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SECURITIES

Overview

Four recent decisions of the United States Court of Appeals for the Tenth Circuit[1] have clarified the court's position on issues central to securities litigation. This survey will examine the decisions and the questions with which each dealt in the following order: first, the problem of when the federal equitable tolling doctrine applies to statutes of limitations in securities fraud cases;[2] second, whether purchases of lots in a real estate development, combined with the sellers' promises to develop the property, constitute a "security";[3] third, what the required standards and burdens of proof are in establishing a conflict of interest in violation of the Investment Company Act of 1940;[4] fourth, what degree of wrongful intent is required for aiding and abetting a violation of that Act;[5] and fifth, whether a private right of action under rule 10b-5[6] extends to a plaintiff seeking injunctive relief to prevent the defendant from issuing securities for the purpose of financing litigation against the plaintiff, where the securities consisted of agreements to share money recovered in the lawsuit.[7]

I. Tolling the Statute of Limitations in Federal Securities Cases

In *Aldrich v. McCulloch Properties, Inc.*,[8] the plaintiffs, who purchased subdivided lots in the defendants' real estate development, sought to recover their investment under several federal securities provisions, as well as under the Interstate Land Sales Full Disclosure Act (ILSFDA),[9] and under various common law theories.[10] However, the plaintiffs did not file their lawsuit

1. Ohio v. Peterson, 651 F.2d 687 (10th Cir. 1981); Decker v. SEC, 631 F.2d 1380 (10th Cir. 1980); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980); Westinghouse Credit Corp. v. Bader & Dufty, 627 F.2d 221 (10th Cir. 1980).

2. Ohio v. Peterson, 651 F.2d 687 (10th Cir. 1981); Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980).

3. Aldrich v. McCulloch Properties, Inc., 627 F.2d 1036 (10th Cir. 1980).

4. 15 U.S.C. § 80a-1 (1976); Decker v. SEC, 631 F.2d 1380 (10th Cir. 1980).

5. Decker v. SEC, 631 F.2d 1380 (10th Cir. 1980).

6. 17 C.F.R. § 240.10b-5 (1981), which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

7. Westinghouse Credit Corp. v. Bader & Dufty, 627 F.2d 221 (10th Cir. 1980).

8. 627 F.2d 1036 (10th Cir. 1980).

9. 15 U.S.C. § 1701 (1976).

10. 627 F.2d at 1038.

until more than eight years after they had purchased the lots in question.[11] The United States District Court for the District of Colorado ruled that the applicable statutes of limitations barred all the plaintiffs' claims.[12]

The United States Court of Appeals for the Tenth Circuit partly affirmed and partly reversed the district court's decision, and held that while the claims under the ILSFDA were indeed barred, the claims under the securities laws were not.[13] According to the court of appeals, the federal equitable tolling doctrine protected the plaintiffs' securities violations claims from summary disposal, even though the limitations period had expired, because the plaintiffs had asserted facts supporting the allegation that the defendants concealed the fraud until the limitations period had run.[14]

Since the federal securities provisions under which the plaintiffs sued do not contain a limitations period, the court adopted the policy delineated by the United States Supreme Court in *Ernst & Ernst v. Hochfelder*:[15] whenever a remedy is judicially implied (as in, for example, a rule 10b-5 action),[16] and no statute of limitations is provided, the forum state's limitations period is adopted.[17] Colorado law provides a three-year limitations period for fraud actions.[18] Under normal legal principles, this alone would not have helped the plaintiffs, who sued more than eight years after signing the contract complained of.[19] However, as stated above, the court utilized federal equitable tolling principles to delay the operation of the Colorado statute of limitations.

The equitable tolling doctrine is based on the premise that a plaintiff in a fraud case should not be penalized when the defendant conceals the fraud so efficiently that even if the plaintiff is diligent, the fraud remains hidden until it is too late to bring suit. The United States Supreme Court recog-

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11. *Id.*

12. *Id. See* 15 U.S.C. § 1711 (1976) (amended 1979); COLO. REV. STAT. §§ 13-80-108, -109 (1973).

13. 627 F.2d at 1041-42.

14. *Id.* at 1042.

15. 425 U.S. 185 (1976).

16. *Id.* at 210 n.29.

17. 627 F.2d at 1041 (citing Ernst & Ernst v. Hochfelder, 425 U.S. at 210 n.29). The court also cited Nickels v. Koehler Mgmt. Corp., 541 F.2d 611, 613 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977) (where no federal statute of limitations exists, federal courts must implement the state statute of limitations which best effectuates the policy objectives of the federal remedy provided). *See* Holmberg v. Armbrecht, 327 U.S. 392, 395 (1946), where the Supreme Court stated:

> If Congress explicitly puts a limit upon the time for enforcing a right which it created there is an end of the matter. The Congressional statute of limitation is definitive . . . . The rub comes when Congress is silent . . . . [T]he silence of Congress has been interpreted to mean that it is federal policy to adopt the local law of limitation . . . . The implied absorption of State statutes of limitation within the interstices of the federal enactments is a phase of fashioning remedial details where Congress has not spoken but left matters for judicial determination within the general framework of familiar legal principles.

See also 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 2.5(1) at 41-42 (1981).

18. COLO. REV. STAT. §§ 13-80-108, -109 (1973). Section 13-80-109 states that "[b]ills for relief on the ground of fraud shall be filed within three years after the discovery by the aggrieved party of the facts constituting such fraud, and not afterwards."

19. 627 F.2d at 1038.

nized this problem in *Bailey v. Glover*,[20] a bankruptcy case, and summarized the doctrine: "[w]here the ignorance of the fraud has been produced by affirmative acts of the guilty party in concealing the facts from the other, the statute will not bar relief provided suit is brought within proper time after the discovery of the fraud."[21] The Court also held that the equitable tolling doctrine applies to actions at law as well as in equity.[22]

The *Bailey* holding was reaffirmed in *Exploration Co. v. United States*,[23] a Colorado land patent fraud case in which the Court allowed the United States government to benefit from the equitable tolling doctrine.[24] The doctrine was further clarified in *Holmberg v. Armbrecht*,[25] where the Court held that in federal actions, equitable tolling principles apply to federal as well as to state statutes of limitations regardless of whether an action is grounded in fraud: "[t]his equitable doctrine is read into every federal statute of limitation . . . . It would be too incongruous to confine a federal right within the bare terms of a State statute of limitation unrelieved by the settled federal equitable doctrine."[26]

The Tenth Circuit Court of Appeals in *Aldrich* followed Supreme Court decisions and reaffirmed its own precedents in applying federal tolling rules to state statutes of limitation. Nine years before *Aldrich*, the court held that "it is a matter of federal law as to the circumstances that will toll a state statute applied to private actions under the securities laws."[27]

The federal equitable tolling doctrine has no effect on the ILSFDA statute of limitations.[28] The court emphasized that equitable principles are read into state and federal statutes of limitations only if no contrary intent appears.[29] Unlike the federal securities statutes discussed in *Aldrich*,[30] the

20. 88 U.S. (21 Wall.) 342 (1874).

21. *Id.* at 347-48.

22. *Id.* at 349. *See* text accompanying notes 58-61 *infra*.

23. 247 U.S. 435 (1918).

24. *Id.* at 446, 449-50.

25. 327 U.S. 392 (1946).

26. *Id.* at 397. *See* Comment, *Fraudulent Concealment as Tolling the Antitrust Statute of Limitations*, 36 FORDHAM L. REV. 328, 329-30 (1967). *See also* Glus v. Brooklyn E. Dist. Terminal, 359 U.S. 231 (1959), where the statute of limitations was tolled because the defendants fraudulently represented it to be longer than it actually was.

27. DeHaas v. Empire Petroleum Co., 435 F.2d 1223, 1226 (10th Cir. 1970) (citing Esplin v. Hirschi. 402 F.2d 94, 103 (10th Cir. 1968), *cert. denied*, 394 U.S. 928 (1969)). The limitations period begins to run from the date the plaintiff has actual or constructive notice of the fraud. Jones v. Ford Motor Co., 599 F.2d 394 (10th Cir. 1979); Dzenits v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 494 F.2d 268 (10th Cir. 1974). *See also* Janigan v. Taylor, 344 F.2d 781, 784 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); Public Serv. Co. v. Gen. Elec. Co., 315 F.2d 306 (10th Cir.), *cert. denied*, 374 U.S. 809 (1963); 1 A. BROMBERG & L. LOWENFELS, *supra* note 17, at 42.

28. 627 F.2d at 1042; 15 U.S.C. § 1711 (1976) (amended 1979). A plaintiff alleging a fraudulent land sale may sue both under the ILSFDA and under the securities laws; neither cause of action precludes the other. 627 F.2d at 1039 n.2; Jenne v. Amrep Corp., [1978] FED. SEC. L. REP. (CCH) ¶ 96,343, at 93,166 (D.N.J. Feb. 14, 1978).

29. 627 F.2d at 1042 (citing Glus v. Brooklyn E. Dist. Terminal, 359 U.S. at 234 (equitable estoppel applies to toll the Federal Employers' Liability Act statute of limitations where the language of the Act does not preclude such an application); Holmberg v. Armbrecht, 327 U.S. at 395.

30. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1976); 17 C.F.R. § 240.10b-5 (1981); Securities Act of 1933 § 17, 15 U.S.C. § 77(q) (1976).

ILSFDA contains a three-year statute of limitations.[31] The court found that Congress intended this limitation period to be absolute and not susceptible to extension under the federal equitable tolling doctrine, "notwithstanding allegations of fraudulent concealment."[32]

Thus, according to the *Aldrich* court, congressional intent overrides the general rule, embraced by the United States Supreme Court, that the equitable tolling doctrine is "read into every federal statute of limitation."[33] The language of the ILSFDA statute of limitations indicates such a contrary congressional intent, that is, an intent to render the limitations period absolute notwithstanding extenuating circumstances.[34] At the time the lawsuit was brought, the ILSFDA statute of limitations concluded with the statement that "[i]n no event shall any such action be brought by a purchaser more than three years after the sale or lease to such purchaser."[35] The court, following Illinois federal district court precedent,[36] ruled that this language created "an absolute bar to untimely suits under the ILSFDA."[37] The ILSFDA statute of limitations begins to run from the time the initial contract is signed, not, as the plaintiffs suggested, from the time all installments on the contract are paid.[38]

The *Aldrich* court inserted a note of caution: While the language of the ILSFDA statute of limitations definitely precludes its extension through the federal equitable tolling doctrine, other equitable doctrines are not foreclosed. The ILSFDA statute of limitations may be tolled by the principle of equitable estoppel when the wrongdoer persuades his victim not to sue until it is too late.[39]

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31. 15 U.S.C. § 1711 (1976) (amended 1979). This statute was amended to provide a three-year limitation period for all ILSFDA violations, instead of varying limitations with an "in no event" provision attached. *See* text accompanying note 35 *infra*. *See also* H.R. REP. NO. 154, 96th Cong., 1st Sess. 38, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 2317, 2354. In light of this change, it is uncertain whether the *Aldrich* ruling still applies to post-1979 actions under the ILSFDA.

32. 627 F.2d at 1043.

33. *Id.* at 1042 (citing Holmberg v. Armbrecht, 327 U.S. at 397).

34. 627 F.2d at 1042-43. The court pointed out that the interpretation of the ILSFDA statute of limitations as absolute accords with an identical interpretation generally given to the statute of limitations under § 13 of the Securities Act of 1933, 15 U.S.C. § 77 (1976), upon which the ILSFDA is based. 627 F.2d at 1043. *See, e.g.*, Brick v. Dominion Mtg. & Realty Trust, 442 F. Supp. 283, 291 (W.D. N.Y. 1977). However, there are federal decisions sanctioning the tolling or extension of the ILSFDA statute of limitations. *See, e.g.*, Lukenas v. Bryce's Mountain Resort, Inc., 538 F.2d 594, 597 (4th Cir. 1976); Fuls v. Shastina Properties, Inc., 448 F. Supp. 983, 987-88 (N.D. Cal. 1978); Fogel v. Sellamerica, Ltd., 445 F. Supp. 1269, 1274 (S.D. N.Y. 1978) (monthly payments on fraudulent land contract constitute fresh violations of the ILSFDA, hence the two-year statute of limitations has not run, even though the purchase agreement was signed two years before the plaintiffs sued on it); Happy Inv. Group v. Lakeworld Properties, Inc., 396 F. Supp. 175, 188 (N.D. Cal. 1975). In Timmreck v. Munn, 433 F. Supp. 396, 408-09 (N.D. Ill. 1977), upon which the *Aldrich* court relied, the court tolled the two-year ILSFDA statute of limitations, even while it refused to toll the three-year "in no event" limitations period. *See* text accompanying note 35 *infra*.

35. 15 U.S.C. § 1711 (1976) (amended 1979).

36. 627 F.2d at 1043; Timmreck v. Munn, 433 F. Supp. at 408-09.

37. 627 F.2d at 1043.

38. *Id.* at 1043-44. *But see* Fogel v. Sellamerica, Ltd., 445 F. Supp. at 1274.

39. 627 F.2d at 1043 n.7. *See* Glus v. Brooklyn E. Dist. Terminal, 359 U.S. at 233-34; Bomba v. W.L. Belvidere, Inc., 579 F.2d 1067 (7th Cir. 1978).

In regard to the equitable tolling of limitations periods, the *Aldrich* opinion left two questions unanswered. The first is whether a recent Supreme Court case, *Board of Regents v. Tomanio*,[40] prohibits the application of the federal equitable tolling doctrine to state statutes of limitations in federal securities cases. In *Tomanio*, the Supreme Court held that in a civil rights action under 42 U.S.C. § 1983, federal courts must apply both state statutes of limitations and state equitable tolling principles.[41] The *Aldrich* court declined to decide this issue, since "the state and federal tolling rules here coincide."[42] It also skirted the question of how to dispose of the issue of the plaintiff's diligence. It is indisputable that equitable tolling principles do not rescue a lax plaintiff who would have discovered the fraud in the exercise of reasonable diligence.[43] However, the *Aldrich* holding did not specify whether the issue of due diligence could be disposed of in a motion for summary judgment, or if it is an issue for determination by the finder of fact.[44] A subsequent Tenth Circuit case, *Ohio v. Peterson*,[45] answered both questions.

On October 7, 1976, the State of Ohio (Ohio) brought a securities fraud action against a lawyer, Lowry, and the law firm which had represented a bankrupt enterprise, King Resources Company (KRC). The lawsuit was initiated six years after Ohio had purchased promissory notes from KRC. The Federal District Court for the District of Colorado summarily dismissed the action because the limitations period had expired.[46] Ohio appealed from the summary judgment, arguing that the limitations period should have been stayed until January 5, 1976, when Lowry's involvement in the fraud allegedly was discovered.[47]

The court of appeals first addressed the question of whether *Tomanio* undermines the Tenth Circuit rule "that in fraud cases only the limitations *period* is borrowed from state law, whereas the tolling rule is supplied by

40. 446 U.S. 478 (1980).

41. *Id.* at 484-85.

42. 627 F.2d at 1041. In reaching this conclusion, the court compared the federal cases of Holmberg v. Armbrecht, 327 U.S. at 397, Bailey v. Glover, 88 U.S. (21 Wall.) at 347, and deHaas v. Empire Petroleum Co., 435 F.2d at 1225-26, with the Colorado cases of Wright of Nelson, 125 Colo. 217, 226-27, 242 P.2d 243, 247-48 (1952), and Pipe v. Smith, 5 Colo. 146, 158 (1879) ("[T]he statute commenced to run upon the discovery of the facts constituting the fraud.") The court also pointed to a Colorado statute of limitations, COLO. REV. STAT. § 13-80-109 (1973), which states, "[b]ills for relief on the ground of fraud shall be filed within three years after the discovery by the aggrieved party of the facts constituting such fraud, and not afterwards."

43. *See, e.g.*, Dzenits v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 494 F.2d at 171; deHaas v. Empire Petroleum Co., 435 F.2d at 1226; Greco v. Pullara, 166 Colo. 465, 467, 444 P.2d 383, 383 (1968); Pipe v. Smith, 5 Colo. at 159.

44. 627 F.2d at 1042. The court did state that "[t]he question of whether a plaintiff should have discovered the basis of his suit under the doctrine of equitable tolling does not lend itself to determination as a matter of law." *Id.* Yet, the court held the trial court's dismissal of the securities claims on the pleadings "improper," *id.*, only because facts were pled that complicated the due diligence issue. *Id.* at 1041-42.

45. 651 F.2d 687 (10th Cir. 1981).

46. *Id.* at 689.

47. *Id.* at 690. Lowry had made certain revelations in a deposition. Ohio claimed that despite its exercise of due diligence, it had no way of knowing about Lowry's complicity until the deposition, since the court had imposed a stay of discovery during earlier litigation in the same case. *Id.* at 690-91.

federal jurisprudence."[48] This doctrine had been derived originally from the United States Supreme Court case of *Holmberg v. Armbrecht*.[49] The *Ohio* court decided that *Tomanio* applies only to actions under federal civil rights provisions.[50] The court reasoned that allowing the *Tomanio* holding to expand beyond the borders of civil rights and invade the securities regulation territory would effectively overrule *Holmberg*, "a decision whose continuing vitality is attested by the many cases relying upon it in § 10(b) private actions."[51]

Having decided that federal equitable tolling rules do apply to toll Colorado's limitations period whenever justice so requires, the court next turned to the problem of whether the question of the plaintiff's diligence may be decided in a motion for summary judgment (as permitted by federal law),[52] or whether it must be submitted to the finder of fact (as Colorado law requires).[53] The plaintiff argued that diligence in discovering the fraud is a jury question, and that the trial court's summary judgment was therefore invalid.[54] The court disagreed, and ruled that in this matter, federal precedent was preferable because the law of diligence should relate to securities fraud alone, rather than to vigilant discovery of any given cause of action.[55]

Federal judges within the Tenth Circuit therefore are empowered to decide summarily whether a plaintiff who failed to discover the fraud within the limitations period was sufficiently diligent so as to merit suspension of the limitations period until the date the plaintiff actually discovered the cause of action.[56] The *Ohio* court explained that the rationale of allowing federal judges such discretion is steeped in English and Early American precedent: "[i]n equity the issue of diligence was decided by the chancellor often on written petitions as opposed to live testimony—a procedure much like our summary judgment . . . ."[57]

Even though the tolling doctrine is of equitable origin, many legislatures, English and American, have codified it in order to apply it to statutes of limitations in legal actions as well as to the laches principle in equity.[58] The equitable rule continues to exist, and has been applied in cases at law where a statutory tolling rule does not exist.[59] Because of the equitable origins of the tolling doctrine, the court decided that "there remains some room

48. *Id.* at 691 (emphasis in original).

49. 327 U.S. 392 (1946). *See* text accompanying notes 25-26 *supra*.

50. 651 F.2d at 691.

51. *Id.*

52. For a discussion of the applicable federal law, see *id.* at 692-94.

53. *Id.* at 692. *See* Owens v. Brochner, 172 Colo. 525, 474 P.2d 603 (1970); Norton v. Leadville Corp., 610 P.2d 1348 (Colo. App.), *cert. denied*, 449 U.S. 993 (1980).

54. 651 F.2d at 692.

55. *Id.*

56. *Id.* at 693-94. The court may have resolved a conflict within the Tenth Circuit on this issue. Aldrich v. McCulloch Properties, Inc., 627 F.2d at 1042, and Dzenits v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 494 F.2d at 172, could be cited in favor of jury resolution of the diligence issue, while Jones v. Ford Motor Co., 599 F.2d 394, 399-400 (10th Cir. 1979) affirmed the trial court's summary judgment on the ground that the plaintiff had had sufficient notice of the fraud before the limitations period had run out.

57. 651 F.2d at 693. *See* FED. R. CIV. P. 56.

58. 651 F.2d at 693.

59. *Id.* Actions under the federal securities laws are a prime example of such an application. The *Ohio* court quoted Bailey v. Glover, 88 U.S. (21 Wall.) at 349: "[w]e see no reason

for discretion by the court on the issue of plaintiff's discovery and diligence in cases under § 10(b) when the pleadings show that the action would be time-barred but for the equitable doctrine."[60] Thus, the *Ohio* court held that the question of whether to toll the statute of limitations in a securities fraud action may be decided by the trial court pursuant to a motion for summary judgment.[61]

In dicta the court noted that summary disposition of the statute of limitations question is desirable from a policy standpoint. The policy behind statutes of limitations is one of repose,[62] of preventing vexatious and protracted litigation, crowded dockets, delays resulting in ineffective evidence, contingent liabilities, and absent witnesses.[63] Making the statute of limitations defense a jury question "defeats the statute's purpose of preventing trials of stale claims."[64] In actions under section 10(b), where multiple lawsuits may result from the same transaction, the interest in avoiding outdated lawsuits is especially strong.[65]

The court next turned to the level of proof needed to support summary judgment based on a statute of limitations, and decided that summary disposition is appropriate where the defendant shows that the plaintiff would have discovered the fraud before the statute of limitations expired if reasonable diligence had been exercised.[66] This diligence is required regardless of whether the defendant actively attempted to cover up his wrongdoing. The court rejected the defendant's view that attempts to prevent discovery of the fraud tolls the statute of limitations "until actual discovery regardless of diligence."[67] If the evidence before the court is insufficient to demonstrate the plaintiff's lack of diligence, the statute of limitations issue becomes a jury question to be decided by a preponderance of the evidence.[68]

The court cautioned that it would uphold the trial court's exercise of discretion only in cases involving material misstatements about publicly traded securities.[69] Trial courts may have less discretion in summarily ruling on statute of limitations questions in private fraud actions under section 10(b).[70]

The trial court's summary judgment was sustained on several grounds.

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why the principle [of equitable tolling] should not be as applicable to suits tried on the common-law side of the court's calendar as to those on the equity side."

60. 651 F.2d at 693.

61. *Id.* at 693-94. The court, citing Aldrich v. McCulloch Properties, Inc., 627 F.2d at 1042, acknowledged that "the question of whether a plaintiff should have discovered the basis of his suit under the doctrine of equitable tolling does not lend itself to determination as a matter of law." 651 F.2d at 693 n.13. Nevertheless, the court added that this issue is properly subjected to the discretion of the trial judge, because of the equitable origins of tolling. *Id.*

62. 651 F.2d at 694.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.* Thus, the court ruled that in the Tenth Circuit, "there is but one federal doctrine of equitable tolling, as set forth in Holmberg v. Armbrecht." *Id.* at 694-95.

67. *Id.* at 694.

68. *Id.*

69. *Id.* at 694 n.15.

70. *Id.* *Aldrich* and *Dzenits* were private fraud actions under § 10(b), and in both cases the Tenth Circuit was pessimistic about a trial judge's ability to determine adequately the question

Pleadings in previous lawsuits on the same facts and involving the same defendant had revealed information about Lowry's role in the fraud. The plaintiff, if diligent, would have obtained the pleadings and the information contained in them long before the statute of limitations precluded the lawsuit.[71] Mere allegations are sufficient to set the limitations period running; such allegations need not be "supported by hard evidence."[72] Thus the plaintiff had three years[73] after actual or constructive discovery of the fraud in which to obtain evidence sufficient to support a lawsuit. The plaintiff also could have obtained more time for investigation by filing a timely lawsuit, thereby taking advantage of extensions granted for pre-trial discovery.[74] Additionally, Ohio's knowledge that Lowry signed a fraudulent letter of certification, structured the allegedly unsavory transaction, and prepared the relevant documents provided further justification for the trial court's enforcement of the limitations period.[75]

II. Are Subdivided Real Estate Lots Securities?

In *Aldrich v. McCulloch Properties, Inc.*,[76] the plaintiffs' amended complaint alleged that they had purchased real estate lots for investment purposes, after having been enticed by the defendants' promises of appreciations in property value stemming from construction activities on the lots.[77] The lots, therefore, were securities for purposes of the federal securities laws, according to the plaintiffs.[78]

The trial court dismissed the allegations because the necessary elements of a security were not averred in the complaint.[79] The court of appeals remanded the case to the trial court without deciding whether the lots constituted securities, holding only that the plaintiffs' allegations were "sufficient to preclude determination of this issue on a Rule 12(b) motion."[80]

The plaintiffs had asserted that the lots, together with the defendants' promises to develop them, were "investment contracts" and therefore securities under section 2(1) of the Securities Act of 1933[81] and section 3(a)(10) of

of diligence. Aldrich v. McCulloch Properties, Inc., 627 F.2d at 1042; Dzenits v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 494 F.2d at 172.

71. 651 F.2d at 695.

72. *Id.*

73. Colo. Rev. Stat. §§ 13-80-108, -109 (1973).

74. 651 F.2d at 695.

75. *Id.*

76. 627 F.2d 1036 (10th Cir. 1980). The plaintiffs sued under the federal securities laws, as well as under the ILSFDA. A lawsuit under the ILSFDA does not preclude analogous claims under the federal securities laws. *Id.* at 1039 n.2; Jenne v. Amrep Corp., [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,343 at 93,166 (D. N.J. Feb. 14, 1978). *See* Securities Act Release No. 5347, [1972-73] Fed. Sec. L. Rep. (CCH) ¶ 79,163 at 82,536 (Jan. 4, 1973): "[t]he offer of real estate as such, without any collateral arrangements with the seller or others, does not involve the offer of a security. When the real estate is offered in conjunction with certain services, a security, in the form of an investment contract, may be present."

77. 627 F.2d at 1039.

78. *Id.* at 1038.

79. *Id.*

80. *Id.*

81. 15 U.S.C. § 77(b)(1) (1976).

the Securities Exchange Act of 1934.[82] The court stated that this was a factual question—from the plaintiffs' allegations one could infer either an investment in a common enterprise, which is a security, or merely an ordinary real estate purchase.[83] Thus, the court set out guidelines for the trial court's use in determining whether the sale of a security actually had occurred.[84]

The court first applied the test formulated in *SEC v. W.J. Howey, Inc.*,[85] to determine whether the transaction in *Aldrich* constituted an investment contract. *Howey* defines 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 a third party."[86] The plaintiffs' allegations may have satisfied the *Howey* requirements: the plaintiffs claimed the defendants promised to develop the subdivided lots, provide amenities, and establish a trust "to construct and operate facilities for their common benefit."[87] It did not matter that the plaintiffs expected no profits until the property was resold. A transaction may involve an investment contract, and therefore a security, as long as there is an intent to invest and the profits arise from capital appreciation resulting from development of the initial investment.[88] The court cautioned that while "capital appreciation" resulting from planned development characterizes a security, ordinary appreciation in property values resulting from random neighborhood growth and improvements does not.[89]

Furthermore, the lots could have constituted a security even if they were subdivided, that is, sold in individual parcels rather than in undivided shares similar to shares of stock: "[a] common enterprise does not require the sale of undivided interests or an entirely separable and express management contract."[90] Since it was necessary to analyze the underlying transaction carefully to determine whether the characteristics of an investment contract were present, the *Aldrich* court remanded the case to the trial court for this very purpose: "[w]hile. . . it could be inferred that what plaintiffs purchased was not an investment in a common enterprise but merely individual parcels of real estate, resolution of these conflicting inferences was inappropriate without greater factual exploration."[91]

The court next turned to the test expounded in *SEC v. C. M. Joiner Leas-*

82. *Id.* § 78c(a)(10).

83. 627 F.2d at 1039-40.

84. *Id.*

85. 328 U.S. 293 (1946).

86. *Id.* at 298-99.

87. 627 F.2d at 1039.

88. *Id.* (citing United Housing Found'n, Inc., v. Forman, 421 U.S. 837, 852 (1975)). *See also* Timmreck v. Munn, 433 F. Supp. at 401.

89. 627 F.2d at 1039 n.1.

90. *Id.* at 1039. The court was referring to the holding of SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), in which the United States Supreme Court held that the sale of oil lease assignments, where the lessees were to drill for oil on individually owned parcels of property, involved "a form of investment contract in which the purchaser was paying both for a lease and for a development project." 320 U.S. at 349.

91. 627 F.2d at 1039. As of this writing, the action was pending in the federal district court.

ing Corp.,[92] which emphasizes the promotional aspect of the securities sale. This test characterizes a transaction on the basis of what the seller promised: "[t]he test . . . is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[93] Again, this entailed a remand to the trial court to determine exactly what representations the sellers made.[94]

Other criteria set forth in *Aldrich* included the question of whether the plaintiffs purchased the lots primarily for residential purposes or for personal use and enjoyment, without expectation of profit.[95] If so, the lots were not securities.[96] The court also indicated that the trial court should examine whether the developers were obligated to provide significant development services, to the extent that the "burden of management and development . . . rest[s] on the developers."[97] Thus, minimal managerial functions alone do not turn a real estate deal into a security. Under *Howey*, as modified by *SEC v. Glenn W. Turner Enterprises, Inc.*,[98] a transaction constitutes a security if the profits are produced essentially through the efforts of someone other than the investor.[99]

III. STANDARDS AND BURDENS OF PROOF IN INVESTMENT COMPANY VIOLATIONS

In *Decker v. SEC*,[100] the court decided that the standard of proof needed to establish violations of the Investment Company Act of 1940 (ICA)[101] should be the least restrictive one—preponderance of the evidence—even though the petitioners argued in favor of a more stringent standard. The court gave primary consideration to the overall statutory intent to protect investors, concluding that a liberal standard of proof fulfills this statutory intent.

The petitioner, Decker, appealed from a Securities and Exchange Commission (Commission) order censuring him for aiding and abetting a violation of the conflict of interest provisions of the ICA.[102] The alleged conflict of interest involved the relationships between an investment advisory firm, the Forum Corporation (Forum) and its subsidiary Forum Investment Coun-

92. 320 U.S. 344 (1943).
93. *Id.* at 352-53.
94. 627 F.2d at 1040. *See* note 91 *supra*. The court distinguished Woodward v. Terracor, 574 F.2d 1023 (10th Cir. 1978), in which summary judgment was affirmed on the ground that, considering the pleadings, the court "fail[ed] to see any common venture or common enterprise between the plaintiffs and Terracor." 574 F.2d at 1025. *See* McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975), where the court allowed the plaintiffs to amend their pleadings, since they had raised factual questions that precluded summary judgment, although they had not alleged federal securities violations.
95. 627 F.2d at 1040.
96. *Id.*
97. *Id.*
98. 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).
99. 627 F.2d at 1040 n.3. *See also* SEC v. Koscot Interplanetary Inc., 497 F.2d 473 (5th Cir. 1974).
100. 631 F.2d 1380 (10th Cir. 1980).
101. 15 U.S.C. § 80a-1 (1976).
102. 631 F.2d at 1382. The provision allegedly violated was 15 U.S.C. § 80a-17(e)(1) (1976).

selors, Inc. (FIC), and a brokerage firm, Jesup & Lamont, Inc. (J & L) and its subsidiary Jesup & Lamont International Limited (J & L International). J & L International allegedly made illegal payments to FIC to induce Forum to use J & L to handle the affairs of Forum's clients. Pursuant to a contract, FIC was to provide investment and research services to J & L International in exchange for $25,000 per year. The Commission sued, claiming the payments were actually intended to be, at least in part, compensation to Forum for increasing its volume of business with J & L.[103] The Commission alleged this was a violation of section 17(e)(1) of the ICA.[104]

Section 17 of the ICA generally prohibits transactions creating conflicts of interests in the relationships between investment companies and their investment advisors, principal underwriters, and other affiliates, without the Commission's advance approval.[105] Section 17(e)(1) in particular limits the compensation, regardless of its source, that affiliated agents of registered investment companies may receive for purchasing or selling property to or on behalf of the registered investment company.[106] The Commission alleged that Forum's brokerage business was illegally allocated to its affiliate, J & L, as a consequence of the agreement between the two firms' subsidiaries.

The case was tried before an administrative law judge (ALJ). The ALJ applied a "clear and convincing" standard of proof, and concluded that the Commission's Enforcement Division failed to establish a nexus between the compensation J & L International paid to FIC and the brokerage business Forum allocated to J & L. The ALJ also decided the Enforcement Division had not proven that the services performed by FIC for J & L International were worth less than the $25,000 paid annually from J & L International to FIC.[107] The ALJ's decision was appealed to the Commission, which reversed and found that Decker willfully aided and abetted a section 17(e)(1) violation.[108] The Commission did not discuss the standard of proof it used in its determinations. Pursuant to section 203(e)(5) of the Investment Advisors Act,[109] the Commission censured Decker for his role in the violation.

The Tenth Circuit affirmed the Commission's decision on the ground that the "preponderance of the evidence" standard of proof is the correct standard to use in establishing ICA violations. Decker had argued that the intermediate "clear and convincing" standard was proper because the Com-

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103. 631 F.2d at 1382.

104. 15 U.S.C. § 80a-17(e)(1) (1976).

105. *See* Rosenblat & Lybecker, *Some Thoughts on the Federal Securities Laws Regulating External Investment Management Arrangements and the ALI Federal Securities Code Project*, 124 U. PA. L. REV. 587, 598 (1976).

106. 15 U.S.C. § 80a-17(e)(1) (1976) provides:

> (e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—
>
> (1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker. . . .

107. 631 F.2d at 1383.

108. *Id.*

109. 15 U.S.C. § 80b-3(e)(5) (1976).

mission alleged fraud, which carries potentially severe sanctions.[110] The United States Supreme Court had approved the clear and convincing standard for use in civil cases "involving allegations of fraud or some other quasi-criminal wrongdoing by the defendant,"[111] where the interests at stake are more than merely pecuniary ones and may be reputational, or may involve individual liberties.[112] The Court established a balancing test to determine which standard of proof to use in such cases: The individual's interests are weighed against the interests of society in deciding how to allocate the risk of error.[113] In *Decker*, the court of appeals applied this balancing test and decided in favor of the "preponderance of the evidence" standard. Since the primary purpose of the ICA is to protect investors, such a purpose takes priority over the possibility of unjust injury to the defendants involved in the litigation.[114] Therefore the court found, in balancing individual interests against those of the public, that "primary consideration must be given to the statutory intent to protect investors,"[115] and endorsed the use of the "preponderance of the evidence" standard in cases involving violations of section 17(e)(1) of the ICA.

The *Decker* court next stated that because section 17(e)(1) prohibits the receipt of compensation for the purchase or sale of property to or for an investment company, a nexus must be established between the compensation received and the property bought or sold, in order to prove a section 17(e)(1) violation. The compensation must have been received for the transaction in question, although intent to influence need not be shown.[116] It is not sufficient merely to show that a conflict of interest existed with respect to the allocation of brokerage business.[117] The court agreed with Decker that to interpret section 17(e)(1) to prohibit *per se* conflicts of interest without requiring a showing of the actual purpose of the compensation received is "too expansive."[118]

Thus, the court continued, when a conflict of interest is demonstrated, for example, when the Commission shows that compensation was received in exchange for the purchase or sale of investment company property, a presumption of a section 17(e)(1) violation arises. The burden then shifts to the defendant to show that the compensation creating the conflict of interest was not in violation of section 17(e)(1). In Decker's case, the compensation received in exchange for increased brokerage business presented a presumption of a violation.[119] The court, in affirming the Commission's ruling and clarifying the law, carefully summarized the procedure for proving a section

110. 631 F.2d at 1383-84. Such sanctions include censure, placing of limitations on, or suspension or revocation of, an investment advisor's registration. 15 U.S.C. § 80b-3(e)(5) (1976).

111. Addington v. Texas, 441 U.S. 418, 424 (1979).

112. *E.g.*, *Addington* applied the clear and convincing standard to a proceeding to commit an individual to a state mental hospital indefinitely. *Id.* at 419-20.

113. *Id.* at 425.

114. 631 F.2d at 1384.

115. *Id.* (quoting Associated Sec. Corp. v. SEC, 283 F.2d 773, 775 (10th Cir. 1960)).

116. 631 F.2d at 1384-85.

117. *Id.*

118. *Id.* at 1384.

119. *Id.* at 1385. *See* Investors Research Corp. v. SEC, 628 F.2d 168, 175 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980).

17(e)(1) violation. First, the Enforcement Division must prove each element of the violation by a preponderance of the evidence. When the Enforcement Division presents prima facie evidence of a conflict of interest (in the allocation of brokerage business, in this case), the burden shifts to the defendant to show that no compensation was received illegally for the sale or purchase of investment company property. If the defendant produces such evidence, the presumption vanishes, and the Commission must "consider all relevant evidence and determine whether the Enforcement Division established its case by a preponderance of the evidence."[120]

In light of the command to consider all relevant evidence, the court remanded the case to the Commission for reconsideration of evidence that the Commission had disregarded. The testimony of Decker's expert witnesses, who testified that the fair market value of the services performed by FIC for J & L International equalled the sum actually paid, was disregarded on the ground of subjectivity.[121] Even though the court expressed doubt that the transactions would be rendered valid if the services were actually worth the compensation paid,[122] it nevertheless remanded the case to the trial court, stating that no rule of law was known that would permit a court or agency to discount valuation evidence properly received in the record.[123]

IV. State of Mind and the Imposition of Sanctions

One who violates a provision of the ICA may have sanctions levied against him only if the Commission finds that he acted willfully.[124] To levy sanctions against aiders and abettors such as the petitioner in *Decker*, however, requires a higher standard. Because aiding and abetting liability is a still unpolished facet of the securities regulation scheme,[125] the Commission and court turned to a recent District of Columbia Circuit case, *Investors Research Corp. v. SEC*,[126] for guidance.

In *Investors Research Corp.*, the court first concluded that a violation of section 17(e)(1) does not require an awareness of wrongdoing.[127] The *Decker* court agreed, on the basis that section 17(e)(1) contains no language requir-

120. 631 F.2d at 1385 n.7.

121. *Id.* at 1385-86. No objective evidence of market value existed since FIC did not sell the services in question to anyone but J & L International. Thus, there were no other arm's length transactions with which one could compare FIC's dealings with J & L International. *Id.*

122. *Id.* at 1385 n.8.

123. *Id.* at 1386.

124. *Id.* The *Decker* court quoted Tager v. SEC, 344 F. 2d 5, 8 (2d Cir. 1965): " 'willfully' in this context means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules or Acts."

125. 631 F.2d at 1387.

126. 628 F.2d 168 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980).

127. As the *Decker* court pointed out, 631 F.2d at 1387 n.13, "awareness of wrongdoing" is not the same as "scienter." "Scienter" is defined in Ernst & Ernst v. Hochfelder, 425 U.S. at 193 n.12, as a "mental state embracing intent to deceive, manipulate, or defraud." The mental state referred to in *Investors Research Corp.* and in *Decker* is merely a general awareness that one is involved in an improper activity; intent to deceive is not necessary. Decker v. SEC, 631 F.2d at 1386-87; Investors Research Corp. v. SEC, 628 F.2d at 178. For a discussion of scienter in the Tenth Circuit, see *Securities, Seventh Annual Tenth Circuit Survey*, 58 DEN. L.J. 489 (1981); Note, *Aaron v. SEC: The Scienter Requirement in SEC Injunctive Actions, Seventh Annual Tenth Circuit Survey*, 58 DEN. L.J. 493 (1981).

ing awareness of wrongdoing for primary liability. The United States Supreme Court has maintained that statutory language principally determines whether a particular state of mind is a required element of a securities violation.[128] Since no state of mind requirement is evident from the language of section 17(e)(1), a primary violator may be punished even if he was not aware he was committing a wrongful act.

Both the *Investors Research Corp.* court and the *Decker* court agreed, however, that aiders and abettors of section 17(e)(1) violations constitute a different class. In order to punish aiders and abettors, the requisite state of mind, which is "an awareness of wrongdoing,"[129] must be proven, "to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh, [sic] civil, criminal, or administrative penalties."[130]

The *Decker* court remanded the case to the Commission on this issue as well, to determine whether Decker possessed an awareness of wrongdoing sufficient to sustain the commission's censure[131] for aiding and abetting an ICA violation.[132]

V. Rule 10b-5 and Litigation-Financing Securities

The United States Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[133] adopted the *Birnbaum*[134] rule, which limits the class of plaintiffs in private rule 10b-5 actions to actual purchasers or sellers of securities.[135] Nevertheless, a recent Tenth Circuit case, *Westinghouse Credit Corp. v. Bader & Dufty*,[136] raised the question of whether a defendant in a lawsuit may sue for injunctive relief under section 10(b) of the Securities Exchange Act of 1934[137] and rule 10b-5,[138] to prevent the plaintiff and the plaintiff's legal counsel from illegally issuing securities to finance the lawsuit against the defendant. The securities allegedly consisted of agreements to share the fruits of the litigation.[139]

Westinghouse Credit Corporation, the original defendant, acknowledged that the *Blue Chip Stamps* holding precluded those who did not purchase or sell securities from suing under rule 10b-5.[140] Westinghouse also acknowledged that it did not purchase or sell the securities offered by Woodmoor Corporation, the original plaintiff.[141] Westinghouse argued, however, that it had standing to sue on the ground that the *Blue Chip Stamps* holding is

128. Aaron v. SEC, 446 U.S. 680, 695-96 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. at 197.
129. *See* note 127 *supra*.
130. 631 F.2d at 1388 (quoting Investors Research Corp. v. SEC, 628 F.2d at 177).
131. Pursuant to § 203(e)(5) of the Investment Advisers Act, 15 U.S.C. § 80b-3(e)(5) (1976).
132. 631 F.2d at 1388-89.
133. 421 U.S. 723 (1975).
134. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).
135. 421 U.S. at 736, 749.
136. 627 F.2d 221 (10th Cir. 1980).
137. 15 U.S.C. § 78j(b) (1976).
138. 17 C.F.R. § 240.10b-5 (1981).
139. 627 F.2d at 222.
140. *Id* at 223.
141. *Id*.

inapplicable to actions where the only relief sought is injunctive. A previous Tenth Circuit case, *Vincent v. Moench*,[142] was offered for the proposition that whenever equitable relief under rule 10b-5 is sought, "any person showing a 'causal connection' between the fraudulent sale of a security and an injury to himself may invoke federal jurisdiction."[143]

The *Westinghouse* court affirmed the trial court's dismissal of Westinghouse's suit. The issue of Westinghouse's standing to sue was resolved pursuant to the *Vincent* rule rather than the more restrictive *Blue Chip Stamps* rule: "[w]e do not feel compelled to here decide whether the rule of *Blue Chip Stamps* applies to a private action under Rule 10b-5 which is purely injunctive in nature, since in our view Westinghouse does not have standing even under the rule of *Vincent*."[144]

The court pointed out that the "causal connection" rule of *Vincent* requires a direct association between the fraudulent sale and the plaintiff's injury.[145] Mere allegations of "a scheme to defraud, a deceptive purchase of a security, and an injury to the plaintiffs"[146] are not sufficient to invoke federal jurisdiction; the injury must ensue directly from the fraudulent sale of a security. According to the court, the *Vincent* rule, applied to the facts of *Westinghouse*, revealed at best an indirect connection between the sale of profit-sharing agreements and the maintenance of litigation against Westinghouse[147] (even though Westinghouse alleged that without the sale of the profit-sharing agreements, Woodmoor would be unable to finance or to pursue its lawsuit against Westinghouse).[148] Furthermore, the court expressed doubt that the securities statutes contemplated litigation as an injury worthy of standing to sue.[149]

Westinghouse also claimed standing on the ground that Woodmoor's failure to register its securities and to report to the Commission, as required by law,[150] deprived Westinghouse of information it could use to defend the lawsuit.[151] The court dismissed this assertion on the basis that the registration and reporting requirements of the securities laws were not designed to facilitate discovery in securities litigation; rather, they were enacted to help the investing public make informed investment decisions.[152] Hence, Westinghouse did not have standing to challenge Woodmoor's failure to register and report to the Commission.

Westinghouse is a narrow holding and thus leaves many questions unanswered. First, and most obvious, is whether the *Blue Chip Stamps* holding

142. 473 F.2d 430 (10th Cir. 1973).
143. 627 F.2d at 223 (citing Vincent v. Moench, 473 F.2d at 435).
144. 627 F.2d at 223.
145. *Id.* (citing Vincent v. Moench, 473 F.2d at 435).
146. 627 F.2d at 223.
147. *Id.*
148. *Id.* at 222.
149. *Id.* at 224.
150. Securities Act of 1933 § 5, 15 U.S.C. § 77(e) (1976); Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m(a) (1976).
151. 627 F.2d at 224.
152. *Id.* (citing SEC v. Continental Tobacco Co., 463 F.2d 137, 154 (5th Cir. 1972); Greater Iowa Corp. v. McLendon, 378 F.2d 783, 790 (8th Cir. 1967)).

denies standing to non-purchasers or non-sellers who seek only injunctive relief under rule 10b-5. But a larger question looms: whether *Westinghouse* has demonstrated the need for new remedies for third parties who indirectly are affected by fraudulent securities transactions in which they have not partaken.

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