds, debentures,³⁹ subordinate debentures,⁴⁰ and other corporate offerings of debt or equity to non-managerial investors are securities. Completion of the contract is not required for the creation of a security or for securities violations. For example, a conditional assignment of stock in exchange for future promissory notes in a corporate merger creates a security that must be registered, even if the consideration is not paid, the merger is not completed, and the contract is not enforceable.⁴¹

Securities controversies involving stocks, bonds, and debentures sometimes occur during corporate mergers and acquisitions or during the sale of a business, especially if a former owner retains some managerial control. For instance, in *Landreth Timber Company v. Landreth*,⁴² Ivan Landreth and his sons sold all of their common stock in a lumber company, but Ivan continued to manage some daily operations.⁴³ The sawmill lost money and the new owners sued Landreth

31. *State v. Goetz*, 312 N.W.2d 1, 9 (N.D. 1981), *cert. denied*, 455 U.S. 924 (1982); *State v. Weigel*, 165 N.W.2d 695, 698 (N.D. 1969); *State v. Weisser*, 161 N.W.2d 360, 366 (N.D. 1968).

32. *State v. Davis*, 131 N.W.2d 730, 732 (N.D. 1964).

33. *United States v. Henderson*, 446 F.2d 960, 967 (8th Cir. 1971).

34. *Tarvestad v. United States*, 418 F.2d 1043, 1048 (8th Cir. 1969), *cert. denied*, 397 U.S. 935 (1970).

35. *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974).

36. *See* N.D. CENT. CODE § 10-04-02(13) (1995) (defining security).

37. *Schultz v. Dain Corporation*, 568 F.2d 612, 615 (8th Cir. 1978); *see also Fargo Partners v. Dain Corp.*, 405 F. Supp. 739, 741 (N.D. 1975) (holding that the Fargo Partners' venture was not a common enterprise and was not a security within federal securities laws).

38. *State v. Merry*, 243 N.W. 788, 790 (N.D. 1932).

39. *Giese v. Engelhardt*, 175 N.W.2d 578, 586 (N.D. 1970).

40. *Schollmeyer v. Saxowsky*, 211 N.W.2d 377, 384 (N.D. 1973); *Weidner v. Engelhardt*, 176 N.W.2d 509, 518 (N.D. 1970).

41. *State v. Davis*, 131 N.W.2d 730, 732 (N.D. 1964).

42. 471 U.S. 681 (1985).

43. *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 683 (1985).

for alleged securities violations.⁴⁴ Landreth claimed the 100% sale of common stock was a “sale of a business” rather than a securities offering.⁴⁵ The United States Supreme Court ruled that Landreth retained managerial control and illegally sold unregistered securities of common stock to the new owners.⁴⁶

In *Barnes v. Sunderman*,⁴⁷ Barnes sold his 50% stock ownership in a corporation that operated the Front Page Bar in Bismarck, North Dakota to Sunderman in exchange for a promissory note.⁴⁸ Sunderman paid one installment but refused to pay more.⁴⁹ He claimed Barnes had not disclosed financial problems.⁵⁰ The North Dakota Supreme Court affirmed the trial court’s finding that Sunderman was aware of problems and the Court awarded Barnes judgment on the promissory note.⁵¹ Although three of five justices did not rely upon securities law to decide the case,⁵² the promissory note was a security.⁵³

3. *Other Securities*

Securities definitions for partnership interests, multilevel marketing programs, limited liability companies, and other forms of financial contracts depend upon the transfer of managerial control from investors to fund managers. Limited partnership shares are securities that must be registered because managerial control over funds is transferred from passive limited partners to a general partner.⁵⁴ General partnership interests are not securities because general partners manage their own funds. Some financial managers attempt to avoid registration and public disclosure by using deceptive “general partner” labels to describe non-managerial investors. However, practical substance is more important than document labels or deceptive semantics in determining whether or not business associations need to register securities. According to a North Dakota Attorney General’s opinion, a business “association” that operates like a limited partnership is subject to the

44. *Id.* at 684.

45. *Id.*

46. *Id.* at 687.

47. 453 N.W.2d 793 (N.D. 1990).

48. *Barnes v. Sunderman*, 453 N.W.2d 793, 794 (N.D. 1990).

49. *Id.*

50. *Id.* at 795.

51. *Id.* at 794, 797.

52. *Id.* at 798.

53. *Barnes*, 453 N.W.2d at 798.

54. *Securities—Limited Partnership Interest—Subject to Act*, 1968 ATT’Y GEN. ANN. REP. 324-327.

North Dakota Securities Act if “[t]he substance of the entire scheme clearly makes it a security regardless of the form used.”⁵⁵

Multilevel marketing programs are illegal pyramid schemes if the primary goal is to recruit new members, rather than to sell products or services.⁵⁶ The Federal Trade Commission has determined that legitimate multilevel marketing programs pay performance bonuses for product sales rather than headhunting fees and buy back excess inventory from dealers.⁵⁷ Multilevel marketing companies also should analyze securities and franchise laws when they sell investment contracts. The North Dakota definition of a franchise⁵⁸ includes cooperative marketing agreements that can include elements of securities law.⁵⁹ In *Meadow Fresh Farms, Inc. v. Sandstrom*,⁶⁰ Meadow Fresh Farms violated both securities and franchise laws by distributing products in a multilevel marketing program that paid sales commissions and bonuses for the recruitment of new distributors.⁶¹ The North Dakota Supreme Court ruled that a “security” is created when “the returns of persons investing in a common enterprise depend to any extent upon inducing other persons to participate in the enterprise.”⁶²

New types of organizations like limited liability companies (LLCs)⁶³ and limited liability partnerships (LLPs)⁶⁴ present new legal issues for securities definitions. The four-part test is a useful guideline to analyze new forms of contracts, which are securities if they involve (1) investment (2) in a common enterprise (3) where the investor expects profits (4) from the managerial efforts of others.⁶⁵

55. *Id.* at 327.

56. See N.D. CENT. CODE § 51-16.1-01(3) (1995) (defining pyramid promotional schemes).

57. In re Amway Corp., 93 F.T.C. 618, 706 (1979).

58. N.D. CENT. CODE § 51-19-02(5)(a) (1995) (defining “franchise” as an agreement to sell goods or services under a marketing plan for a direct or indirect fee to use the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol).

59. *Quist v. Best Western Int’l, Inc.*, 354 N.W.2d 656, 660 (N.D. 1984).

60. 333 N.W.2d 780 (N.D. 1983).

61. *Meadow Fresh Farms, Inc. v. Sandstrom*, 333 N.W.2d 780, 781 (N.D. 1983).

62. *Id.* at 783.

63. See generally Mary B. Bader, *Organization, Operation, and Termination of North Dakota and Minnesota Limited Liability Companies*, 70 N.D. L. REV. 585 (1994) (providing an overview of LLCs and transfers of interest in LLCs); Garry A. Pearson, *The North Dakota Limited Liability Act: Formation and Tax Consequences*, 70 N.D. L. REV. 67 (1994) (discussing the tax advantages of LLCs).

64. William L. Guy III, *First LLC’S and now . . . LLP’S!*, GAVEL (N.D. State Bar Ass’n), April/May 1995, at 8.

65. See SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946) (defining an investment contract as “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party”).

III. REGISTRATION EXEMPTIONS

Companies should register with the state Securities Commissioner⁶⁶ or Federal Securities and Exchange Commission to sell securities that are not exempt from registration, because an “offer for sale”⁶⁷ or sale⁶⁸ of unregistered securities is illegal.⁶⁹ Sometimes preliminary discussions with potential investors actually are illegal “offers for sale.” Therefore, companies should register securities early in the process of capital formation to avoid potential liability for violations. Securities registrations and public financial disclosures help expose investments that are as worthless as buying chunks of intangible blue sky. State “blue sky” laws for securities regulation protect consumers against investment fraud. Under North Dakota’s blue sky laws, the Securities Commissioner can deny registration for securities that appear to be fraudulent, unfair, unjust, or inequitable.⁷⁰

Material misrepresentations or nondisclosures of material facts on securities applications⁷¹ can generate civil penalties,⁷² liability for fraudulent practices,⁷³ rescission refunds to investors,⁷⁴ and criminal prosecution.⁷⁵ The United States Supreme Court has ruled that “material” facts must be disclosed if there is a substantial likelihood the disclosure would be considered significant by a reasonable investor.⁷⁶ In North Dakota federal courts, “material” facts are “those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security.”⁷⁷ Securities registrations and disclosures of material facts usually are necessary, but some securities are exempt from registration.

66. N.D. CENT. CODE § 10-04-04 (1995).

67. *Id.* § 10-04-02(6) (defining “offer for sale” and “offer to sell”).

68. *Id.* § 10-04-02(10) (defining “sale” and “sell”).

69. *Id.* § 10-04-04 (requiring registration of securities).

70. *Id.* § 10-04-08.1.

71. *See* State v. Pandolfo, 106 N.W.2d 615, 620 (N.D. 1960) (discussing misrepresentation or nondisclosure of material facts on an application for registration); State v. Pandolfo, 98 N.W.2d 161, 167 (N.D. 1959) (discussing misrepresentation or nondisclosure of material facts on an application for registration).

72. N.D. CENT. CODE § 10-04-16(1) (1995).

73. *Id.* § 10-04-15.

74. *Id.* § 10-04-17.

75. *Id.* § 10-04-18(1).

76. Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988).

77. SEC v. First American Bank & Trust Co., 481 F.2d 673, 679 (8th Cir. 1973).

A. NORTH DAKOTA EXEMPTIONS

North Dakota exemptions for securities issuers⁷⁸ and securities transactions⁷⁹ prevent regulatory duplication and reduce compliance costs for small companies and relatively private transactions. Some securities registration exemptions must be approved by the Securities Commissioner⁸⁰ but others are self-executing.⁸¹

1. *Exempt Securities*

Securities are exempt from North Dakota registration if they are issued by government agencies in the United States or Canada, or by banks, savings and loan institutions, credit unions, railroads, trust companies, insurance companies, religious and charitable organizations, educational and nonprofit institutions, public utilities, blue-chip companies, North Dakota cooperatives, the North Dakota Education Association, and other listed entities.⁸² Federal Land Bank stock issued to borrowers is exempt from registration,⁸³ and securities listed on the New York Stock Exchange, the American Stock Exchange, the NASDAQ national market system, the Chicago Board Options Exchange, the Philadelphia Stock Exchange, and the Pacific Stock Exchange all are exempt from securities registration in North Dakota.⁸⁴ Securities exemptions prevent regulatory duplication by the Securities Commissioner because financial institutions, national stock exchanges, public utilities, and blue-chip companies are regulated by the SEC and other governmental agencies. Other exemptions for religious, charitable, non-profit, educational, and cooperative organizations help reduce compliance costs for important community activities.

2. *Exempt Transactions*

Some securities transactions are exempt from registration because they are monitored by other government agencies.⁸⁵ Like the

78. N.D. CENT. CODE § 10-04-05 (1995).

79. *Id.* § 10-04-06.

80. *See id.* § 10-04-05(4) (requiring a notice filing with the Securities Commissioner); § 10-04-05(8) (requiring that proof of exemptions be filed with the Commissioner); § 10-04-05(11) (requiring descriptions of collateral be filed with the Commissioner).

81. *See id.* § 10-04-04 (providing in part that securities sold under § 10-04-06(9) need not be registered for lawful sale).

82. *Id.* § 10-04-05.

83. *Federal Land Bank of St. Paul v. Anderson*, 401 N.W.2d 709, 713 (N.D. 1987).

84. N.D. CENT. CODE § 10-04-05(15) (1995). The Philadelphia Stock Exchange and the Pacific Stock Exchange were granted exempt status by order of the Securities Commissioner on February 23, 1996 for Tier I offerings.

85. *Id.* § 10-04-06(1).

exemptions for securities, the exemptions for transactions help reduce regulatory duplication. For example, judicial, estate, receivership, and bankruptcy sales are exempt from registration because they are approved by judges or trustees in court proceedings.⁸⁶ Securities sales to institutional buyers and financially sophisticated investors like banks, pension trusts, and insurance companies are exempt from securities registration because those investors presumably have less need for government protection in analyzing investment information.⁸⁷ Other exempt transactions essentially are internal management decisions rather than public sales to investors. For instance, company stock dividends granted to existing shareholders without commissions, stock transfers for mergers and consolidations, and internal stock conversions are exempt from registration.⁸⁸ State exemptions also reduce compliance costs for small companies that offer shares to 25 or fewer North Dakota investors and for offerings of \$500,000 or less.⁸⁹ Exemptions do not apply to sellers in fraud cases,⁹⁰ whether filed by investors⁹¹ or the Securities Commissioner,⁹² and the defendant has the burden of proof for North Dakota securities exemptions.⁹³

Securities registration exemptions for companies that issue securities are different from exemptions for the people who sell securities. Salespeople must register to sell any securities, including exempt securities.⁹⁴ For example, shares in a North Dakota cooperative are exempt from securities registration,⁹⁵ but people who sell exempt cooperative shares should register with the Securities Commissioner.⁹⁶ Similarly, bank securities are exempt from registration,⁹⁷ but people who sell bank securities need to register as dealers and salesmen.⁹⁸ Although registration is required for dealers and salespeople who sell *exempt*

86. *Id.*

87. *Id.* § 10-04-06(5).

88. *Id.* §10-04-06(6)-(7).

89. N.D. CENT. CODE § 10-04-06(9) (1995). The exemptions for small North Dakota companies in § 10-04-06(9)(a)(3) require approval of the Securities Commissioner. *Id.* The streamlined application normally includes a five-page Form E or E(S), an Offering Circular of approximately 5-30 pages that describes the business plan and risks, an Impoundment Agreement to escrow the money until all funds for the offering are collected, and a \$100 filing fee.

90. *Barnes v. Sunderman*, 453 N.W.2d 793, 796-97 (N.D. 1990).

91. N.D. CENT. CODE § 10-04-17 (1995) (providing remedies for purchasers of securities).

92. *Id.* § 10-04-15 (prohibiting fraudulent practices in the sale of securities).

93. *Id.* § 10-04-19(1). The defendant also has the burden of proof for securities exemptions in federal court. *Koehler v. Pulvers*, 614 F. Supp. 829, 842 (S.D. Cal. 1985).

94. N.D. CENT. CODE § 10-04-05(6) (1995) (providing supervision of the sale of securities).

95. *Id.* § 10-04-05(9).

96. *Id.* § 10-04-10.

97. *Id.* § 10-04-05(2).

98. *State ex rel. Holloway v. First Am. Bank & Trust Co.*, 186 N.W.2d 573, 580 (N.D. 1971), *appeal filed*, *State ex rel. Holloway v. First Am. Bank & Trust Co.*, 197 N.W.2d 14 (N.D. 1972) (requiring the Bank to be registered as a securities dealer).

securities, registration is not required for dealers and salespeople involved in *exempt transactions*.⁹⁹

Dealers, salesmen, investment advisers, and investment adviser representatives¹⁰⁰ must register with the Securities Commissioner each year.¹⁰¹ However, people who are not securities professionals¹⁰² can sell their own securities in an isolated sale without registration.¹⁰³ Bankers, lawyers, and accountants are not exempt from the definition of “dealer” in North Dakota,¹⁰⁴ but they are excluded from the definition of “investment adviser” if the investment advice is incidental to their other professional services.¹⁰⁵

B. FEDERAL EXEMPTIONS

Federal securities exemptions mirror North Dakota exemptions. A North Dakota company that offers securities exclusively to North Dakota residents need only register the *intrastate* offering with the state Securities Commissioner. However, a company that offers securities to any investor from another state must register the *interstate* offering with the federal Securities and Exchange Commission¹⁰⁶ and with each state that has jurisdiction,¹⁰⁷ unless the offering qualifies for a federal exemption.¹⁰⁸ The Securities Act of 1933 covers initial offerings, the 1934 Securities Exchange Act governs secondary trading after initial

99. *See id.* § 10-04-06 (providing for exempt transactions).

100. N.D. CENT. CODE §§ 10-04-02(2)-(4), (11) (1995) (defining dealer, investment adviser, investment adviser representative, and salesman). The North Dakota legislature should adopt a more gender-neutral term like “agent” rather than “salesman” to describe securities salespeople.

101. N.D. CENT. CODE § 10-04-10(6). *State v. Henderson*, 156 N.W.2d 700, 707 (N.D. 1968).

102. *State v. Weisser*, 161 N.W.2d 360, 367 (N.D. 1968) (finding the issue of an isolated sale exemption irrelevant since the dealer was not registered as required).

103. N.D. CENT. CODE § 10-04-06(3) (1995).

104. *See id.* § 10-04-02(2) (defining “dealer” as including “every person” and not excluding bank employees, attorneys, or accountants).

105. N.D. CENT. CODE § 10-04-02(3)(c) (excluding bankers, lawyers, investment adviser representatives, financial institutions, accountants, engineers, teachers, news publishers, and securities dealers from the definition of “investment adviser” for advice incidental to the practice of their professions). In addition, § 10-04-10(3)(a)(2) exempts investment advisers from registration if their only North Dakota clients are investment companies, securities dealers, banks, trust companies, savings and loan associations, insurance firms, large employee benefit plans, government agencies, or other institutional investors. *Id.* § 10-04-10(3)(a)(2). The state legislature apparently felt that large institutional investors do not need government protection or assistance for their decisions involving investment advice.

106. Securities Act of 1933 § 5(a), 33 U.S.C. § 77e (1988); 17 C.F.R. § 230.133 (1995); [1984-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 3001, at 3021 (Jan. 30, 1991).

107. *See Guon v. United States*, 285 F.2d 140, 143-44 (8th Cir. 1960) (upholding a conviction for selling unregistered interstate securities).

108. Securities Act of 1933 § 3(a), 33 U.S.C. § 77 (1988); 17 C.F.R. § 231.538 (1995); Solicitation Under Deposit Agreement, Securities Act Release No. 33-538 [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2001, at 2551 (Dec. 16, 1987).

offerings, and the Investment Company Act of 1940 includes federal regulations for mutual funds.

1. *Exempt Securities*

Federal exemptions reduce regulatory duplication by the Securities and Exchange Commission for companies regulated by other governmental agencies. For example, exempt securities issued or guaranteed by the United States government or by any state, bank, trust company, insurance company, or employee benefit plan¹⁰⁹ are regulated by other agencies. Exempt railroad trusts¹¹⁰ and bankruptcy trusts¹¹¹ are monitored by trustees, and corporate reorganizations are exempt if the securities are approved by a court or governmental agency.¹¹²

Other federal exemptions preclude government interference in private offerings. Securities that companies exchange with their own shareholders are exempt if no commissions are paid.¹¹³ Exemptions for small business offerings not exceeding \$5 million,¹¹⁴ oil or gas offerings not exceeding \$250,000,¹¹⁵ specified limited offerings not exceeding \$1 million,¹¹⁶ offerings not exceeding \$5 million for 35 or fewer offerees,¹¹⁷ and offerings sold to accredited and experienced investors¹¹⁸ are exempt from federal registration because they are relatively small private offerings.

109. Securities Act of 1933 § 3(a)(2), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2021, at 2556 (Nov. 11, 1990).

110. Securities Act of 1933 § 3(a)(6), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2075, at 2569 (Oct. 9, 1991).

111. Securities Act of 1933 § 3(a)(7), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2085, at 2570 (Oct. 9, 1991).

112. Securities Act of 1933 § 3(a)(10), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2171, at 2590 (Oct. 16, 1991).

113. Securities Act of 1933 § 3(a)(9), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2125, at 2581 (Oct. 9, 1991). This exemption does not include securities exchanged in a bankruptcy.

114. Securities Act of 1933 § 3(b) Regulation A, 33 U.S.C. §§ 77c, 77s (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2359, at 2623 (Jan. 12, 1994). Regulation A allows companies to "test the waters" for potential interest in a securities offering before filing or delivering an offering statement.

115. Securities Act of 1933 § 3(b) Regulation B, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.302(a) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2382, at 2638 (Mar. 16, 1983).

116. Securities Act of 1933 § 3(b) Regulation D, Rule 504, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.504(b)(2) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2376, at 2635-10 (Dec. 20, 1995).

117. Securities Act of 1933 § 3(b) Regulation D, Rule 505, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.505(b)(2)(ii) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2377, at 2635-13 (Dec. 20, 1995).

118. Securities Act of 1933 § 3(b) Regulation D, Rule 506, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.505(b)(2)(ii) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2378, at 2635-13 (Dec. 20, 1995).

Commercial paper with a maturity not exceeding nine months¹¹⁹ is exempt from registration because commercial paper transactions normally involve sophisticated institutional investors who have substantial financial experience. Exemptions for securities issued by religious, educational, benevolent, fraternal, charitable, non-profit, savings and loan, and farmer cooperative groups reduce compliance costs for preferred¹²⁰ community organizations.¹²¹

The Federal Securities Act of 1933 provides an *intrastate* exemption for an issuer who is "resident¹²² and doing business"¹²³ within a state and who offers securities only to residents of the same state.¹²⁴ Resales to nonresidents are restricted for nine months after the last sale.¹²⁵

2. *Exempt Transactions*

Some securities transactions are exempt from registration because the investors have access to financial information and presumably have less need for government protection against investment fraud. For example, sales to accredited investors¹²⁶ and transactions executed on an exchange or in an over-the-counter market for unsolicited orders¹²⁷ are exempt from registration. Private transactions that do not involve an issuer, underwriter, or dealer are exempt from registration under certain conditions,¹²⁸ and private-placement issuers¹²⁹ can offer securities to

119. Securities Act of 1933 § 3(a)(3), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2035, at 2565 (Oct. 9, 1991).

120. Securities Act of 1933 § 3(a)(4), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2051, at 2565-6 (Dec. 27, 1995).

121. Securities Act of 1933 § 3(a)(5), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2061, at 2567 (Oct. 9, 1991).

122. Securities Act of 1933 § 3(a)(11), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2253, at 2603-2 (Dec. 20, 1995). An issuer is deemed to be a "resident" of the state of incorporation or organization for a corporation, trust, or limited partnership. 17 C.F.R. § 230.147(c)(1) (1995). General partnerships and other business organizations are "resident" in the state where the principal office is located. *Id.*

123. Securities Act of 1933 § 3(a)(11), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2253, at 2603-2 (Mar. 12, 1990). An issuer is deemed to be "doing business" in a state if the issuer (including subsidiaries) (1) derived at least 80% of its gross revenues within the state during the most recent fiscal year; (2) has at least 80% of its assets located within the state; (3) uses at least 80% of the net proceeds from the offering within the state for business or real property; and (4) the principal office is located within the state. 17 C.F.R. § 230.147(c)(2) (1995).

124. Securities Act of 1933 § 3(a)(11) Rule 147, 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2251, at 2601-3 (Oct. 9, 1991).

125. Securities Act of 1933 § 3(a)(11) Rule 147, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.147(e) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2253, at 2603-3 (Mar. 12, 1990).

126. Securities Act of 1933 § 4(6), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2993, at 2962 (Feb. 26, 1992).

127. Securities Act of 1933 § 4(4), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2901, at 2951 (Sept. 13, 1995).

128. Securities Act of 1933 § 4(1), 33 U.S.C. § 77 (1988); [1983-1995 Transfer Binder] 1 Fed.

“accredited” and “experienced” investors¹³⁰ without federal registration.¹³¹ An “accredited investor”¹³² is defined in federal law as:

- (1) any natural person with a net worth of at least \$1,000,000 (including spouse);
- (2) any natural person with an annual income of at least \$200,000 (\$300,000 with spouse) in the previous two years and a reasonable expectation of similar annual income in the current year;
- (3) any corporation, partnership, or business trust with total assets of \$5,000,000;
- (4) insiders of the issuer firm, including officers and directors of a corporation or general partners in a partnership; and
- (5) institutional investors, including registered investment companies, government pension plans in excess of \$5 million, banks, savings and loan associations, charitable trusts described in section 501(c)(3) of the Internal Revenue Code with assets in excess of \$5 million, securities brokers and dealers, and insurance companies.

IV. INVESTOR REMEDIES

North Dakota securities laws provide legal and equitable remedies through private litigation and through the office of the Securities Commissioner for consumers who buy unregistered or fraudulent investments. One of the most significant investor remedies for securities violations is contract rescission, which includes a refund of the original investment, interest, attorney fees, and court costs.¹³³ Rescission must be offered to all investors equally¹³⁴ and rescission does not limit any other remedies.¹³⁵ Some investment contracts are both securities and

Sec. L. Rep. (CCH) ¶ 2705, at 2779 (Oct. 17, 1995).

129. Securities Act of 1933 § 4(2) Regulation D, Rule 506, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.506(b)(1) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2378, at 2635-13 (Dec. 20, 1995).

130. Securities Act of 1933 § 3(b) Regulation B, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.506(b)(2)(ii) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2378, at 2635-13 (Dec. 20, 1995).

131. Securities Act of 1933 § 3(b) Regulation D, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.501(e)(1)(iv) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2378, at 2635-13 (Dec. 8, 1993).

132. Securities Act of 1933 § 3(b) Regulation D, Rule 501, 33 U.S.C. § 77 (1988); 17 C.F.R. § 230.501(a) (1995); [1983-1995 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) ¶ 2372, at 2635-3 (Dec. 8, 1993).

133. N.D. CENT. CODE § 10-04-17 (1995).

134. See *Hummel v. Kranz*, 126 N.W.2d 786, 790 (1964) (finding that the seller must offer a refund equally to all buyers for rescission).

135. N.D. CENT. CODE § 10-04-17(3) (1995). See also *Adams v. Little Missouri Minerals Ass'n*, 143 N.W.2d 659, 669 (N.D. 1966) (finding that remedies for securities litigation can be based on contract and fraud).

franchises,¹³⁶ and rescission is available for both types of violations.¹³⁷ Investors might waive rescission by not accepting a rescission offer within thirty days,¹³⁸ by acting inconsistent with rescission intent,¹³⁹ or by delaying action after discovering violations.¹⁴⁰ Equitable remedies like rescission are not automatic.¹⁴¹ Therefore, the liability of individual promoters,¹⁴² exemptions,¹⁴³ arbitration clauses,¹⁴⁴ investor election of remedies,¹⁴⁵ and other issues depend upon the specific facts of each particular case.

One of the most common securities violations in North Dakota that produces rescission remedies is the failure to register a company or salesperson. Rescission for unregistered sales of securities or franchises is a practical way for investors to simplify litigation claims and avoid some complex issues of offer, acceptance, consideration, due diligence, capacity to contract, integration of a series of negotiations or documents, the statute of frauds, parol evidence, promissory estoppel, third-party beneficiaries, partial performance, and other contract issues.¹⁴⁶ Furthermore, investors who lose money with unregistered or fraudulent securities can collect damages from a dealer bond for each year in a series of transactions¹⁴⁷ or from agents and corporate directors who have personal liability¹⁴⁸ or who control an alter ego corporation.¹⁴⁹ People who would like to research information about securities companies and investors who need assistance for investor remedies should contact the Securities Commissioner. Records in the office of the Securities

136. See *Meadow Fresh Farms, Inc. v. Sandstrom*, 333 N.W.2d 780, 783-84 (N.D. 1983) (determining that Meadow Fresh fit the definition of a security and a franchise).

137. N.D. CENT. CODE § 10-04-17 (1995) (allowing rescission of securities agreements); *id.* § 51-19-12 (allowing rescission of franchise agreements).

138. *Id.* § 10-04-17(2).

139. See *Check Control, Inc. v. Shepherd*, 462 N.W.2d 644, 648 (N.D. 1990) (finding that rescission can only be granted when that a claimant acts with reasonable diligence).

140. *Fargo Biltmore Motor Hotel Corp. v. Best Western Int'l, Inc.*, 742 F.2d 459, 462 (8th Cir. 1984).

141. *Peck of Chehalis, Inc. v. C.K. of Western America, Inc.*, 304 N.W.2d 91, 97-98 (N.D. 1981).

142. See *Schollmeyer v. Saxowsky*, 211 N.W.2d 377, 387 (N.D. 1973) (determining that a corporate president who had no personal contact with the buyer was liable for unregistered securities).

143. See *McCarney v. Johanneson*, 315 N.W.2d 470, 472 n.1 (N.D. 1982) (providing listing of exempt transactions under N.D. CENT. CODE § 10-04-06).

144. See *Country Kitchen of Mount Vernon, Inc. v. Country Kitchen of Western America, Inc.*, 293 N.W.2d 118, 120 (N.D. 1980) (providing discussion of the franchise investment law under N.D. CENT. CODE § 59-19-12).

145. See *Woodhull v. Minot Clinic*, 259 F.2d 676, 679 (8th Cir. 1958) (discussing the investor election of remedies under North Dakota law).

146. N.D. CENT. CODE § 10-04-17 (1995).

147. *Giese v. Engelhardt*, 175 N.W.2d 578, 587 (N.D. 1970).

148. *Weidner v. Engelhardt*, 176 N.W.2d 509, 511 (N.D. 1970).

149. *Larson v. Unlimited Business Exch.*, 330 N.W.2d 518, 519-20 (N.D. 1983).

Commissioner contain useful information about companies and people who sell investments, and most of the documents are open public records. Investors often file complaints for unregistered or fraudulent securities, and companies sometimes use filed documents to deny potential claims of failure to disclose material facts or failure to warn investors about risks.

The Securities Commissioner can deny applications,¹⁵⁰ suspend or revoke registrations,¹⁵¹ issue investigative subpoenas,¹⁵² conduct hearings,¹⁵³ assess a civil penalty of \$10,000 per violation,¹⁵⁴ issue orders, and seek state or federal court injunctions.¹⁵⁵ Orders and injunctions are preventive measures for public protection that do not require harm to a specific investor or continuous illegal conduct.¹⁵⁶ A willful securities violation is a Class B felony that can trigger ten years in jail and a \$10,000 fine per violation, and the Securities Commissioner can refer willful violations to criminal prosecutors. "Willfully" means the defendant intended to do the illegal conduct but evil motive or knowledge of violating the law is not required.¹⁵⁷ In federal court, "willfully" means acts "done knowingly and deliberately with bad purpose" but knowledge of violating the law is not necessary for criminal prosecution.¹⁵⁸

V. CONCLUSION

Attorneys who do not specialize in securities law can avoid malpractice liability by consulting with securities attorneys regarding technical matters. However, they should also review fundamental principles of securities law to analyze basic securities definitions, judicial interpretations, registration exemptions, and potential investor remedies for the investment contracts of their clients. The North Dakota Securities Commissioner protects consumers against investment fraud and regulates the securities industry in the state. Attorneys and investors should contact the Securities Commissioner for securities and franchise

150. N.D. CENT. CODE §§ 10-04-08.1, 10 (1995).

151. *Id.* §§ 10-04-09, 11.

152. *Id.* § 10-04-16.1(2).

153. *Id.* § 10-04-12.

154. *Id.* § 10-04-16(1).

155. N.D. CENT. CODE § 10-04-16 (1995).

156. *SEC v. First Am. Bank & Trust Co.*, 481 F.2d 673, 681-82 (8th Cir. 1973) (determining that injunctions may issue based on the likelihood of future violations, even if the improper conduct has ceased).

157. N.D. CENT. CODE § 10-04-18(2) (1995) (defining "willfully"); *State v. Bilbrey*, 349 N.W.2d 1, 3 (N.D. 1984).

158. *Tarvestad v. United States*, 418 F.2d 1043, 1047 (8th Cir. 1969), *cert. denied*, 397 U.S. 935 (1970).

questions, for investment fraud complaints, and for any suggestions that would improve the agency's public service in North Dakota.