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66 S.Ct. 1100
Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION
v.
W. J. HOWEY CO. et al.

No. 843.
|
Argued May 2, 1946.
|
Decided May 27, 1946.
|
Rehearing Denied Oct. 14, 1946.

See 67 S.Ct. 27.

Synopsis
Suit by the Securities and Exchange Commission against W. J. Howey Company and Howey-in-the-Hills Service, Inc., to restrain alleged violations of the Securities Act. To review a judgment of the Circuit Court of Appeals, 151 F.2d 714, affirming a judgment of the District Court, 60 F.Supp. 440, for defendants, plaintiff brings certiorari.

Reversed.

Mr. Justice FRANKFURTER dissenting.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

West Headnotes (4)

[1] **Securities Regulation** In general; investment contracts

An "investment contract", as used in the Securities Act, means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from efforts of promoter or a third party, it being immaterial whether shares in enterprise are evidenced by formal certificate or by nominal interests in physical assets employed in enterprise. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1).

1359 Cases that cite this headnote

[2] **Securities Regulation** In general; investment contracts

Congress by including the term "investment contract" in Securities Act as one of the things constituting a security required to be registered, without further definition of term, intended that term be given meaning which had been crystallized by prior judicial interpretation thereof as used in various state "blue sky" laws. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1).

67 Cases that cite this headnote

[3] **Securities Regulation** Real estate contracts; condominium interests

Corporations, offering opportunity to contribute money and to share in profits of a large citrus fruit enterprise managed and partly owned by corporations to persons residing in distant localities who lack equipment and experience requisite to operation of a citrus grove through medium of service contracts and land sales contracts and warranty deeds, which serve as a convenient method of determining investors' allocable shares of profits, were offering "investment contracts" within meaning of Securities Act requirement for registering such contracts as nonexempt securities, notwithstanding that some purchasers chose not to accept full offer of investment contract by declining to enter into a service contract. Securities Act of 1933, §§ 2(1, 3), 3(b), 5(a), 15 U.S.C.A. §§ 77b(1, 3), 77c(b), 77e(a).

971 Cases that cite this headnote

[4] **Securities Regulation** In general; investment contracts

The test of an investment contract within Securities Act is whether scheme involves an investment of money in a common enterprise with profits to come solely from efforts of others, and, if test is satisfied, it is immaterial whether enterprise is speculative or nonspeculative or whether there is a sale of property with or without intrinsic value. Securities Act of 1933, §§ 2(1, 3), 3(b), 5(a), 15 U.S.C.A. §§ 77b(1, 3), 77c(b), 77e(a).

1354 Cases that cite this headnote

Attorneys and Law Firms

****1100** ***294** Mr. Roger S. Foster, of Philadelphia, Pa., for petitioner.

****1101** Messrs. C. E. Duncan, of Tavares, Fla., and George C. Bedell, of Jacksonville, Fla., for respondents.

Opinion

Mr. Justice MURPHY delivered the opinion of the Court.

This case involves the application of s 2(1) of the Securities Act of 1933 [1] to an offering of units of a citrus grove development coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor.

1 48 Stat. 74, 15 U.S.C. s 77b(1), 15 U.S.C.A. s 77b(1).

The Securities and Exchange Commission instituted this action to restrain the respondents from using the mails and instrumentalities of interstate commerce in the offer and sale of unregistered and nonexempt securities in violation of s 5(a) of the Act, 15 U.S.C.A. s 77e(a). The District Court denied the injunction, 60 F.Supp. 440, and the Fifth Circuit Court of Appeals affirmed the judgment, 151 F.2d 714. We granted certiorari, 327 U.S. 773, 66 S.Ct. 821, on a petition alleging that the ruling of the Circuit Court of Appeals conflicted with other federal and state decisions and that it introduced a novel and unwarranted test under the statute which the Commission regarded as administratively impractical.

Most of the facts are stipulated. The respondents, W. J. Howey Company and Howey-in-the-Hills Service ***295** Inc., are Florida corporations under direct common control and management. The Howey Company owns large tracts of citrus acreage in Lake County, Florida. During the past several years it has planted about 500 acres annually, keeping half of the groves itself and offering the other half to the public 'to help us finance additional development.' Howey-in-the-Hills Service, Inc., is a service company engaged in cultivating and developing many of these groves, including the harvesting and marketing of the crops.

Each prospective customer is offered both a land sales contract and a service contract, after having been told that it is not feasible to invest in a grove unless service arrangements are made. While the purchaser is free to make arrangements with other service companies, the superiority of Howey-in-the-Hills Service, Inc., is stressed. Indeed, 85% of the acreage sold during the 3-year period ending May 31, 1943, was covered by service contracts with Howey-in-the-Hills Service, Inc.

The land sales contract with the Howey Company provides for a uniform purchase price per acre or fraction thereof, varying in amount only in accordance with the number of years the particular plot has been planted with citrus trees. Upon full payment of the purchase price the land is conveyed to the purchaser by warranty deed. Purchases are usually made in narrow strips of land arranged so that an acre consists of a row of 48 trees. During the period between February 1, 1941, and May 31, 1943, 31 of the 42 persons making purchases bought less than 5 acres each. The average holding of these 31 persons was 1.33 acres and sales of as little as 0.65, 0.7 and 0.73 of an acre were made. These tracts are not separately fenced and the sole indication of several ownership is found in small land marks intelligible only through a plat book record.

***296** The service contract, generally of a 10-year duration without option of cancellation, gives Howey-in-the-Hills Service, Inc., a leasehold interest and 'full and complete' possession of the acreage. For a specified fee plus the cost of labor and materials, the company is given full discretion and authority over the cultivation of the groves and the harvest and marketing of the crops. The company is well established in the citrus business and maintains a large force of skilled personnel and a great deal of equipment, including 75 tractors, sprayer wagons, fertilizer trucks and the like. Without the consent of the company, the land owner or purchaser has no right of entry to market the crop; [2] ****1102** thus there is ordinarily no right to specific fruit. The company is accountable only for an allocation of the net profits based upon a check made at the time of picking. All the produce is pooled by the respondent companies, which do business under their own names.

2 Some investors visited their particular plots annually, making suggestions as to care and cultivation, but without any legal rights in the matters.

The purchasers for the most part are non-residents of Florida. They are predominantly business and professional people who lack the knowledge, skill and equipment necessary for the care and cultivation of citrus trees. They are attracted by the expectation of substantial profits. It was represented, for example, that profits during the 1943—1944 season amounted to 20% and that even greater profits might be expected during the 1944—1945 season, although only a 10% annual return was to be expected over a 10-year period. Many of these purchasers are patrons of a resort hotel owned and operated by the Howey Company in a scenic section adjacent to the groves. The hotel's advertising mentions the fine groves in the vicinity and the attention of the patrons is drawn to the ***297** groves as they are being escorted about the surrounding countryside. They are told that the groves are for sale; if they indicate an interest in the matter they are then given a sales talk.

It is admitted that the mails and instrumentalities of interstate commerce are used in the sale of the land and service contracts and that no registration statement or letter of notification has ever been filed with the Commission in accordance with the Securities Act of 1933 and the rules and regulations thereunder.

Section 2(1) of the Act defines the term 'security' to include the commonly known documents traded for speculation or investment.[3] This definition also includes 'securities' of a more variable character, designated by such descriptive terms as 'certificate of interest or participation in any profit-sharing agreement,' 'investment contract' and 'in general, any interest or instrument commonly known as a 'security.'' The legal issue in this case turns upon a determination of whether, under the circumstances, the land sales contract, the warranty deed and the service contract together constitute an 'investment contract' within the meaning of s 2(1). An affirmative answer brings into operation the registration requirements of s 5(a), unless the security is granted an exemption under s 3(b), 15 U.S.C.A. s 77c(b). The lower courts, in reaching a negative answer to this problem, treated the contracts and deeds ***298** as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer.

3 'The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, 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.'

[1] **[2]** The term 'investment contract' is undefined by the Securities Act or by relevant legislative reports. But the term was common in many state 'blue sky' laws in existence prior to the adoption of the federal statute and, although the term was also undefined by the state laws, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality. An investment contract thus came to mean a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.' State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938. This definition was uniformly applied by state courts to a variety of situations ****1103** where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of some one other than themselves.[4]

4 State v. Evans, 154 Minn. 95, 191 N.W. 425, 27 A.L.R. 1165; Klatt v. Guaranteed Bond Co., 213 Wis. 12, 250 N.W. 825; State v. Health, 199 N.C. 135, 153 S.E. 855, 87 A.L.R. 37; Prohaska v. Hemmer-Miller Development Co., 256 Ill.App. 331; People v. White, 124 Cal.App. 548, 12 P.2d 1078; Stevens v. Liberty Packing Corp., 111 N.J.Eq. 61, 161 A. 193. See also Moore v. Stella, 52 Cal.App.2d 766, 127 P.2d 300.

By including an investment contract within the scope of s 2(1) of the Securities Act, Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims. In other words, an investment contract for purposes of the Securities Act means a contract, transaction ***299** 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in Securities Exch. Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88, and has been enunciated and applied many times by lower federal courts. [5] It permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security.' H.Rep.No.85, 73rd Cong., 1st Sess., p. 11. It embodies 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.

5 Atherton v. United States, 9 Cir.,. 128 F.2d 463; Penfield Co. of California v. S.E. C., 9 Cir., 143 F.2d 746; S.E.C. v. Universal Service Association, 7 Cir., 106 F.2d 232; S.E.C. v. Crude Oil Corp., 7 Cir., 93 F.2d 844; S.E.C. v. Bailey, D.C., 41 F.Supp. 647; S.E.C. v. Payne, D.C., 35 F.Supp. 873; S.E.C. v. Bourbon Sales Corp., D.C., 47 F.Supp. 70; S.E.C. v. Wickham, D.C., 12 F.Supp. 245; S.E.C. v. Timetrust, Inc., D.C., 28 F.Supp. 34; S.E.C. v. Pyne, D.C., 33 F.Supp. 988. The Commission has followed the same definition in its own administrative proceedings. In re Natural Resources Corporation, 8 S.E.C. 635.

[3] The transactions in this case clearly involve investment contracts as so defined. The respondent companies are offering something more than fee simple interests in land, something different from a farm or orchard coupled with management services. They are offering an opportunity to contribute money and to share in the profits of a large citrus fruit enterprise managed and partly owned by respondents. They are offering this opportunity to persons who reside in distant localities and who lack the equipment ***300** and experience requisite to the cultivation, harvesting and marketing of the citrus products. Such persons have no desire to occupy the land or to develop it themselves; they are attracted solely by the prospects of a return on their investment. Indeed, individual development of the plots of land that are offered and sold would seldom be economically feasible due to their small size. Such tracts gain utility as citrus groves only when cultivated and developed as component parts of a larger area. A common enterprise managed by respondents or third parties with adequate personnel and equipment is therefore essential if the investors are to achieve their paramount aim of a return on their investments. Their respective shares in this enterprise are evidenced by land sales contracts and warranty deeds, which serve as a convenient method of determining the investors' allocable shares of the profits. The resulting transfer of rights in land is purely incidental.

****1104** Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed. The investment contracts in this instance take the form of land sales contracts, warranty deeds and service contracts which respondents offer to prospective investors. And respondents' failure to abide by the statutory and administrative rules in making such offerings, even though the failure result from a bona fide mistake as to the law, cannot be sanctioned under the Act.

This conclusion is unaffected by the fact that some purchasers choose not to accept the full offer of an investment contract by declining to enter into a service contract with ***301** the respondents. The Securities Act prohibits the offer as well as the sale of unregistered, non-exempt securities. [6] Hence it is enough that the respondents merely offer the essential ingredients of an investment contract.

6 The registration requirements of s 5 refer to sales of securities. Section 2(3) defines 'sale' to include every 'attempt or offer to dispose of, or solicitation of an offer to buy,' a security for value.

[4] We reject the suggestion of the Circuit Court of Appeals, 151 F.2d at page 717, that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative or whether there is a sale of property with or without intrinsic value. See S.E.C. v. C. M. Joiner Leasing Corp., supra, 320 U.S. 352, 64 S.Ct. 124, 88 L.Ed. 88. The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae.

Reversed.

Mr. Justice JACKSON took no part in the consideration or decision of this case.

Mr. Justice FRANKFURTER dissenting.

'Investment contract' is not a term of art; it is conception dependent upon the circumstances of a particular situation. If this case came before us on a finding authorized by Congress that the facts disclosed an 'investment contract' within the general scope of s 2(1) of the Securities Act, 48 Stat. 74, 15 U.S.C. s 77b(1), 15 U.S.C.A. s 77b(1), the Securities and Exchange Commission's finding would govern, unless, on the record, it was wholly unsupported. But ***302** that is not the case before us. Here the ascertainment of the existence of an 'investment contract' had to be made independently by the District Court and it found against its existence. 60 F.Supp. 440. The Circuit Court of Appeals for the Fifth Circuit sustained that finding. 151 F.2d 714. If respect is to be paid to the wise rule of judicial administration under which this Court does not upset concurrent findings of two lower courts in the ascertainment of facts and the relevant inferences to be drawn from them, this case clearly calls for its application. See Allen v. Trust Co. of Georgia, 326 U.S. 630, 66 S.Ct. 389. For the crucial issue in this case turns on whether the contracts for the land and the contracts for the management of the property were in reality separate agreements or merely parts of a single transaction. It is clear from its opinion that the District Court was warranted in its conclusion that the record does not establish the existence of an investment contract:

'* * * the record in this case shows that not a single sale of citrus grove property ****1105** was made by the Howey Company during the period involved in this suit, except to purchasers who actually inspected the property before purchasing the same. The record further discloses that no purchaser is required to engage the Service Company to care for his property and that of the fifty-one purchasers acquiring property during this period, only forty-two entered into contract with the Service Company for the care of the property.' 60 F.Supp. at page 442.

Simply because other arrangements may have the appearances of this transaction but are employed as an evasion of the Securities Act does not mean that the present contracts were evasive. I find nothing in the Securities Act to indicate that Congress meant to bring every innocent transaction within the scope of the Act simply because a perversion of them is covered by the Act.

All Citations

328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244, 163 A.L.R. 1043

940 F.2d 564
United States Court of Appeals,
Tenth Circuit.

William T. USELTON; W.D. Hupp; C.J. Dowling; Kenneth Miles; G.D. Jeffcoat; Jack Wilson; K.D. Witt; Paula Rosa; Johnny S. Hunt; James A. Mason; Robert E. Stuart; Jerry Don Casey; Maurice Uhrmacher; Loyd A. Duncan; Vernon Jordan; Hubert D. Williamson; J.W. Haris; D.L. Haralson; Harvey Leo Hess; Wood G. Ishmael; Harold W. Summers; Charles E. Stockton; Joe C. Gray; Earl G. Jackson; E.L. Whilhock; Melvin Carpenter; Robert T. Keener; Troy G. Carson; Jack L. Blankinship; Carl L. Davidson; J.F. Maxwell; Paul M. Warren; Jay W. Harned; E.H. Coulter; Earl E. White; Cleo C. McDaniel; Bobby F. Stansbury; Bill J. Anderson; Daniel A. Denny; Carl Lee Wilson; Leroy Barrett; James E. Lee; Donald L. Butler; L.W. Gonzales; Daisy “Maurene” Davis; Keith W. Braul; Jerry L. Edgemon; Gilbert L. Robles; Loyd E. Courtney; Hollis M. Mauldin; Johnny L. Johnson; Carmel M. Doern; Tom Thelkekd; T.L. Jones; Kenneth W. Hays; Jackie Jones; William Donley; Howard L. Mitchell; Earl D. Denton; Stanley R. Gomes; Jack P. Rowland; K.L. Billingsley; Earl L. Woffard; D. Td. Frizell; H.W. Richardson; Donald Kendrix; Betty Cox; James M. Woodward; Frank Donald R. Winter Jack Yarbrough; Finis M. Yocum; Tommy L. Kirkland; John A. Moyshen; Harold Allison; Marion McClelland; Leslie R. Walcher; Lloyd Fortune, Sr.; B.C. Evans; Raymond B. Horn; Leeha McCormick; Pete Wolf; Leon Hancock; William Anderson; Robert G. Porter; Eldon W. Bishop; E.B. Copeland; D.K. Hanshue; E.G. Dedmon; Leslie R. Walcher; Carl L. Holman; Kenneth W. Jackson; Joel Robinson; Charles Pemberton; Bruce O. Smith; T.D. Jack; James T. Johnson; Willie G. Loudermilk; Raymond Horn; George C. Tsoodle; Gerold L. Goad; B.J. Burrell; D.Y. Qualine; Frances M. McKye; Alonzo Anderson; Hoarce E. Reeves; Betty Moore; Billy R. Jenkins; Jerry A. Warren; C.J. Womack; Johnny Ballard; Kelley Ruminer; Deborah Yandell; Robert Ferguson; Claudie C. Weaver; John O. Stanley; William R. Bricker; Elen H. Spiva; Phillip Horne; Earl V. Griffin; Anna M. Burkett; James E. Neal; James McCampbell; Valorie Booker; J.W. Rackley; Ronnie J. Steward; Clarence Burns; John L. Knapp; Ramon L. Wolfe; W.A. Smith; Alan Prudhome; James E. Thompson; Henry S. Baxter; Patsy R. Brock; Larry Joe Stafford; Daniel Looney; Byron A. Bouchelle; Carl F. Davis; Jerry I. Poindexter; Lee Roy Houston; Clinton H. Reynolds; Nib E. Hill; David R. Hines; C.G. Olson; Cleophos Frost; Bobby G. Decker; James Long; Lorita A. Goya; Wayne T. Wells; Gerald A. Luton; Harold Shea; Johnnie T. Henson, Jr.; Opal Lee Broussard; Homer Kimble; Jerry Nohnager; Judy A. Rogers; Ilona Garrison Edward A. King; Alyce L. King; Evert L. Carroll; Ben H. Marshall; Shirley J. Lamb; John William Edwards; Maurice Cannon; Leroy Phelps; J.D. Burkhalter; Rickki L. Barnes; Bob J. Sharber; William D. Sandell; William E. Shockley; Don Cutler; Nancy A. Bomhoff; Vaughn Bryant; Warren Rex Chapin; Herman L. Klaus; Willie L. Wixom; Billy O. Hawkins; Jack D. Edwards; Rita Henry; Carl Holiday; Douglas Messel; Diane J. Trigg; Tommy A. Howard; Norvell Lancaster; Bobby Bowling; P.J. Warren; Robert C. Anderson; Doyle C. Adams; Glenn D. Christians; Willard Terry; Bill Stewart; Jimmy King; Richard Borne; Johnny Warmoth; Franklin A. Nieley; Charles Norton; Glen Layton; Leo Thompson; D.L. Loman; Marland Glover; Bobby Bennett; Jerry Chronister; Lawrence White; Donald Fitz; Odis Ward; Donald T. Kendrix; Ruel L. Monroe; Randall Johnston; Douglas Webb; Roger L. Smith; Benny Shumway; Bobby Johnson; Theal Crews; Arnett Richardson; Junior Lee Golden; Jim Bob Keith; Bob L. Wilkerson; Jerry R. Kennedy; James L. Freeman; Marvin E. Meek; Leroy Gray; Leroy Hill; Lealus Thomas; A.W. Barnett; Donald L. Mayfield; Jimmie Masters; Jmwa E. Poerwe; James E. Young; Rickey D. Allen; William W. Partin; James E. Vap; Edith J. Vap; John Reynolds; Arthur Golden; Joe C. Nixon; Willie Joseph; John H. Heil Donald H. Brechinsen; James Altizen; William T. Wimmer; I.B. Boyd; E. Ferrell Bussing; Jimmie L. Williams; Roy J. Sassano, Sr.; Eleanor C. Mowery;

Eugene D. Rider; George W. Baldwin; Garland R. Hooper; Earl Joslin; Karen Nydick; Gerold Wagner; L.V. Foreman; Don Lepley; E.J. Fidler; Claude W. Woeley; Fred M. Silver; Herbert L. Keith; Carl E. Davis; Paul Goodman; Ronald C. Daudill; William P. Dodd; Dennis S. Crews; Willis D. Keesee; Jerry D. Bass; R.T. Skelton; Delbert D. Utsler; Don E. Bailey; Howard Whittenberg; Marcia C. Long; A.C. Phillips; Jo Ann Martin; Leon Combs; Jerry C. Forbes; J.R. Bishop; Billy Reeves; Farrell J. Pickens; James Richard Howells; Lawrence Shelton; Charles Huckabee; Jmwa Axheowswe; Thomas Jaramillo; J. David Smith; W.T. Young; Carl H. Davison; Sharon Key Harris; Lew F. Fresonke; Joe Knapp; Lesley E. Chapman; R.D. Bivins; George W. Barton; Marion A. Neal; Rebecca Crawford; Deatron I. Morgan; W.H. Nevels; Jim Oliver; Clarence E. Smith; Robert Wilson; Linda Lekawski; Michael Fundstein; Jerry L. Bender; William D. Beery; Donald M. Larson; William J. Azlin; Dwight W. Rogers; Judy A. Rogers; Walter R. Lewis; Charles Huckaboy; Barbara Harwell; Rebecca Pearson; Molly Hoffman; Patricia McCanlies; K.E. Sterrett; Thurman B. Nelson Nelda M. Carroll; Johnny Wallace; Guadalupe Rodriguez; Raymond Davey; L.V. Davis; Bobby D. Price; Gary L. Passon; Lanora Workman; John Davenport; Jimmie D. Jennings; Leo Scruggs; Dallas Niblock; Leo Suggs; Stanley W. Moore; John D. Horn; Anthony Spitzley; Manual Sena; James F. Ayres; Daniel A. Sikorsky; Albert E. Oyos; C.D. Ridgley; Earl Greene; Salvador C. Perez; Cesar B. Sheen; Joe Manuel; Benjamin Saenz; Arturo C. Marquez; Edward Lavelle; Robert Rognon; Bernardo Saenz; Protacio S. Abrego; Steven Moylan; Carl M. Lavender; Ruben D. Cota; Manuel F. Gamez; Narcizo Reaza; Frank M. Hernandez; Ronald Murdock; Jesse Terrazas; Jimmie Rodriguez; Manuel R. Barrera; Howard Wing; Robert R. Contreras; Joe C. Nixon; Oscar J. Munoz; Theresa A. Wright; Dora Perkins; W.H. Hohensee; W.R. Gunn; Bob Kwnnixurr; Kenneth D. Williams; Javier Adame; Manuel M. Holquin; Harry Hill; Rick Skinner; Harold Mitchell; Vince Wolpoff; Warren Yoder; William Salinas; John D. Lent; Carl Christensen; J.M. Ferez; Lisardo Jaramillo; Henry L. Hoskison; Bill Bass; Bob Rognon; Fred Walling; Hector R. Mendoza; Martin Bautista; Daniel A. Merkle; Roger A. Peterson; Jack L. Bynum; Joel E. Henderson, Sr.; Marvin L. Wright; C.R. Blades; Rolando L. Galindo Esequiel Barcena; Floyd L. Biddlecome, Sr.; Ramon A. Rodriguez; Ruben Williams; Alva J. Chaney, Jr.; Ceasar Val Verde; Gilbert Hernandez; Victor Juarez; John L. Washington; David L. Carney; Thomas Jaranille; James D. Weston; Ronald R. Murdock; Tony C. Gonzales; Richard A. Sanchez; Shirley F. Bennett; Bobby Derring; Fulton Marks, Jr.; Adolfo Elias, Jr.; D. Patrick Wright; Norman E. Cardwell; Robert M. Ferguson; Don R. Wheeler; J. Brannon; Robert A. Wesley; Alvin D. Fitzgerald; James E. Rowe; Alfred M. Martinez; Berry R. Raymondo; Carroll C. Abel; Oscar G. Powell, Jr.; Alvin W. Green; Huey A. Fredeiu; Ben Saenz; Harold R. Dagne; Britt Ingrid Keith; Robert M. Turner, Plaintiffs–Appellants–Cross–Appellees,

v.

COMMERCIAL LOVELACE MOTOR FREIGHT, INC., also known as C.L. Motor Freight, doing business as Lee Way Motor Freight, Inc.; M.T. Alcox; W.D. Persavich; C.C. McCracken; N.L. Ingrum; H.J. Hill; G.W. McIntyre; Transportation Equipment Services, Inc. and their directors; Edward L. Mulcahy; Phillip White; H.F. Poston, Defendants–Appellees,

and

Pepsico, Inc., doing business as Lee Way Motor Freight, Inc., a Delaware corporation, individually; S.E. Schroder; James English; Lawrence F. Dickie; Judy Norman–Davis; Richard Campbell, Defendants–Appellees–Cross–Appellants.

Nos. 88–1253, 88–1750.

|

July 12, 1991.

Synopsis

Former employee brought action against employer alleging violations of federal and state securities laws and common-law fraud. The United States District Court for the Western District of Oklahoma, Layn R. Phillips, J., found that employee stock ownership plan was not a security under federal law. Appeal and cross appeal was taken. The

Court of Appeals, Kane, Senior District Judge, sitting by designation, held that: (1) evidence showed that employee stock ownership plan was voluntary and contributory; (2) contributory, voluntary employment plan was subject to federal securities regulation; and (3) ERISA did not provide sufficient protection to plan participants to displace application of federal securities laws.

Affirmed in part; reversed and remanded in part.

West Headnotes (20)

[1] **Securities Regulation** In general; investment contracts

Test to determine whether financial relationship is investment contract is whether scheme involved investment of money in common enterprise with profits to come solely from efforts of others; in applying test, economic realities of transaction and not names employed by parties are determinative. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

8 Cases that cite this headnote

[2] **Securities Regulation** Stock warrants, options and subscription or other rights

Employee benefit plan which is either noncontributory or compulsory is not an investment contract subject to the Securities Act, as those types of plans do not allow participant to make required "investment." Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

[3] **Securities Regulation** Stock warrants, options and subscription or other rights

To meet requirement that employee benefit plan be "investment" for purposes of applying Securities Acts, investment may take form of cash, goods and services, or any other exchange of value; fact that terms of employee stock ownership plan did not permit employees to make direct monetary contributions was not determinative of whether employees invested in or contributed to plan. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

2 Cases that cite this headnote

[4] **Securities Regulation** Stock warrants, options and subscription or other rights

To determine whether employees contributed to employee stock ownership plan, proper inquiry is whether economic realities of transaction as whole show an investment or an exchange of value by employees. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[5] **Securities Regulation** Stock warrants, options and subscription or other rights

Contributing legal right to portion of their wage to company in return for right to acquire company stock by means of employee stock ownership plan and to participate in profit-sharing plan was sufficient tangible and definable consideration to serve as "investment" or "contribution" to employee benefit plan for purposes of determining whether Securities Act applied. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

2 Cases that cite this headnote

[6] **Securities Regulation** Stock warrants, options and subscription or other rights

Because each employee had option of either accepting wage reduction program or continuing employment under terms of existing union contract, participation in employee stock ownership plan was voluntary, and, thus, employees were investors making investment decision when they individually agreed to give up portion of their wages in return for interest in stock ownership plan, for purposes of determining whether Securities Act applied to plan. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[7] **Securities Regulation** Stock warrants, options and subscription or other rights

Any desire on part of employees to save employer and their jobs did not negate otherwise voluntary decision to invest in employee stock ownership plan; "save the company, save our jobs" motive identified by court was consistent with traditional investment motive. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[8] **Securities Regulation** Stock warrants, options and subscription or other rights

Employees' investment in employee stock ownership plan meets test for investment contract if plan is voluntary, contributory employee benefit plan. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

2 Cases that cite this headnote

[9] **Securities Regulation** Stock warrants, options and subscription or other rights

For purposes of determining whether employee stock ownership plan was subject to Securities Act, plan qualifies as common enterprise if enterprise can reasonably be expected to produce profits in form of capital appreciation or participation in earnings resulting from investment and if success or failure of enterprise is significantly affected by managerial or entrepreneurial efforts of persons other than investors. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[10] **Securities Regulation** Stock warrants, options and subscription or other rights

Employees' interests in employee stock ownership plan were investment contracts, and thus securities under the Securities Act, in light of evidence that interest would occur through dividend distribution and appreciation of value of stock allocated to employees' accounts, that distributions would result primarily from efforts of company's managers and its employees, and that interest concerned common enterprise in which profits came solely from efforts of others. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

4 Cases that cite this headnote

[11] **Securities Regulation** Stock warrants, options and subscription or other rights

Each employee deliberately chose to surrender right to percentage of preexisting compensation package in return for interest in employee stock ownership plan, and, thus, each employee contributed specific consideration for interest rather than merely exchanging labor for individual compensation plan that incidentally provided for participation in a pension plan as necessary for voluntary contributory participation in plan to create investment contract. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[12] **Securities Regulation** Securities and Exchange Commission in general

Securities and Exchange Commission's finding that voluntary contributor employee benefit plans are securities for purposes of the Securities Act was entitled to considerable weight absent showing that it violated clear meaning of statute.

Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

[13] **Securities Regulation** Construction and operation in general

Test for determining whether existence and application of nonsecurities related federal regulation bars application of Securities Acts is whether alternate federal regulation accomplishes same purposes as securities law, thus making securities laws' protection for investors duplicative and unnecessary; if alternate federal regulation abundantly protects investors by requiring disclosure to investors of relevant information on investment decision and by providing meaningful remedies for violation of antifraud provisions of laws, then regulation may displace application of federal securities laws. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[14] **Securities Regulation** Construction and operation in general

Extent of disclosure of reporting requirements imposed on employee stock ownership plan administrators under ERISA did not satisfy requirement that alternate federal regulation compelled disclosure of relevant, accurate information on which to base investment decision for purposes of determining whether ERISA displaced application of Securities Acts; ERISA, unlike Securities Acts, did not require plan administrators or promoters to provide any information about plan to individuals considering whether to become participants. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.; Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[15] **Securities Regulation** Construction and operation in general

ERISA's funding requirements and fiduciary responsibilities on plan administrators by civil or administrative action, although providing federal regulators with authority to take corrective action on behalf of plan participants to protect investment, did not essentially guarantee each individual's investment, and, thus, ERISA did not provide the virtual guarantee necessary to displace protection of securities laws and its disclosure provisions over employee stock ownership plan. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.; Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

5 Cases that cite this headnote

[16] **Securities Regulation** Construction and operation in general

Even if monitoring and enforcement authority under ERISA fulfilled underlying purpose of Securities Acts' disclosure requirements, ERISA did not satisfy test for displacement of Securities Act where it failed to provide meaningful remedy to plan participants who alleged that plan administrators or promoters acted fraudulently in inducing employees to join plan. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.; Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

1 Cases that cite this headnote

[17] **Securities Regulation** Construction and operation in general

Even if ERISA did permit cause of action for rescission of employee's participation in employee stock ownership plan and restitution of contributions in cases of fraudulent inducement, some fiduciaries were not amenable to suit under ERISA so that it could not be said that ERISA abundantly protected employees by providing them with remedy for fraud allegedly committed by nonfiduciaries and others in inducing employees to join employee stock ownership plan, and, thus, ERISA did not displace Securities Act's application to plan. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.; Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

3 Cases that cite this headnote

[18] **Securities Regulation** Construction and operation in general

Even if ERISA duplicated investor protection offered by Securities Act to employees who participated in employee stock ownership plan, alternate federal regulation did not prevent employees from establishing that their interests in voluntary, contributory plans were securities nor did it bar them from invoking Securities Acts to protect those interests. Employee Retirement Income Security Act of 1974, § 2 et seq., 29 U.S.C.A. § 1001 et seq.; Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

[19] **Federal Civil Procedure** Discretion of Court

Although leave to amend should be freely given if justice requires, whether leave should be granted is left to trial court's discretion. Fed.Rules Civ.Proc.Rule 15(a), 28 U.S.C.A.

2 Cases that cite this headnote

[20] **Federal Civil Procedure** Time for amendment

District court did not abuse its discretion in denying employees' third request for leave to amend complaint where issues to be resolved at trial had been set for more than a year and trial was scheduled to begin in three months. Fed.Rules Civ.Proc.Rule 15(a), 28 U.S.C.A.

4 Cases that cite this headnote

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***570** Before McKAY and SEYMOUR, Circuit Judges, and KANE, [*] District Judge.

[*] Honorable John L. Kane, Senior District Judge, United States District Court for the District of Colorado, sitting by designation.

Opinion

KANE, Senior District Judge.

This appeal arises out of an action brought by more than four hundred former employees of Lee Way Motor Freight, Inc. against their former employer and others alleging violations of federal and Oklahoma securities law and common law fraud. After a segmented trial to the court on the issue of whether an interest in the instrument at issue, an employee stock ownership plan, constituted a security under federal law, the district court held that it did not and entered judgment for defendants on the federal securities claims. Finding no basis for federal jurisdiction over the plaintiffs' remaining state law claims, the court dismissed them in their entirety. This appeal and cross-appeal followed upon the court's denial of defendants' motion for costs and fees. We affirm in part and reverse in part.

Background

The following facts are undisputed unless otherwise noted: Plaintiffs-appellants in this matter are 485 former union employees of Lee Way Motor Freight, Inc. (Lee Way), a common carrier engaged in the interstate and intrastate transportation of commodities. In 1976, Lee Way was acquired by defendant-appellee Pepsico, Inc., which operated the company as a wholly owned subsidiary until June 1984 when it agreed to sell Lee Way to defendant-appellee Commercial Lovelace Motor Freight, Inc. (CL). Because CL was also a common carrier, this sale was not finalized until the Interstate Commerce Commission (ICC) approved the transaction in August 1984. CL operated Lee Way pursuant to a management agreement with Pepsico pending ICC approval of the sale.

Shortly after taking over Lee Way's operations, CL began soliciting Lee Way employees to participate in a Wage Reduction Program (Program) that had been in place at CL since 1983. This Program, which was optional for plaintiffs and Lee Way's other union employees,[1] provided each participating union employee with an interest both in CL's existing company-administered employee stock ownership plan (CL ESOP) and a profit-sharing plan in return for the individual employee's agreement to a 17.35% reduction in the wages due him or her under the union's collective bargaining agreement. CL represented to Lee Way employees that the company would probably fail if they did not enroll in the Program. All of the plaintiffs in this action individually elected to participate in the Program. Less than a year later, CL merged with Lee Way and filed for bankruptcy. Lee Way's former assets were then allegedly reacquired by Pepsico.

1 Participation in the Program was a mandatory condition of employment for Lee Way's nonunion, salaried employees.

In this action, plaintiffs allege that Pepsico's sale of Lee Way to CL and its subsequent reacquisition of Lee Way's assets upon CL's rapid demise were all part of a sham transaction designed to disguise Pepsico's intended and ultimately successful liquidation of Lee Way. Plaintiffs further allege that certain aspects of this sham transaction, including CL's solicitation of them to accept a wage reduction in return for an interest in the CL ESOP, violated federal and Oklahoma securities laws and constituted common law fraud. Plaintiffs seek various relief from defendants CL, Pepsico and officers and directors of both companies for these alleged transgressions, including, among other things, revocation of the plaintiffs' participation in the CL ESOP and recovery of more than $6 million in wages lost by plaintiffs as a result of their participation in the Wage Reduction Program.[2] Plaintiffs do not seek to recover benefits from the CL ESOP or otherwise enforce their rights as ESOP participants.

2 Plaintiffs also seek $65 million from the defendants for fraud in the loss of their jobs and conversion of credit union and insurance deductions and $120 million in exemplary damages. Doc. 111 (Second Amended Complaint) at 49.

***571** In their federal securities claim, plaintiffs allege that their interests in the CL ESOP were "investment contracts" subject to federal securities regulation pursuant to section 2(1) of the Securities Act of 1933 (1933 Act), 15 U.S.C. §§ 77b(1) (1988) (defining "security" to include "investment contracts"), and section 3(a)(10) of the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. § 78c(a)(10) (1988) (same). Plaintiffs further allege that CL's solicitation of Lee Way employees to accept an interest in the CL ESOP as part of the Wage Reduction Program constituted a sale of an unregistered security and securities fraud in violation of Sections 5 and 17(A) of the 1933 Act, 15 U.S.C. §§ 77e, 77q(a), and Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b).

The defendants filed various motions to dismiss and for summary judgment challenging plaintiffs' threshold assertion that their ESOP interests were investment contracts subject to protection under the 1933 and 1934 Acts (collectively "Securities Acts"). The district court denied these motions, but did hold that in order to prove that their interests in the CL ESOP were investment contracts, plaintiffs would have to demonstrate that the ESOP was "a voluntary contributory [employee benefit] plan [that] otherwise fit within the definition of a security." *Hupp v. Commercial Lovelace Motor Freight,* No. CIV–84–2807–A (W.D.Okla. Aug. 1, 1986) (1986 Order). The district court then ordered a segmented trial "limited to the factual issues as to whether the ESOP is a security" under this legal standard. *Id.*

Following a bench trial on this issue in December 1987, the district court ruled that plaintiffs' ESOP interests were not investment contracts and hence not securities under federal law. *Uselton v. Commercial Lovelace Motor Freight, Inc.,* CIV–84–2807–P (W.D.Okla. Jan. 29, 1988) (1988 Order). In reaching this result, the district court relied on its finding that the CL ESOP was a compulsory, noncontributory employee benefit plan and on the Supreme Court's holding in *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979), that such plans do not qualify as investment contracts under the three-part test first enunciated by the Court in *SEC v. W.J. Howey Co.,* 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946). 1988 Order at 14. The district court then entered judgment against plaintiffs' federal securities claims and dismissed their state law claims for lack of jurisdiction. Plaintiffs timely appealed this judgment. The Pepsico defendants[3] cross-appealed the district court's denial of their post-trial motion for costs and fees.

3 The Pepsico defendants are Pepsico, Inc., S.E. Schroder, James English, Lawrence Dickie, Judy Norman–Davis and Richard Campbell.

The parties have stipulated that the CL ESOP is an employee benefit plan that CL created and funded in March 1983 by issuing 4,001,000 shares (just more than fifty percent) of its common stock to the Central National Bank of Cleveland, Ohio, as Trustee for the plan. In return, CL received five promissory notes (Trust Notes) from the Trustee, each in the amount of $150,000, which were to mature serially from 1984 to 1988. Initially, CL held all of the plan's CL stock in pledge as security for the Trust Notes. As each Trust Note matured, however, the CL ESOP agreement required CL either to forgive the Trust Note then maturing or to make a cash contribution to the CL ESOP in the amount of the Trust Note so that the Trustee could pay off the Trust Note by redelivering the funds to CL. Once the annual Trust Note was paid by either of these methods, the ESOP agreement required CL to release 800,000 shares of the pledged stock to the ESOP to be allocated to the individual accounts of ESOP participants according to a formula stated in the ESOP agreement. This allocation formula was based on the ratio of each participant's compensation for a given year to the total compensation of all participants for that year. In the two years the CL ESOP operated, 1,600,000 CL shares were released to the ESOP and allocated to ESOP participants through these procedures. ***572** Under the terms of the ESOP, these allocations vested immediately with the ESOP participants.

All shares allocated to participating employees through the ESOP were derived from those initially issued to the Trust. No proceeds from the Program's wage reduction requirement were used to purchase CL stock or to otherwise fund the CL ESOP, no CL shares were ever purchased by the Trustee on the open market and no CL shares other than those initially issued by CL to the Trustee were ever acquired by the Trust. The CL ESOP agreement also prohibited participants from making direct monetary contributions to the CL ESOP and no such employee contributions were ever made. As an employee benefit plan, the CL ESOP was subject to regulation under the Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§ 1001–1461 (1988).

Discussion

The principal issue in this appeal and cross-appeal is whether the district court was correct in holding that plaintiffs' interests in the CL ESOP were not investment contracts and hence not "securities" subject to the protections of the Securities Acts. Other issues on appeal concern the district court's dismissal of plaintiffs' Oklahoma securities claims, several of the court's evidentiary rulings and its denial of the Pepsico defendants' motion for costs and fees. We address each of these issues in turn.

A. Federal Securities Issue

The plaintiffs contend that the district court erred as a matter of law in holding that their interests in the CL ESOP were not investment contracts and hence not securities within the purview of the Securities Acts. We address this question in two steps. First, we consider the district court's holding that these ESOP interests are not investment contracts under the standards stated by the Supreme Court in *Howey* and *Daniel.* Following our conclusion that plaintiffs' ESOP interests are securities under these standards, we proceed to a legal question not reached by the district court, which is whether these interests are nonetheless outside the reach of the Securities Acts due to their regulation under ERISA.

In addressing these issues, we consider questions of law *de novo,* while reviewing the district court's decision on questions of fact under the clearly erroneous standard. *Las Vegas Ice & Cold Storage Co. v. Far West Bank,* 893 F.2d 1182, 1185 (10th Cir.1990). On the mixed question of whether the facts satisfy the proper legal standard, we conduct a *de novo* review if the question primarily involves the consideration of legal principles and apply the clearly erroneous standard if the question is primarily a factual inquiry. *Love Box Co. v. Commissioner,* 842 F.2d 1213, 1215 (10th Cir.), *cert. denied,* 488 U.S. 820, 109 S.Ct. 62, 102 L.Ed.2d 40 (1988).

1. *Whether the plaintiffs' interests in the CL ESOP were investment contracts*

[1] Plaintiffs contend that their interests in the CL ESOP qualify as securities under the Securities Acts because they are investment contracts. Under the Supreme Court's seminal decision in *SEC v. W.J. Howey Co.,* 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946), the test to determine whether a financial relationship constitutes an investment contract is "whether the scheme involves [1] an investment of money [2] in a common enterprise [3] with profits to come solely from the efforts of others." *Id.* at 301, 66 S.Ct. at 1104; *see United Hous. Found., Inc. v. Forman,* 421 U.S. 837, 852, 95 S.Ct. 2051, 2060–61, 44 L.Ed.2d 621 (1975); *Banghart v. Hollywood Gen. Partnership,* 902 F.2d 805, 807 (10th Cir.1990). In applying this test, "the economic realities of the transaction—rather than the names that may have been employed by the parties," are determinative. *Forman,* 421 U.S. at 851–52, 95 S.Ct. at 2060–61.

The Supreme Court has had one opportunity since *Howey* to consider whether an employee benefit plan is an investment contract and hence a security under the Securities ***573** Acts. In that case, *International Brotherhood of Teamsters v. Daniel,* 439 U.S. 551, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979), the question presented was whether a participant in a company pension plan could invoke the Securities Acts as part of an effort to recover benefits under the plan. *See id.* at 553, 555–56, 99 S.Ct. at 794–95. The Court held that he could not because: (1) the participant's interest in the pension plan failed the *Howey* test for an investment contract; (2) there was no congressional or administrative record of such plans being subject to federal securities regulation and (3) ERISA already provided participants in such plans with the right to challenge benefit determinations. *See id.* at 558–70, 99 S.Ct. at 795–802.

In applying the *Howey* test to the plaintiff's pension plan interest, the Court first identified the plan in question as a compulsory, noncontributory defined benefit plan. *Id.* at 553, 554 n. 3, 99 S.Ct. at 794 n. 3. This description indicates that the plaintiff, as an employee of his company, had no option but to participate in the plan, that he made no cash or other type of contribution specifically to the plan, *see id.,* and that the benefits he expected to receive from the plan were fixed without reference to the success or failure of the plan's investments. *See Cunha v. Ward Foods, Inc.,* 545 F.Supp. 94, 99 nn. 3–5 (D.Haw.1982), *aff'd in part and rev'd in part on other grounds,* 804 F.2d 1418 (9th Cir.1986); *O'Neil v. Marriott Corp.,* 538 F.Supp. 1026, 1030 (D.Md.1982) (defining a voluntary plan); *Tanuggi v. Grolier, Inc.,* 471 F.Supp. 1209, 1213 n. 3 (S.D.N.Y.1979) (defined benefit plan).

The Court determined that the plaintiff's interest in this type of employee benefit plan failed both the first and third prongs of the *Howey* test. The Court found that it failed *Howey*'s initial "investment of money" requirement because the plan's noncontributory structure precluded the plaintiff from making the requisite investment at the same time that its involuntary component prevented him from making an affirmative investment decision "to give up a specific consideration in return for a separable financial interest with the characteristics of a security." *Daniel,* 439 U.S. at 559, 99 S.Ct. at 796. The Court also considered and rejected plaintiff's alternate contention that his labor provided the necessary "investment" in the pension plan, concluding instead that the plan was "a relatively insignificant part of [the plaintiff's] total and indivisible compensation package" so that "[h]is decision to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities of a future pension." *Id.* at 560, 99 S.Ct. at 797. As to *Howey*'s final requirement, the Court held that the plaintiff's expected profits from his company's defined benefit plan were not dependent on entrepreneurial or managerial efforts of others, as required by *Howey,* because the plan's income consisted primarily of continuing employer contributions, "a source in no way dependent on the efforts of the [plan's] managers." *Id.* at 562, 99 S.Ct. at 797. In addition, the Court noted that the plan at issue required participants to meet "substantial" preconditions before their interests in the plan and hence in the plan benefits vested. *Id.* As a result, the Court found that even if the plan benefits were considered profit on some investment by the employee, "this profit would depend primarily on the employee's effort to meet the vesting requirements, rather than the [plan's] investment success." *Id.* (footnote omitted).

[2] Since the *Daniel* decision, both this court and others have considered whether various types of employee benefits plans qualify as investment contracts under the *Howey* test. *See, e.g., Salazar v. Sandia Corp.,* 656 F.2d 578, 581–82 (10th Cir.1981) (compulsory, noncontributory pension plan); *Black v. Payne,* 591 F.2d 83, 87–88 (9th Cir.) (compulsory, contributory employee benefit plan), *cert. denied,* 444 U.S. 867, 100 S.Ct. 139, 62 L.Ed.2d 90 (1979); *Cunha,* 545 F.Supp. at 99–101 (voluntary, contributory plan). The consensus from these decisions is that an employee benefit plan that is either noncontributory or compulsory is not an investment contract because it does not allow a participant to make the "investment" required by the ***574** first prong of the *Howey* test. *See, e.g., Salazar,* 656 F.2d at 582. The SEC concurs in this view. *See* Employee Benefit Plans, Securities Act Release

No. 33–6188, 1 Fed.Sec.L.Rep. (CCH) ¶ 1051 at 2073–8 to 2073–9 (Feb. 1, 1980) [hereinafter "SEC Release No. 33–6188"]; Employee Benefit Plans, Securities Act Release No. 33–6281, 1 Fed.Sec.L.Rep. (CCH) ¶ 1052 at 2073–31 (Jan. 15, 1981) [hereinafter "SEC Release No. 33–6281"]. A number of courts have also held that certain voluntary, contributory employee benefit plans are not investment contracts, but only because specific aspects of each plan caused it to fail *Howey*'s final requirement that the profits or benefits from the plan result from the efforts of others. *See, e.g., Coward v. Colgate–Palmolive Co.,* 686 F.2d 1230, 1236–37 (7th Cir.1982), *cert. denied,* 460 U.S. 1070, 103 S.Ct. 1526, 75 L.Ed.2d 948 (1983); *Cunha,* 545 F.Supp. at 99–100; *O'Neil,* 538 F.Supp. at 1031; *Tanuggi,* 471 F.Supp. at 1214, 1216; *Newkirk v. General Elec. Co.,* [1979–80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,216, 1979 WL 1270 (N.D.Cal. Aug. 31, 1979).

[3] In this case, the district court held that plaintiffs' interests in the CL ESOP were not investment contracts because the ESOP was neither contributory nor voluntary and thus failed *Howey*'s "investment" requirement. 1988 Order at 14. The plaintiffs argue on appeal that both of these findings are incorrect as a matter of law, that their interests in the CL ESOP were in fact both voluntary and contributory and hence meet the first prong of the *Howey* test and that the ESOP otherwise satisfies *Howey*'s requirements for establishing the existence of an investment contract. We agree with plaintiffs on each of these points.

The district court held that the CL ESOP was noncontributory because Lee Way employees made no monetary contributions to the plan through wage deductions or other means. 1988 Order at 14. This finding reflected the court's legal conclusion that an employee benefit plan must fit within the following definition of "contributory" in order to satisfy *Howey*'s initial "investment of money" requirement:

> 2. "Contributory" plan means that the workers must be making payments into and enhancing the ESOP corpus, although these payments may be accomplished through some accounting system set up by the employer, the ESOP Trust or otherwise.
>
> 3. Neither lump sum [n]or periodic payments on behalf of the workers made by others will suffice for a contributory plan.
>
> 4. A mere showing that the employer obtained relief from its overhead obligation for wages, creating a savings from which it paid down the ESOP note, will not suffice.

1986 Order at 1–2.

This is an incorrect statement of *Howey*'s "investment" requirement for two reasons. First, the district court's definition of "contributory" assumes that only direct monetary contributions will satisfy the requirement. In fact, and in spite of *Howey*'s reference to an "investment of money," it is well established that cash is not the only form of contribution or investment that will create an investment contract. Instead, the "investment" may take the form of "goods and services," *Daniel,* 439 U.S. at 560 n. 12, 99 S.Ct. at 797 n. 12, or some other "exchange of value." *Hocking v. Dubois,* 885 F.2d 1449, 1471 (9th Cir.1989), *cert. denied,* 494 U.S. 1078, 110 S.Ct. 1805, 108 L.Ed.2d 936 (1990); *see Yoder v. Orthomolecular Nutrition Inst., Inc.,* 751 F.2d 555, 560–61 (2d Cir.1985) (stating that a person who commits herself to employment in return for the promise of stock in her employer's company makes the necessary investment in her company's securities to form an investment contract); *Dubin v. E.F. Hutton Group, Inc.,* 695 F.Supp. 138, 145–44 (S.D.N.Y.1988) (holding that plaintiff's acceptance of employment based in part on the value of a promised interest in his employer's equity ownership plan resulted in the sale of a security). Thus, the fact that the terms of the CL ESOP did not permit employees to make direct monetary contributions to it is not determinative of whether Lee Way's ***575** union employees invested in or contributed to the CL ESOP as required by the first prong of the *Howey* test.

[4] **[5]** The legal standard employed by the district court also errs in focusing solely on the terms of the CL ESOP to determine whether plaintiffs contributed to the plan. The proper inquiry was whether the economic realities of the transaction as a whole demonstrated an investment or "an exchange of value" by the plaintiffs. *See Forman,* 421 U.S. at 849, 851, 95 S.Ct. at 2059, 2060; *Hocking,* 885 F.2d at 1471. Here, it is undisputed that the transaction in question, plaintiffs' election to participate in CL's Wage Reduction Program, required plaintiffs and Lee Way's other union employees to surrender a portion of the wages due them under a valid collective bargaining agreement in exchange for an interest in the CL ESOP and the profit-sharing plan. The economic reality of the transaction, therefore, was that plaintiffs contributed their legal right to a portion of their wages to CL in return for the right to acquire CL stock via the CL ESOP and to participate in CL's profit-sharing plan. At least two courts have held that employee contributions of this sort constitute sufficient tangible and definable consideration to serve as an "investment" or "contribution" to an employee benefit plan for purposes of the *Howey* test. *See Hood v. Smith's Transfer Corp.,* 762 F.Supp. 1274, 1291 (W.D.Ky.1991); *Harris v. Republic Airlines, Inc.,* [1987–88 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,772 at 98,625–26, 1988 WL 56256 (D.D.C. May 18, 1988). We agree with this conclusion and accordingly hold, under the proper legal standard and the undisputed facts of this case, that plaintiffs' interests in the CL ESOP were contributory as a matter of law.

[6] We also conclude as a matter of law that the district court erred in holding that plaintiffs' participation in the CL ESOP was involuntary and thus precluded them from having any investment motive in joining the plan. *See* 1988 Order at 14. The district court based this conclusion on its factual finding that plaintiffs felt they had no choice but to join the Wage Reduction Program if they wanted to save Lee Way and their jobs. *Id.* at 13, 14. We have several difficulties with holding the CL ESOP to be an involuntary plan on this basis. First, the established definition of a voluntary plan is simply a plan that permits employees to elect whether or not to participate. *See Salazar,* 656 F.2d at 581; *Cunha,* 545 F.Supp. at 99 n. 4; *O'Neil,* 538 F.Supp. at 1030; SEC Release No. 33–6188 at 2073–6 n. 19. This definition is consistent with the Supreme Court's statement in *Daniel* that an investor is someone who "chose to give up a specific consideration in return for a separable financial interest with the characteristics of a security." *Daniel,* 439 U.S. at 559, 99 S.Ct. at 796. Applying this legal standard to this case, there is no question that participation in the CL ESOP was in fact voluntary for Lee Way's union employees because each such employee had the option of either accepting CL's Wage Reduction Program or of continuing employment under the terms of the existing union contract. There is also no question that each union employee who joined the CL ESOP gave up specific consideration, *i.e.,* a portion of his or her wages, in return for a separable financial interest in the CL ESOP. Each employee's interest in the CL ESOP, moreover, translates into an interest in CL stock, an interest having all of the characteristics of a security. [4] No more than this is required to prove that Lee Way's union employees were investors making an investment decision when they individually agreed to give up a portion of their wages in return for an interest in the CL ESOP. *See id.* [5]

[7] ***576** We also disagree with the district court's legal conclusion that the plaintiffs' desire to save Lee Way and their jobs negated their otherwise voluntary decision to invest in the CL ESOP through the Wage Reduction Program. In fact, the "save the company, save our jobs" motive identified by the district court is consistent with a traditional investment motive because each is concerned with and makes an investment in the future of the company. [6] Thus, we find no basis for the district court's holding that this motive made plaintiffs' participation in the CL ESOP involuntary or otherwise prevented them from acting as investors when they elected to participate in the CL ESOP. *See Hood,* 762 F.Supp. at 1290 (holding that employees' participation in ESOP was voluntary even though employer represented to employees that company's survival depended on employees' acceptance of wage reduction/ESOP package). [7]

4 Several courts have found that this fact alone is sufficient to establish that an ESOP interest is stock and hence is a security without reference to *Howey*'s test for the existence of an investment contract. *See Harris,* [1987–88 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,772 at 98,623; *Hood,* 762 F.Supp. at 1289–90; *Foltz v. U.S. News & World Report, Inc.,* 627 F.Supp. 1143, 1159 (D.D.C.1986). Because plaintiffs have not pleaded or argued that their ESOP interests might be a security under this alternate theory, we do not address it.

5 This determination is also consistent with the SEC's conclusion that "[a]n employee who is given a choice whether to participate in a voluntary pension plan, and decides to contribute a portion of his earnings or savings to such plan, has clearly made an investment decision, particularly when his contribution is invested in securities issued by his employer." SEC Release No. 33–6188 at 2073–10.

6 CL itself recognized the close link between these concepts when it stated in its Lee Way solicitation materials that "a principal purpose for instituting the [Wage Reduction] Program is to provide a possibility for a return of the companies['] profitability and to provide employees with a share of any such profits." Defendants' Ex. 20, Subex. D at 2.

7 The district court's holding that the CL ESOP was an involuntary plan and hence not an investment contract because of the plaintiffs' desire to save their jobs is also troubling because it essentially permits employers to avoid regulation under the Securities Acts (assuming the ESOP interest would otherwise meet the *Howey* test) simply by persuading employees that they must contribute to the ESOP if they want to preserve the company and their jobs. The employees, however, may

> not have sufficient information available to them to test their employer's representations concerning the company's financial condition. It seems particularly inappropriate, therefore, to determine whether the employees' interest is a security subject to the protective disclosure and anti-fraud provisions of the Securities Acts on the basis of the employees' acceptance of these representations.

[8] Because the CL ESOP was a voluntary, contributory employee benefit plan for Lee Way's union employees, their interests in the ESOP resulted from their "investment" in the ESOP, thus satisfying the first prong of *Howey*'s test for an investment contract. *See Cunha,* 545 F.Supp. at 99–100. The question remains, however, whether these interests also satisfy *Howey*'s final two requirements that these interests concern "a common enterprise" in which profits "come solely from the efforts of others." *Howey,* 328 U.S. at 301, 66 S.Ct. at 1104. The district court did not reach this question because it found *Howey*'s initial investment requirement to be dispositive.

[9] **[10]** Upon review of the record, we hold that the plaintiffs' ESOP interests satisfy both of these requirements as a matter of law. There is no dispute that the CL ESOP qualifies as a common enterprise and thus satisfies the second prong of the *Howey* test. *See Childers v. Northwest Airlines, Inc.,* 688 F.Supp. 1357, 1363 (D.Minn.1988); *Harris,* [1987–88 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,772 at 98,624. *Howey*'s final requirement is met if the enterprise can reasonably be expected to produce profits in the form of capital appreciation or participation in earnings resulting from the investment, *Forman,* 421 U.S. at 852, 95 S.Ct. at 2060–61, and the success or failure of the enterprise is significantly affected by the managerial or entrepreneurial efforts of persons other than the investor.[8] *See Banghart,* 902 F.2d at 807; *SEC v. Goldfield Deep Mines Co.,* 758 F.2d 459, 463 (9th Cir.1985). Both of these requirements are met in this case because any profit on plaintiffs' ESOP interest would occur through dividend distributions and appreciation in the value of the stock allocated to their accounts, which in both cases would result primarily from the ***577** efforts CL's managers and its employees. Thus, "[e]ach employee that invested in the [Wage Reduction Program] was dependent on the efforts of others to realize any benefits from his or her investment decision." *Harris,* [1987–88 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 93,772 at 98,624. This fact distinguishes the CL ESOP from other voluntary, contributory employee benefit plans that have failed this final prong of the *Howey* test. *See, e.g., Coward,* 686 F.2d at 1236–37; *Cunha,* 545 F.Supp. at 99–100;[9] *O'Neil,* 538 F.Supp. at 1031; *Tanuggi,* 471 F.Supp. at 1214, 1216; *Newkirk,* [1979–80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,216.[10] Accordingly, plaintiffs' interests in the CL ESOP satisfy this final *Howey* requirement. Having previously concluded that plaintiffs' interests in the CL ESOP satisfy *Howey*'s other requirements for establishment of an investment contract, we therefore hold that these interests were investment contracts and hence securities under the Securities Acts.

8 As this language suggests, *Howey*'s requirement that profits "come solely from the efforts of others" is not read literally to prevent formation of an investment contract when the investor contributes some effort to the enterprise. *See, e.g., Meyer v. Dans un Jardin, S.A.,* 816 F.2d 533, 535 (10th Cir.1987); *SEC v. Aqua–Sonic Prods. Corp.,* 687 F.2d 577, 584 (2d Cir.), *cert. denied,* 459 U.S. 1086, 103 S.Ct. 568, 74 L.Ed.2d 931 (1982).

9 The district court's reliance on *Cunha, see* 1988 Order at 14, is misplaced for this reason.

10 Most of these cases concerned defined benefit plans that pay fixed or determinable benefits based on factors such as the age at which a participant retires, *see* SEC Release No. 33–6118 at 2073–7, rather than defined contribution plans, such as the CL ESOP, that provide varying benefits based on factors such as the amount of plan contributions and the plan's investment success. *See, e.g., Coward,* 686 F.2d at 1236–37; *Cunha,* 545 F.Supp. at 99–100; *Tanuggi,* 471 F.Supp. at 1214, 1216. The only two courts that appear to have considered whether employee interests in a voluntary, contributory defined contribution plan might satisfy the *Howey* test held that they did not because of plan characteristics that are not present here. *See O'Neil,* 538 F.Supp. at 1031 (in a "close question," no security found to exist because (1) plan's staggered vesting requirements made benefits dependent on length of service, (2) significant plan profits derived from other employees withdrawing from the plan before becoming fully vested, (3) amount of earnings on employee contributions was capped and (4) amount of benefits was significantly dependent on amount of employer, rather than employee, contribution); *Newkirk,* [1979–80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,216 (apparently holding plan interests were not securities because majority of plan's income was derived solely from employer contributions and amount of benefits was dependent on employees' success in meeting vesting requirements).

The defendants contend that the Supreme Court's *Daniel* decision requires a different result and supports the district court's decision that plaintiffs' interests in the CL ESOP are not securities. In making this argument, they focus on the Court's rejection of the employee's assertion that the labor he provided his employer constituted an "investment" in the employer's compulsory, noncontributory pension plan. The Court rejected this argument because:

> In a pension plan such as this one, ... the purported investment is a relatively insignificant part of an employee's total and indivisible compensation package.... Only in the most abstract sense may it be said that an employee "exchanges" some portion of his labor in return for these possible benefits. He surrenders his labor as a whole, and in return receives a compensation package that is substantially devoid of aspects resembling a security. His decision to accept and retain covered employment may have only an attenuated relationship, if any, to perceived investment possibilities of a future pension. Looking at the economic realities, it seems clear that an employee is selling his labor primarily to obtain a livelihood, not making an investment.

Daniel, 439 U.S. at 560, 99 S.Ct. at 797 (footnote omitted). Similarly, defendants argue, the economic reality of this transaction is that plaintiffs sold their labor to CL in order to obtain a compensation package that only incidentally included participation in the CL ESOP.

[11] The difficulty with this argument is that it ignores that Lee Way's union employees did more than merely contribute labor to obtain an interest in the CL ESOP. Instead, each deliberately chose to surrender his or her right to a percentage of a preexisting compensation package in return for an ESOP interest. Thus, each contributed specific consideration for his interest, rather than merely exchanging labor for an indivisible compensation plan that incidentally provided for participation ***578** in a pension plan. The Supreme Court's holding that no investment contract existed with respect to the employee benefit plan and transaction before it in *Daniel* is not, therefore, determinative of this same question presented in the context of the very different plan and transaction at issue in this case. [11] For the reasons set out in our discussion of the *Howey* test, we also conclude that our decision that plaintiffs' voluntary, contributory participation in the CL ESOP created an investment contract under *Howey*'s three-part test is fully consistent with the Supreme Court's statement and application of that test in *Daniel.* [12]

11 The *Daniel* Court's holding regarding the third *Howey* requirement, concerning profit from the efforts of others, is also inapplicable here due to the differences between the CL ESOP and the pension plan at issue in *Daniel.* In *Daniel,* the pension fund's "income" consisted almost entirely of employer contributions, rather than profits generated by the efforts of the fund managers, and the employee's expectation of profits, if any, depended primarily on his or her success in meeting the plan's vesting requirements, rather than on the fund's investment success. 439 U.S. at 561–62, 99 S.Ct. at 797–98. In this case, in contrast, the plaintiffs' right to the stock they received via the CL ESOP vested immediately and any profits they received on their ESOP investment were directly attributable to the efforts of CL and its managers.

12 Defendants also cite *In re Crippin,* 877 F.2d 594 (7th Cir.1989), *Childers v. Northwest Airlines, Inc.,* 688 F.Supp. 1357 (D.Minn.1988) and *Bauman v. Bish,* 571 F.Supp. 1054 (N.D.W.Va.1983) for the proposition that an employee's acceptance of a wage reduction in return for participation in an ESOP is an employment/compensation agreement rather than an investment in a security. Each of these cases is distinguishable. In both *Bauman* and *Childers,* the district courts held that an employee's acceptance of a wage reduction as part of a modified, union-approved compensation package that included participation in an ESOP did not constitute "value" sufficient to establish the "sale" of an ESOP interest under the Securities Acts. *See Childers,* 688 F.Supp. at 1363; *Bauman,* 571 F.Supp. at 1064. These cases are thus distinguishable in that employee-participants in these plans did not make individual investment decisions and in the courts' examination of their investment in the context of determining whether a sale occurred rather than whether a security existed in the first instance. *See id. In re Crippin* is even more readily distinguishable because it considered the effect of an employee's wage-reduction-for-ESOP-interest exchange only for purposes of determining whether the exchange was an executory contract that could be rejected as part of an employee-participant's bankruptcy. 877 F.2d at 596–97. To the extent these cases are not distinguishable, we

also simply disagree that plaintiffs' wage concessions in this case were not investments that led to the creation of investment contracts under *Howey.*

[12] Our decision that the CL ESOP is an investment contract is also consistent with *Daniel* for another reason. In that case, the Supreme Court concluded that plaintiff's pension plan interest was not a security in part because there was no administrative or congressional record interests in such plans being subject to regulation under the Securities Acts. *See id.* at 563–69, 99 S.Ct. at 798–02. As the *Daniel* Court noted, however, this is not true as to voluntary, contributory employee benefit plans. *See id.* The SEC has long distinguished voluntary, contributory employee benefit plans from other types of benefit plans and maintained that such voluntary, contributory plans are "securities" for purposes of the Securities Acts. [13] This consistent and long-standing agency interpretation ***579** of the status of employee interests in voluntary, contributory employee benefit plans under the Securities Acts is entitled to considerable weight unless it violates the "clear meaning of [the] statute, as revealed by its language, purpose, and history." *Daniel,* 439 U.S. at 566 n. 20, 99 S.Ct. at 800 n. 20; *see also United States v. National Ass'n of Sec. Dealers, Inc.,* 422 U.S. 694, 719, 95 S.Ct. 2427, 2442–43, 45 L.Ed.2d 486 (1975).

13 The SEC first stated this position as early as 1941, Opinions of SEC Assistant General Counsel, [1941–44 Transfer Binder] Fed.Sec.L.Serv. (CCH) ¶ 75,195 (1941), *reprinted in* 1 Pens.Plan Guide (CCH) ¶ 1104.101 at 2404–05 (1986) (stating that certain voluntary contributory employee stock investment plans were investment contracts subject to federal securities regulation); *see* Hearings on Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934 Before the House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 894–97 (1941) (testimony of Commissioner Purcell), and reiterated this view in 1953 and 1962, *see* Letter to CCH from Assistant Director, Division of Corporation Finance, Securities Exchange Commission (May 12, 1953), 1 Pens. Plan Guide (CCH) ¶ 1104.102 at 2406 (1986); Letter to CCH from Chief Counsel, Division of Corporation Finance, Securities Exchange Commission (Aug. 1, 1962), 1 Pens.Plan Guide (CCH) ¶ 1104.103 at 2406 (1986), and again in 1979 in successful opposition to a proposal to amend ERISA and the Securities Acts to exclude interests in employee benefits plans from the Securities Acts' antifraud provisions. *See* Hearings on S. 209 Before the Senate Committee on Human Resources, 96th Cong., 1st Sess. 657–74 (1979) (statement of Harold M. Williams, Chairman, Securities and Exchange Commission). The SEC again expressed its view that employee interests in voluntary contributory employee benefit plans are securities in two releases issued after and in response to the Supreme Court's decision in *Daniel. See* SEC Release No. 33–6188 at 2073–9; SEC Release No. 33–6288 at 2073–31.

Congress has also long demonstrated its belief and implied intent that at least some employee benefit plans, and particularly voluntary, contributory plans, are subject to federal securities regulation. In 1934, for example, it rejected an express attempt to exempt employee stock investment plans from the definition of securities under the Acts, basing this decision "on the ground that the participants in [such] plans may be in as great a need of the protection afforded by availability of information concerning the issuer for which they work as are most other members of the public." H.R.Conf.Rep. No. 1838, 73d Cong., 2d Sess. 41 (1934). In 1970, Congress also recognized by implication that some employee benefit plans were subject to the Securities Acts when it amended the 1933 Act to exempt certain employee benefit plans from the Act's registration requirements. *See* Pub.L. No. 91–547 (Dec. 14, 1970) and Pub.L. No. 91–567 (Dec. 22, 1970), *codified at* 1933 Securities Act, § 3(a)(2), 15 U.S.C. § 77c(a)(2). Congress' consideration and rejection of a bill that would have expressly exempted interests in all employee benefit plans from the antifraud provisions of the Securities Acts is also evidence that it considered at least some such interests to be otherwise subject to regulation under these Acts. *See* S.209, 96th Cong., 1st Sess. (Feb. 8, 1979). In a report analyzing the need to enact ERISA, the Senate focused on the plans subject to such regulation when it described its understanding that "[p]ension and profit-sharing plans are exempt from coverage under the Securities Act of 1933 ... *unless the plan is a voluntary contributory pension plan* and invests in the securities of the employer company in an amount greater than that paid into the plan by the employer." [14] Interim Report of Activities of the Private Welfare and Pension Plan Study, 1971, S.Rep. No. 634, 92d Cong., 2d Sess. 96 (1972) (emphasis added). Thus, unlike the situation in *Daniel,* the administrative and congressional record regarding the employee benefit plan at issue here, the voluntary, contributory CL ESOP, supports our decision that the plaintiffs' interests in this plan are securities.

14 The latter reference to the amount of the plan's investment in the employer's securities apparently relates to the requirements for establishing the plan's exemption

from the Securities Act registration requirements under the 1970 amendment described above. *See* 15 U.S.C. § 77c(a)(2). It has no apparent relevance to the definition of employee benefit plans subject to the Securities Acts' antifraud provisions.

2. *The effect of alternate federal regulation of plaintiffs' ESOP interests under ERISA*

Even if the district court erred in concluding that plaintiffs' interests in the CL ESOP were not investment contracts, its judgment that plaintiffs' ESOP interests fall outside the protection of the Securities Acts may nonetheless be affirmed if the "context" of these interests supports this result. 15 U.S.C. §§ 77b(1), 78c(a)(10) (defining an "investment contract" to be a federally protected "security" "unless the context otherwise requires"). In *Holloway v. Peat, Marwick, Mitchell & Co.,* 879 F.2d 772 (10th Cir.1989) (*Holloway I*), we relied on this language as interpreted by the Supreme Court in *Marine Bank v. Weaver,* 455 U.S. 551, 557–59, 102 S.Ct. 1220, 1224–25, 71 L.Ed.2d 409 (1982), and *Daniel,* 439 U.S. at 569–70, 99 S.Ct. at 801–02, to hold that "[e]ven if the instruments [at issue] potentially qualify as securities because of the factual circumstances underlying the transactions, the context of other federal regulation may still remove these instruments from the federal securities laws." ***580** *Holloway I,* 879 F.2d at 783. [15] In this case, it is undisputed that the CL ESOP and plaintiffs' rights as participants in this ESOP are extensively regulated under ERISA, thus requiring us to determine whether this alternate federal regulation removes the plaintiffs' CL ESOP-investment contracts from the realm of federal securities laws.

15 While this appeal was pending, the Supreme Court vacated the judgment in *Holloway I* and remanded the case for further consideration in light of *Reves v. Ernst & Young,* 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990). *See Peat Marwick Main & Co. v. Holloway,* 494 U.S. 1014, 110 S.Ct. 1314, 108 L.Ed.2d 490 (1990). *Reves,* like *Holloway I,* concerned the circumstances under which an instrument categorized as a "note" will be considered a "security" within the meaning of the federal securities laws. *See Reves,* 110 S.Ct. at 948; *Holloway I,* 879 F.2d at 777. In *Reves,* the Court adopted a "family resemblance" test for determining when a note is a "security." *Reves,* 110 S.Ct. at 951. This test initially presumes that a note is a security, but provides that the presumption may be rebutted by reference to four factors, the last of which is "whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary." *Id.* at 951–52. In *Holloway I,* this court employed a similar test, but structured it in two parts, with the first part looking solely at the "security" question, while the second, as described above, focused on the consequences of any alternate federal regulation. *See Holloway I,* 879 F.2d at 775–83, 783–88.

On remand of *Holloway I,* we reaffirmed our earlier judgment upon finding that our original analysis had adequately addressed the four *Reves* factors. *Holloway v. Peat, Marwick, Mitchell & Co.,* 900 F.2d 1485, 1487–88 (10th Cir.) (*Holloway II*), *cert. denied,* 498 U.S. 958, 111 S.Ct. 386, 112 L.Ed.2d 396 (1990). In so doing, we implicitly adopted our earlier analysis in *Holloway I. See id.* at 1488 & n. 1. Because *Reves* contains no language undercutting the premise of *Holloway I*'s federal regulatory analysis, which is that the existence of alternate federal regulation will in some cases prevent an erstwhile security from being regulated under the Securities Acts, *see Holloway I,* 879 F.2d at 778, 783, we find that this analysis is still valid and may be relied upon in this case. *See Marine Bank,* 455 U.S. at 558–59, 102 S.Ct. at 1224–25 (federal bank regulations providing investors with abundant protection from fraud sufficient to prevent bank certificate of deposit from being subject to Securities Acts); *Daniel,* 439 U.S. at 569–70, 99 S.Ct. at 801–02 (ERISA regulation of compulsory, noncontributory pension plan one factor in holding that plan was not a security).

[13] The test under *Holloway I* for determining whether the existence and application of nonsecurities-related federal regulation bars application of the Securities Acts is whether "such alternate federal regulation accomplishes the same purposes as the securities laws, thereby making the securities laws' protections for investors duplicative and unnecessary." *Holloway I,* 879 F.2d at 778 (citing and construing *Marine Bank,* 455 U.S. at 557–59, 102 S.Ct. at 1224–25; *Daniel,* 439 U.S. at 569–70, 99 S.Ct. at 801–02); *see also Holloway I,* 879 F.2d at 783–84, 786. As we described in *Holloway I,* the fundamental purpose of these laws is protection of the investor " 'from the sale of worthless securities through misrepresentation.' " *Id.* at 786 (quoting *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 756 F.2d 230, 237 (2d Cir.1985)). The Securities Acts achieve this purpose by two means: (1) requiring disclosure to investors of "relevant, accurate information upon which to base an investment decision" and (2) providing "meaningful remedies for investors when the antifraud provisions of the laws have been violated." *Id.* at 786. If alternate federal regulation "abundantly protects" the investor on both of these counts, then this regulation may displace application of the federal securities laws. *Id.* (citing *Marine Bank,* 455 U.S. at 558–59, 102 S.Ct. at 1224–25). The purpose behind at least the first of the Securities Acts' protective provisions may also be served if, "in lieu of full disclosure to investors of relevant, accurate information upon which to base an investment decision, investors are protected by another entity that acts on their behalf to monitor the issuing entity and to take corrective actions to protect their investments." *Id.*

Plaintiffs argue that ERISA does not displace application of the Securities Acts in this case for two reasons. First, they contend that ERISA does not provide the necessary "abundant protection" for their investment in the CL ESOP as required by ***581** *Holloway I.* Second, they argue that even if ERISA did provide such protection, this duplicate federal regulation does not prevent application of the Securities Act in this case because both Congress and the SEC have indicated that voluntary, contributory employee benefit plans, such as CL ESOP, are subject to federal securities regulation notwithstanding the existence of possibly duplicative ERISA regulation. The Pepsico defendants argue in turn that both of these arguments must fail, and that the district court's judgment must be affirmed, because the Supreme Court previously decided in *Daniel* that ERISA preempts application of the Securities Acts to all forms of employee benefit plans. Each of these arguments is discussed below.

a. Investor protection under ERISA

[14] In *Holloway I,* we held that alternate federal regulation must fulfill both the disclosure and remedial purposes of the Securities Acts before it will displace the protections offered by these Acts. 879 F.2d at 786. The first of these purposes is met if the alternate federal regulation either compels the disclosure of "relevant, accurate information upon which to base an investment decision" or allows the federal regulators to act on behalf of investors "to monitor the issuing entity and to take corrective actions to protect their investments." *Id.* In this case, defendants argue that the extensive disclosure and reporting requirements imposed on plan administrators under ERISA satisfy this requirement. As plaintiffs point out, however, all of these disclosure requirements apply only to individuals who are already participants or beneficiaries [16] of an ERISA-regulated benefit plan. [17] *See* 29 U.S.C. § 1021(a) (1988); 29 C.F.R. Part 2520, Subpart F (1990); *see* *Childers,* 688 F.Supp. at 1361 (ERISA disclosure provisions only extend to plan participants and beneficiaries). Thus, ERISA, unlike the Securities Acts, does not require plan administrators or promoters to provide any information about the plan to individuals who are considering whether to become plan participants. *See* 15 U.S.C. § 77e(b) (requiring issuer of security to provide prospectus to potential investor unless security is exempt from registration).

16 ERISA defines a "participant" as "any employee or former employee of an employer ... who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit." 29 U.S.C. § 1002(7). For an individual to be a "participant" under the "may become eligible" portion of this definition, the individual "must have a colorable claim that (1) he or she will prevail in a suit for benefits, or that (2) eligibility requirements will be fulfilled in the future." *Firestone Tire & Rubber Co. v. Bruch,* 489 U.S. 101, 109 S.Ct. 948, 958, 103 L.Ed.2d 80 (1989). ERISA defines a "beneficiary" as "a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder." 29 U.S.C. § 1002(8).

17 This point is emphasized by the fact that ERISA only requires a plan administrator to provide plan information to new plan participants within 90 days *after* the individual joins the plan. 29 U.S.C. § 1024(b).

The focus of ERISA's disclosure requirements, moreover, is on informing plan participants of their rights and obligations under the plan, and not on distributing information regarding the plan's financing or its financial soundness. *See* 29 U.S.C. § 1022(b) (only financial information required to be disclosed to participants under ERISA is "the source of financing of the plan and the identity of any organization through which benefits are provided"); 29 C.F.R. § 2520.102–3(q) (same). Although detailed financial information, such as that subject to disclosure under the Securities Acts, *see* 15 U.S.C. §§ 77e, 77g, 77aa (Schedule A), [18] is available to an ERISA plan participant upon request, *see* 29 U.S.C. § 1024(b)(2), (4) (plan administrator must provide participants with plan's annual report upon request); *id.* at § 1023 (requiring annual report to include detailed financial information), it is not automatically provided ***582** to plan participants or available at all to prospective participants. Accordingly, ERISA does not, as *Holloway I* and the Securities Acts require, compel the disclosure of "relevant, accurate information upon which to base an investment decision." *Holloway I,* 879 F.2d at 786.

18 Schedule A requires the issuer of a security to provide a potential investor, among other things, with a copy of its most recent balance sheet and profit and loss statement. 15 U.S.C. § 77aa(25), (26).

[15] It is less clear whether ERISA nonetheless satisfies the information disclosure purpose of the Securities Acts by granting federal regulators sufficient authority to monitor ERISA plans and to take corrective action on behalf of plan "investors." *See id.* The necessary monitoring authority may be provided by virtue of ERISA's requirement that plan administrators file annual reports with the Secretary of Labor. *See* 29 U.S.C. § 1023. The Secretary's authority to enforce ERISA's funding requirements and fiduciary responsibilities on plan administrators by civil or administrative action, *see id.* § 1132(a)(2), (5); *see also id.* §§ 1081–1086 (funding requirements), 1101–1114 (fiduciary duties), also provides federal regulators with some authority to take "corrective action" on behalf of plan participants "to protect their investments." *See Holloway I,* 879 F.2d at 786. In order for this corrective action authority to take the place of the Securities Acts' disclosure provisions, however, it must essentially guarantee the individual's investment. *Holloway I,* 879 F.2d at 788; *see Marine Bank,* 455 U.S. at 558–59, 102 S.Ct. at 1224–25 (federal banking regulations guaranteeing certificates of deposit displaces federal securities regulation of these certificates). The Secretary's authority to enforce ERISA's funding and fiduciary obligations does not meet this standard with respect to ESOP investments because the value of these investments is entirely dependent on the value of the employer company's stock, and hence on the financial soundness and future prospects of the employer itself, rather than on the employer's continued funding and proper management of plan assets. Accordingly, the Secretary's monitoring and corrective authority under ERISA does not provide "the 'virtual guarantee' necessary to displace the protection of the securities laws" and its disclosure provisions. *Holloway I,* 879 F.2d at 788 (quoting *Marine Bank,* 455 U.S. at 558–59, 102 S.Ct. at 1225).

[16] Even if the Secretary's monitoring and enforcement authority under ERISA fulfilled the underlying purpose of the Securities Acts' disclosure requirements, we would still find that ERISA does not satisfy *Holloway I*'s test for displacement of the Securities Acts because it fails to provide a meaningful remedy to plan participants who allege that plan administrators or promoters acted fraudulently in inducing them to join the plan. *See Holloway I,* 879 F.2d at 786 ("[T]he purposes of the federal securities acts cannot be effectively carried out unless the alternate federal regulation provides for a meaningful [antifraud] remedy to investors.") The Securities Acts provide such a remedy through section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and SEC Rule 10b–5, 17 C.F.R. § 240.10b–5 (1990), which together authorize private damage actions by investors to recover from persons who make untrue statements of material facts or otherwise act fraudulently in connection with the purchase or sale of a security. *See Holloway I,* 879 F.2d at 786; *see generally* T. Hazen, The Law of Securities Regulation § 13.2 (2d ed. 1990). The Securities Acts also permit investors fraudulently induced to enter into an investment transaction to rescind that transaction and recover the amount of their investment. *See, e.g., Hatrock v. Edward D. Jones & Co.,* 750 F.2d 767, 773 n. 4 (9th Cir.1984); *see generally* Hazen at § 13.7.

Neither the parties nor our research has produced any authority indicating that ERISA provides such a remedy for misrepresentation or other fraudulent acts committed in connection with an individual's decision to join an ERISA-regulated plan. ERISA's civil enforcement provision grants plan participants and beneficiaries the right to bring a private action to recover benefits under a plan, *see* 29 U.S.C. § 1132(a)(1); to enforce ERISA's plan disclosure, funding, and administrative requirements, *see id.* § 1132(a)(3), (4); and to obtain "appropriate relief" for breach of fiduciary duty by an ERISA plan administrator or other person who exercises discretionary control or authority ***583** over the plan or its assets. *See id.* §§ 1132(a)(2), 1109 (ERISA liability for breach of fiduciary duty), 1002(21) (defining fiduciary). Only this latter provision regarding breach of fiduciary duty might possibly address fraud committed in connection with an investor's initial decision to join an ERISA plan. Those courts that have considered the issue, however, have held that the fiduciary relationship necessary to state such a claim does not come into existence until an individual becomes an ERISA plan participant, thus denying participants an ERISA remedy for fraud or misrepresentation that occurred before and in connection with their decision to join the plan. *See Isaac v. Life Investors Ins. Co.,* 749 F.Supp. 855, 863 (E.D.Tenn.1990); *Coleman v. General Elec. Co.,* 643 F.Supp. 1229, 1235 (E.D.Tenn.1986), *aff'd,* 822 F.2d 59 (6th Cir.1987); *see also Klank v. Sears, Roebuck & Co.,* 735 F.Supp. 260, 263 (N.D.Ill.1990) (employee who was neither a plan participant nor a beneficiary could not state an ERISA claim against his employer for failure to provide him with information regarding participation in the employer's ERISA plan).

Other authority regarding this issue also indicates that ERISA does not provide a remedy for the type of misconduct that is alleged in this case and is prohibited by the Securities Acts. [19] In *Perry v. P*I*E Nationwide, Inc.,* 872 F.2d 157 (6th Cir.1989), *cert. denied,* 493 U.S. 1093, 110 S.Ct. 1166, 107 L.Ed.2d 1068 (1990), for example, plaintiffs, like the plaintiffs in this case, were employees of a long-distance motor carrier that successfully solicited them to accept a significant wage reduction in return for participation in an ERISA-regulated ESOP. *Id.* at 158–59. After the company took actions in conflict with representations allegedly made to plaintiffs-employees during the solicitation process, plaintiffs sought rescission of their plan participation and restitution of the agreed wage reduction under theories of common law fraud and misrepresentation. *Id.* at 158–59, 161–62. The defendant employer moved to dismiss the action on the ground that these state law claims were preempted by section 1144(a) of ERISA because they "related to" an ERISA-regulated plan. *See id.* at 158. The district court denied the motion on the ground that plaintiffs' claims related to the manner in which the defendant employer procured plaintiffs' agreement to the wage reduction program rather than to the administration of the ESOP or plaintiffs' benefits under the plan. *Id.* at 159. The Sixth Circuit affirmed this result because "[g]iving plaintiffs the benefit of some doubt in this respect, we are uncertain whether 29 U.S.C. § 1132 provides, under the circumstances of this case, an adequate remedy to redress the wrongs claimed, specifically, rescission and refund of wage reductions." [20] *Id.* at 162.

19 Numerous other courts have held that ERISA does not preempt state law claims for fraud in the inducement because such claims are too tenuous and remote to the ERISA plan to be "related to" the plan as required for preemption under section 1144 of the statute. *See, e.g., Perkins v. Time Ins. Co.,* 898 F.2d 470, 473 (5th Cir.1990); *Martin v. Pate,* 749 F.Supp. 242, 246 (S.D.Ala.1990); *Greenblatt v. Budd Co.,* 666 F.Supp. 735, 742 (E.D.Pa.1987); *Miller v. Lay Trucking Co.,* 606 F.Supp. 1326, 1333 (N.D.Ind.1985). This precedent again suggests that ERISA is not directed to prevention of the sort of pre-participation fraud and misrepresentation that would be actionable under the Securities Acts.

20 As the Pepsico defendants point out in their supplemental brief, Supplemental Brief for Certain Appellees at 18, this court has previously held that ERISA permits the remedies of rescission and restitution in at least some circumstances. *See Eaves v. Penn,* 587 F.2d 453, 462 (10th Cir.1978). In that case, however, the court only approved these remedies in the context of a request by plan participants to rescind a plan amendment and to restore funds lost to the plan as a result of the amendment. *See id.* at 463. *Eaves* did not, therefore, concern an attempt under ERISA to rescind participation in a plan or to recover employee contributions to a plan and is thus readily distinguishable from this case.

[17] Even if ERISA did permit a cause of action for rescission of an employee's participation in a plan and restitution of his or her contributions in cases of fraudulent inducement, there is a split in the circuits as to whether this or any other claim for breach of fiduciary duty can be brought against parties who are not, in fact, plan fiduciaries as defined by ERISA. *Compare* ***584** *Nieto v. Ecker,* 845 F.2d 868, 873 (9th Cir.1988) (nonfiduciaries are not liable under ERISA) *with Brock v. Hendershott,* 840 F.2d 339, 342 (6th Cir.1988) (nonfiduciaries are liable under ERISA) and *Lowen v. Tower Asset Management, Inc.,* 829 F.2d 1209, 1220 (2d Cir.1987) (same). ERISA defines a plan fiduciary as a person who

> [1] exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, [2] renders investment advice for a fee or other compensation ... with respect to any moneys or other property of such plan, or has authority or responsibility to do so, or [3] has any discretionary authority or discretionary responsibility in the administration of such plan.

29 U.S.C. § 1002(21)(A). Under this definition, at least some of the defendants in this case, including Pepsico and its officers and directors, are likely to be deemed nonfiduciaries under the statute. Given the uncertainty of their amenity to suit under ERISA, [21] it cannot be said that ERISA "abundantly" protects plaintiffs by providing them with a remedy for fraud allegedly committed by these defendants and others in inducing plaintiffs to join the CL ESOP. [22]

21 It is possible that the Pepsico defendants could qualify as "parties in interest" with CL, *see* 29 U.S.C. § 1002(14) (defining "party in interest"), such that certain transactions between these parties and CL, as plan administrator, would constitute violations of the statute potentially subject to redress by a court. *See Nieto,* 845 F.2d at 873–74. The parties to this action did not address this possibility, however, and we cannot address it *sua sponte* under the present record.

22 In their supplemental brief, plaintiffs also suggest that relief may not be available to them under ERISA because there is a split of authority as to whether an employee may bring an ERISA action challenging oral or written misrepresentations regarding an ERISA-regulated plan. *See* Appellants' Supplemental Brief on the Impact of ERISA at 21. In each of the cases cited, however, the issue was whether a plan participant could sue to enforce alleged ERISA plan provisions that were stated either orally or in the plan's summary description but conflicted with the terms of the plan itself. *See, e.g., Straub v. Western Union Tel. Co.,* 851 F.2d 1262, 1265 (10th Cir.1988) (oral modification); *Nachwalter v. Christie,* 805 F.2d 956, 960 (11th Cir.1986) (same); *Gors v. Venoy Palmer Market, Inc.,* 578 F.Supp. 365, 368 (E.D.Mich.1984) (conflict between summary description and plan itself); *O'Brien v. Sperry Univac,* 458 F.Supp. 1179, 1180 (D.D.C.1978) (same). In this case, plaintiffs are suing to rescind their participation in a plan based on alleged oral misrepresentations, rather than suing to enforce those representations. Thus, to the extent that there is a split among the circuits regarding the effect of oral or written representations on plan terms and conditions, it is irrelevant to the issue before this court.

As discussed above, *Holloway I* only permits ERISA to displace federal securities regulation of the CL ESOP and other employee benefit plans if ERISA duplicates the protection offered to plaintiffs by the Securities Acts' disclosure and antifraud provisions. ERISA fails both of these tests. Accordingly, we hold that ERISA does not provide sufficient protection to plan participants to displace application of federal securities laws to plaintiffs' interests in the CL ESOP.

b. Continued federal regulation of voluntary, contributory employee benefit plans under both ERISA and the Securities Acts

Plaintiffs also argue in the alternative that even if ERISA duplicates the investor protection provided to plaintiffs by the Securities Acts, this duplication has no effect on the "securities" status of interests in voluntary, contributory employee benefit plans such as the CL ESOP. They base this claim on the SEC's assertion, even after ERISA, that these types of plans continue to be subject to regulation under the Securities Acts. *See, e.g.,* SEC Release No. 33–6188 at 2073–9 to 2073–11. As noted earlier, this agency interpretation of its regulatory authority is entitled to considerable weight unless it violates "the clear meaning of [the] statute, as revealed by its language, purpose, and history." [23] *Daniel,* ***585** 439 U.S. at 566 n. 20, 99 S.Ct. at 800 n. 20; *see also National Ass'n of Sec. Dealers,* 422 U.S. at 719, 95 S.Ct. at 2442–43.

23 We disagree with the SEC's contention, however, that all voluntary, contributory employee benefit plans qualify as investment contracts under *Howey.* The voluntary, contributory aspect of such plans satisfies *Howey*'s "investment of money" requirement, but is not determinative of each plan's compliance with *Howey*'s final requirement that profits from this investment result from the efforts of others. *See Howey,* 328 U.S. at 301, 66 S.Ct. at 1104. Depending on the specific terms of the plan, therefore, some voluntary, contributory employee interests will not qualify as investment contracts under the *Howey* test. *See* n. 10 *supra* and accompanying text.

[18] In fact, there is evidence that Congress intended for the SEC to continue regulating employee benefit plans that qualified as securities even after ERISA. In ERISA itself, for example, Congress expressly excluded state securities regulation from preemption under the statute, thus permitting states that had followed the SEC in finding interests in voluntary, contributory plans to be securities to continue in this practice. [24] *See* 29 U.S.C. § 1144(b)(2)(A). In section 1144(d), Congress further provided that ERISA was not intended to supersede any existing federal law, thus allowing the SEC to continue regulating qualifying employee benefit plans as it always had. *See id.* § 1144(d). In 1979, Congress also considered and rejected a bill that, among other provisions, would have amended ERISA to specifically remove interests in employee benefit plans from the definition of "security" for purposes of the antifraud provisions of the Securities Acts. *See* S. 209, 96th Cong., 1st Sess. (Feb. 8, 1979). These congressional actions are consistent with the SEC's determination that at least some voluntary, contributory plans are investment contracts subject to federal securities regulation and support plaintiffs' claim that Congress knew and approved of continued SEC regulation of such plans when it enacted ERISA in 1974. We therefore hold that even if ERISA duplicates the investor protection offered by the Securities Acts to the plaintiffs in this case, this alternate federal regulation does not prevent plaintiffs from establishing that their interests in the voluntary, contributory CL ESOP are securities or bar them from invoking the Securities Acts to protect these interests.

24 As plaintiffs point out, it makes little sense for Congress to have permitted the states this latitude while intending that ERISA preempt federal securities regulation of interests in these same types of plans.

The Pepsico defendants again rely on the Supreme Court's decision in *Daniel* to argue against both this result and our general holding that ERISA has no effect on the status of plaintiffs' ESOP interests as securities. In particular, these defendants maintain that *Daniel* essentially decided that interests in all employee benefit plans, including voluntary, contributory plans, are not subject to regulation under the Securities Acts. This position is based on the Court's statements concerning ERISA's effect on the status of involuntary, noncontributory pension plans under the Securities Acts:

> If any further evidence were needed to demonstrate that pension plans of the type involved [a compulsory, noncontributory plan] are not subject to the Securities Acts, the enactment of ERISA in 1974, would put the matter to rest. Unlike the Securities Acts, ERISA deals expressly and in detail with pension plans. ERISA requires pension plans to disclose specified information to employees in a specified manner, in contrast to the indefinite and uncertain disclosure obligations imposed by the antifraud provisions of the Securities Acts. Further, ERISA regulates the substantive terms of pension plans, setting standards for plan funding and limits on the eligibility requirements an employee must meet. For example, with respect to the underlying issue in this case—whether respondent served long enough to receive a pension—§ 203(a) of ERISA now sets the minimum level of benefits an employee must receive after accruing specified years of service, and § 203(b) governs continuous-service requirements. Thus, if respondent had retired after § 1053 took effect, the Fund would have been required to pay him at least a partial pension. The Securities Acts, on the other ***586** hand, do not purport to set the substantive terms of financial transactions.
>
> The existence of this comprehensive legislation governing the use and terms of employee pension plans severely undercuts all arguments for extending the Securities Acts to noncontributory, compulsory pension plans. Congress believed that it was filling a regulatory void when it enacted ERISA, a belief which the SEC actively encouraged. Not only is the extension of the Securities Acts by the court below unsupported by the language and history of those Acts, but in light of ERISA it serves no general purpose. Whatever benefits employees might derive from the effect of the Securities Acts are now provided in more definite form through ERISA.
>
> We hold that the Securities Acts do not apply to a noncontributory, compulsory pension plan.

Daniel, 439 U.S. at 569–70, 99 S.Ct. at 801–02 (citations omitted).

Contrary to the Pepsico defendants' assertion, this language indicates that *Daniel*'s ultimate holding, as well as most of its statements regarding the interplay between ERISA and the Securities Acts, are limited to the status of noncontributory, compulsory plans under these Acts. To the extent that the Court's broader statements comparing ERISA and the Acts' disclosure and remedial provisions are more than dicta, they are also distinguishable from this case because of the differences between the claims made in *Daniel* and those made here. In *Daniel,* the plaintiff was seeking to recover benefits under a pension plan on the grounds that the defendants had misrepresented certain aspects of his eligibility for plan benefits. *See* 439 U.S. at 554–555, 569, 99 S.Ct. at 801–02. As the Supreme Court noted in the language quoted above, this is precisely the type of claim that ERISA is intended to address. In this case, on the other hand, plaintiffs seek return of their investment in the CL ESOP, rather than a determination of the benefits due them under that benefit plan, on the ground that defendants committed fraud in inducing them initially to enter into the plan. As described earlier in this opinion, ERISA does not provide a remedy for this type of fraudulent behavior. Accordingly, *Daniel* does not require us to hold that ERISA provides such ample investor protection to plaintiffs' interests in the CL ESOP that it displaces regulation of these interests under the Securities Acts.

B. Other Issues on Appeal

Both plaintiffs and the Pepsico defendants also raise a number of additional issues on appeal. Plaintiffs first contend that the district court erred by dismissing their claims under the Oklahoma Securities Act on grounds of federal preemption, and then urge us to hold, as a matter of law, that their ESOP interests are securities under this act. The record, however, indicates that the district court dismissed plaintiffs' state security claims upon finding no basis for federal jurisdiction after dismissal of the federal securities claims, rather than on the basis of federal preemption. 1988 Order at 14–15. Given this record and our holding that dismissal of these federal claims was error, we reverse and remand the district court's dismissal of the state securities claims without reaching plaintiffs' contentions regarding the status of their ESOP interests under Oklahoma securities law.

[19] **[20]** The plaintiffs also assert that the district court abused its discretion in prohibiting them from introducing evidence at trial concerning the profit-sharing component of the Wage Reduction Program. As plaintiffs implicitly admit in their brief, their request to admit evidence on this point amounted to a request for leave to amend their complaint. *See* Brief of Petitioner at 43–45. Although leave to amend "shall be freely given when justice so requires," Fed.R.Civ.P. 15(a), whether leave should be granted is left to the trial court's discretion. *Las Vegas Ice & Cold Storage Co.,* 893 F.2d at 1185. In this case, plaintiffs had twice been granted leave to amend their complaint before this last request. The issues to be resolved at trial had been set for more than a year and trial was scheduled to begin in three months. Given these facts, we will not say that the ***587** district court abused its discretion in denying plaintiffs leave to amend. *See id.* (untimeliness alone may be a sufficient basis for denial of leave to amend).

Plaintiffs' final claim on appeal is that the district court abused its discretion when it excluded certain of plaintiffs' exhibits, namely a series of payroll slips, from trial on the ground that they had not been designated as trial exhibits as required by a pretrial order. In light of the clear wording of the pretrial order, we find no abuse of discretion in this ruling. [25]

25 Of course, neither the parties nor the district court is precluded for revisiting these pleading and evidentiary issues on remand of this matter.

The Pepsico defendants also cross-appeal the district court's denial of their post-trial motion for costs and fees pursuant to 28 U.S.C. § 1927 and Rule 11 of the Federal Rules of Civil Procedure. These defendants allege that they are entitled to such costs and fees due to the plaintiffs' persistence in asserting that their wage reductions were paid into or otherwise contributed to the CL ESOP and that they made a voluntary investment decision. Given our determination on appeal that both of these statements were correct as a matter of law, we find no abuse of discretion in the district court's refusal to award sanctions.

The judgment of the United States District Court for the Western District of Oklahoma is therefore AFFIRMED with respect to its determination of the pleading, evidentiary and sanction issues discussed above. The district court's dismissal of plaintiff's federal and state securities claims is REVERSED, however, and this matter is REMANDED for additional proceedings consistent with this opinion.

All Citations

940 F.2d 564, 60 USLW 2075, Fed. Sec. L. Rep. P 96,097, 13 Employee Benefits Cas. 2473

KeyCite Yellow Flag - Negative Treatment
Declined to Follow by Beck v. Haik, 6th Cir.(Mich.), July 29, 2004

212 F.3d 180
United States Court of Appeals,
Third Circuit.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
v.
The INFINITY GROUP COMPANY; Geoffrey P. Benson; Geoffrey J. O'Connor; Futures Holding Company; SLB Charitable Trust; Susan L. Benson; JGS Trust; Lindsey Springer; Bondage Breaker Ministries Lindsey Springer; Bondage Breaker Ministries, Third–Party Plaintiffs
v.
The Union States of the Constitution, i.e.; Alaska; Alabama; Arkansas; Arizona; California; Colorado; Connecticut; Delaware; Florida; Georgia; Hawaii; Iowa; Illinois; Indiana; Kansas; Kentucky; Louisiana; Massachusetts; Maryland; Maine; Michigan; Minnesota; Missouri; Mississippi; Montana; North Carolina; North Dakota; Nebraska; New Hampshire; New Jersey; New Mexico; Nevada; New York; Ohio; Oklahoma; Oregon; Pennsylvania; Rhode Island; South Carolina; South Dakota; Tennessee; Texas; Utah; Virginia; Vermont; Wisconsin; West Virginia; Wyoming; Washington; Federal District of Columbia, Third–Party Defendants
Geoffrey J. O'Connor (98–1215), Geoffrey P. Benson (98–1216), Susan L. Benson, Pro Se on Behalf of Herself in Her Representative Capacity on Behalf of SLB Charitable Trust, Futures Holding Company and JGS Trust (98–1217), Appellants

Nos. 98–1215, 98–1216, 98–1217.
|
Argued: March 2, 1999
|
Filed: May 4, 2000

Synopsis

Securities and Exchange Commission (SEC) commenced civil securities fraud action against investment trust and its principals. The United States District Court for the Eastern District of Pennsylvania, Stewart Dalzell, J., 993 F.Supp. 324, froze trust's assets, appointed trustee, ordered disgorgement of trust assets, and granted permanent injunction. Defendants appealed. The Court of Appeals, McKee, Circuit Judge, held that: (1) property transfer contracts pursuant to which investors contributed sums of money to trust were securities under federal law; (2) trust's principals had requisite scienter for securities fraud; (3) trial court did not abuse its discretion in denying defendants' untimely request for jury trial; and (4) trial court did not abuse its discretion in prohibiting further disbursement of frozen trust assets for defendants' legal expenses.

Affirmed.

West Headnotes (25)

[1] **Federal Courts** Jurisdiction

The Court of Appeals exercises plenary review over a district court's ruling on a motion to dismiss for lack of subject matter jurisdiction. Fed.Rules Civ.Proc.Rule 12(b)(1), (h)(3), 28 U.S.C.A.

16 Cases that cite this headnote

[2] **Securities Regulation** In general; investment contracts

In order for something to qualify as an "investment contract" under the definition of "security" in the Securities Act of 1933, it must be: (1) an investment of money; (2) in a common enterprise; (3) with profits to come solely from the efforts of others. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

4 Cases that cite this headnote

[3] **Securities Regulation** Particular interests

Property transfer agreements qualified as investment contracts under definition of "security" in Securities Act of 1933, where, pursuant to contracts, investors contributed sums of money to investment trust in return for varying number of "capital units" based on amount invested, and investors were to receive guaranteed rate of return based on amount of investment; horizontal commonality existed despite purported fixed rate of return and purported guaranteed repayment of principal at request of investor. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

4 Cases that cite this headnote

[4] **Securities Regulation** In general; investment contracts

When determining whether profits are to come solely from the efforts of others, as required for something to qualify as an investment contract under the definition of "security" in the Securities Act of 1933, the court focuses on whether the purchaser is attracted to the investment by the prospect of a profit on the investment, rather than a desire to use or consume the item purchased, and whether the purchaser has meaningfully participated in the management of the partnership in which it has invested such that it has more than minimal control over the investment's performance. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

1 Cases that cite this headnote

[5] **Securities Regulation** Questions of law or fact; jury questions

Even if the parties to a civil securities enforcement action agree that the requirements of the definition of a "security" are met, the court has an independent responsibility to determine that the transaction at issue is indeed a security, because the inquiry is jurisdictional. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

[6] **Securities Regulation** In general; investment contracts

"Horizontal commonality," which satisfies the common enterprise requirement to qualify as an investment contract under the definition of "security" in the Securities Act of 1933, is characterized by a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

15 Cases that cite this headnote

[7] **Securities Regulation** In general; investment contracts

The determination of whether something is a "security" under the Securities Act of 1933 does not turn on whether the investor is to receive a variable or fixed rate of return, and the mere fact that the expected rate of return is not speculative does not, by itself, establish that a contract is not an "investment contract" within the definition of security. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

1 Cases that cite this headnote

[8] **Securities Regulation** In general; investment contracts

For purposes of determining whether something qualifies as a "security" under the Securities Act of 1933, "profits" can be either capital appreciation resulting from the development of the initial investment, or earnings contingent on profits gained from the use of investors' funds. Securities Act of 1933, § 2(a)(1), as amended, 15 U.S.C.A. § 77b(a)(1).

[9] **Securities Regulation** Scienter; knowledge or intention

Securities Regulation Scienter, Intent, Knowledge, Negligence or Recklessness

In order to prove securities fraud in a civil action, the Securities and Exchange Commission (SEC) must establish the requisite "scienter," which is a mental state embracing intent to deceive, manipulate, or defraud. Securities Act of 1933, § 17(a), as amended, 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), as amended, 15 U.S.C.A. § 78j(b).

11 Cases that cite this headnote

[10] **Securities Regulation** Scienter; knowledge or intention

Securities Regulation Scienter, Intent, Knowledge, Negligence or Recklessness

For purposes of establishing scienter in a civil securities fraud action, "recklessness" includes highly unreasonable conduct, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the defendant must have been aware of it. Securities Act of 1933, § 17(a), as amended, 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), as amended, 15 U.S.C.A. § 78j(b).

42 Cases that cite this headnote

[11] **Securities Regulation** Scienter; knowledge or intention

Securities Regulation Scienter, Intent, Knowledge, Negligence or Recklessness

Good faith, without more, does not necessarily preclude a finding of recklessness that would establish the scienter required for securities fraud; therefore, even if the defendant believed that its investments were sound, it may still be liable for securities fraud if that belief was based upon nothing more than a reckless disregard of the truth. Securities Act of 1933, § 17(a), as amended, 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), as amended, 15 U.S.C.A. § 78j(b).

10 Cases that cite this headnote

[12] **Securities Regulation** Scienter; knowledge or intention

Securities Regulation Scienter, Intent, Knowledge, Negligence or Recklessness

Investment trust principals had requisite scienter for Securities and Exchange Commission's (SEC's) civil securities fraud action, even if they believed truth of statements in solicitation materials guaranteeing 138-181% return on investments with no risk to investors; there was no reasonable basis for belief, where principals used over $3.6 million of investors' funds for personal expenses, less than half of $26.6 million received from investors was actually invested, no profits were ever realized on those investments, which included payment of $302,000 for bond with face value of $1000 issued by railroad that had ceased to exist over 100 years earlier, and principals failed to obtain certified financial statements from companies in which they invested trust funds, failed to obtain legal opinions about legitimacy of their investment programs, and failed to obtain certificates of good standing. Securities Act of 1933, § 17(a), as amended, 15 U.S.C.A. § 77q(a); Securities Exchange Act of 1934, § 10(b), as amended, 15 U.S.C.A. § 78j(b).

10 Cases that cite this headnote

[13] **Federal Courts** Trial

The Court of Appeals reviews the district court's denial of an untimely request for a jury trial for abuse of discretion. Fed.Rules Civ.Proc.Rule 39(b), 28 U.S.C.A.

11 Cases that cite this headnote

[14] **Jury** Time for making demand

Trial court did not abuse its discretion in denying untimely request for jury trial in Securities and Exchange Commission's (SEC's) civil securities fraud action, even though granting request would not have materially prejudiced SEC; although delay might have been partly attributable to change in counsel, only justification for delay was attorney inadvertence, defendant did not make jury request until two weeks before trial, and quantum of damages sought by SEC, standing alone, was not adequate to show that case was suitable for jury trial. Fed.Rules Civ.Proc.Rule 39(b), 28 U.S.C.A.

20 Cases that cite this headnote

[15] **Jury** Time for making demand

When determining whether to grant an untimely jury demand, courts consider: (1) whether the issues are suitable for a jury; (2) whether granting the motion would disrupt the schedule of the Court or the adverse party; (3) whether any prejudice would result to the adverse party; (4) how long the party delayed in bringing the motion; and (5) the reasons for the failure to file a timely demand. Fed.Rules Civ.Proc.Rule 39(b), 28 U.S.C.A.

38 Cases that cite this headnote

[16] **Federal Courts** Cumulative error

Under the "cumulative error doctrine," the Court of Appeals may determine that, although certain errors do not require relief when considered individually, the cumulative impact of such errors may warrant a new trial; in other words, under this theory, the whole is greater than the sum of its parts.

17 Cases that cite this headnote

[17] **Receivers** Discretion of court

The authority to freeze assets in receivership, in whole or in part, is committed to the district court's sound discretion.

14 Cases that cite this headnote

[18] **Securities Regulation** Registration and distribution regulation violations

Trial court did not abuse its discretion in Securities and Exchange Commission's (SEC's) civil securities fraud action by issuing order, two days before final injunction hearing, prohibiting any further disbursements from frozen assets for defendant-investment trust's legal fees and expenses, where there was evidence that defendant was attempting raise funds from investors to pay for legal services.

9 Cases that cite this headnote

[19] **Federal Civil Procedure** Discretion of court

Matters of docket control and scheduling are within the sound discretion of the district court.

9 Cases that cite this headnote

[20] **Federal Civil Procedure** Assignment of Cases for Trial

Despite its assertion that it was operating under expedited discovery schedule, defendant in Securities and Exchange Commission's (SEC's) civil securities fraud action failed to establish either actual or substantial prejudice resulting from district court's rescheduling final injunction hearing to date two days earlier than originally scheduled, where court notified parties more than three weeks before originally scheduled date that hearing date would have to be changed due to changes in district court's criminal docket.

2 Cases that cite this headnote

[21] **Federal Courts** Admission or exclusion in general

The Court of Appeals reviews the exclusion of lay opinion testimony for abuse of discretion. Fed.Rules Evid.Rule 701, 28 U.S.C.A.

1 Cases that cite this headnote

[22] **Evidence** Facts Forming Basis of Opinion

A lay opinion is rationally based on the witness' perception, as required for its admissibility, if the witness has firsthand knowledge of the factual predicates that form the basis for the opinion. Fed.Rules Evid.Rule 701, 28 U.S.C.A.

[23] **Evidence** Due care and proper conduct in general

Trial court, in Securities and Exchange Commission's civil securities fraud action, properly excluded lay opinion testimony of insurance specialist, who was to testify regarding existence of legitimate investment instruments that produced extremely high returns with minimal risk, in order to show that defendant was not reckless in making similar representations to investors in solicitation materials, since witness had no personal knowledge of investments in question. Fed.Rules Evid.Rule 701, 28 U.S.C.A.

[24] **Federal Courts** Probative value and prejudicial effect

The Court of Appeals reviews a district court's decision to refuse to admit exhibits not previously identified for abuse of discretion, considering: (1) the prejudice or surprise in fact to the opposing party; (2) the ability of the party to cure the prejudice; (3) the extent of disruption of the orderly and efficient trial of the case; and (4) the bad faith or willfulness of the non-compliance.

6 Cases that cite this headnote

[25] **Federal Civil Procedure** Failure to respond; sanctions

Trial court in Securities and Exchange Commission's (SEC's) civil securities fraud action properly excluded exhibits defendants failed to list in pretrial statement, where court excluded only those documents that defendants failed to produce and justified exclusion by stating that SEC was "entitled not to be surprised."

1 Cases that cite this headnote

Attorneys and Law Firms

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Mr. Lindsey K. Springer, Pro Se (Argued), Tulsa, OK.

Before: ALITO and McKEE, Circuit Judges, and SCHWARTZ, District Judge. [*]

[*] The Honorable Murray M. Schwartz, Senior District Judge of the United States District Court for the District of Delaware, sitting by designation.

OPINION OF THE COURT

McKEE, Circuit Judge.

Defendants appeal the grant of a permanent injunction in this civil action for securities fraud. The defendants argue that the instruments that they offered to investors were not "securities" under federal law, and that the district court therefore lacked subject matter jurisdiction. The defendants also challenge certain evidentiary and procedural rulings that the district court made during the hearing on the motion for a permanent injunction. For the reasons that follow, we will affirm.

I.

In November 1995, defendants Geoffrey Benson and Geoffrey O'Connor formed the Infinity Group Company Trust (the "Trust" or "TIGC"). [1] Thereafter, the Trust unveiled an "Asset Enhancement Program" that offered investors an opportunity to invest with the expectation of exceedingly high return and minimal risk. Investors in TIGC were asked to execute "property transfer contracts" pursuant to which the investors contributed substantial sums of money to the Trust for the Trust to invest. TIGC guaranteed investors that they would receive an annual rate of return ranging from 138% to 181% depending on the amount of the participant's principal ***185** investment. [2] The guarantees were based upon the Trust's purported performance experience, financial connections, and the ability to pool large amounts of money. Participants were promised that their principal would be repaid upon demand. Once the property transfer contracts were executed, the transferred funds became assets of the Trust and were subject to investment at the sole discretion of the Board of TIGC.

1 Benson was the Executive Trustee Director of TIGC. O'Connor was also a trustee of TIGC. As Trustees of

TIGC, Benson and O'Connor exercised sole discretion of the Trust's investment programs.

2 For property transfers of $1,200 to $50,000, the guaranteed rate of return was 138%. For amounts greater than $50,000, the return rate was 181%.

TIGC's solicitation was successful. It raised approximately $26.6 million from over 10,000 investors nationwide. However, TIGC only invested $12 million of the funds it received pursuant to the property transfer contracts, and it never earned a profit on the funds it did invest. [3] Rather, the Trust sustained mounting loses that it failed to disclose to investors. The district court described what happened as follows:

3 Defendants contend that the money that was not invested was used for "operating expenses" and charitable contributions or that it constituted "excess profits." Appellant's Br. at 11. The evidence at trial established that the money not invested was used to pay "dividends" to earlier investors and personal expenses of the Benson family. Appellee's Br. at 12–13.

> TIGC also used over $2 million in so-called downline commissions to keep the engine of this enterprise humming like a new Mercedes on the autobahn. In the time-dishonored tradition of Charles Ponzi, TIGC substituted new investors' money for real investment return on old investors' funds.
>
> The rest of TIGC's expenditures were even less investment-related. More than $816,000 was spent on real estate, a significant portion of which went to the purchase and development of a personal residence for Geoffrey and Susan Benson ... the purchase or lease of cars for their garage, ... a $6,133.46 spending spree at Circuit City; more than $2,000 spent at television retailers; over $50,000 in "household expenses"; $5,000 to pay off a home mortgage; $10,000 to pay off personal credit card bills; $10,000 for school tuition for the Bensons' son; as well as hundreds for jewelry, bowling equipment and membership fees, [sic] groceries. In short, the Bensons used TIGC as their personal checking account.
>
> In addition, Geoffrey Benson made an undisclosed donation of $1.265 million of investor funds to Lindsey K. Springer, d/b/a Bondage Breaker Ministries.
>
> In addition to all this, defendants Geoffrey Benson and Geoffrey O'Connor paid themselves nearly $300,000 in cash from TIGC's funds, none of it reported to the Internal Revenue Service or even documented on TIGC's books—which did not exist. Lastly, more than $1.9 million remains unaccounted for,.... [4]

4 The district court agreed with the SEC's claim that the operation of the Trust was "the classic *modus operandi* of Ponzi schemes." Appellee's Br. at 21. For a brief explanation of the origin of "Ponzi schemes" and Charles Ponzi *see Bald Eagle Area School District v. Keystone Financial, Inc.*, 189 F.3d 321, 324 n. 1(3rd Cir.1999), and Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 Am. Bankr. L.J. 157, 158 (1998).

SEC v. Infinity Group Co., 993 F.Supp. 324, 325–26 (E.D.Pa.1998) (original footnote omitted).

On August 27, 1997, the SEC filed the instant complaint in the United States District Court for the Eastern District of Pennsylvania charging "an ongoing scheme, directed by Benson and O'Connor, to defraud public investors through the offer and sale of TIGC securities, in the form of investment contracts," App. 41a, in violation of Section 22 of the Securities Act of 1933, 15 U.S.C. 77v, and Sections 21 and 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78u & 78aa. The Commission sought a permanent injunction, a freeze of ***186** the assets of TIGC, appointment of a Trustee to manage the affairs of TIGC, and an order requiring defendants, and certain third parties (the "relief defendants") to disgorge assets of TIGC that had been improperly transferred. [5]

5 The SEC sought disgorgement from the following relief defendants: Futures Holding Company (controlled, in part, by Benson); SLB Charitable Trust (a charitable trust established in the name of Susan Benson, Benson's wife); Susan L. Benson (trustee of SLB and TIGC); JGS Trust (a "family trust" controlled by Benson); Lindsey Springer (manager and "legal representative" of TIGC and controller of Bondage Breaker Ministries); and Bondage Breaker Ministries.

On September 5, 1997, after a hearing, the district court issued an Order for Preliminary Injunction, Appointment of Trustee, and Freeze of Assets and Other Relief. Although the Trust's funds and assets were frozen, the September 5 Order provided for the release of funds to pay legal expenses and fees, as well as defendants' living expenses. On February 6, 1998, the district court entered a final judgment against the defendants enjoining them from further violations of the securities laws and ordering disgorgement of all amounts contributed to the Trust by the Trust participants. This appeal followed.

II.

Defendants raise four issues on appeal. First, they argue that the property transfer contracts that were used as an "investment" vehicle here were not "securities" under federal securities laws, and therefore that the district court lacked subject matter jurisdiction. Second, they argue that inasmuch as they sincerely believed in the investments that TIGC made, there can be no liability for securities fraud. Third, they allege that the district court erred in denying their concededly untimely demand for a jury trial. Lastly, they contend that several allegedly erroneous procedural and evidentiary rulings constitute reversible cumulative error even though the rulings were harmless when considered separately. We will discuss each argument in turn.

III.

[1] We must first address the defendants' claim that the district court lacked subject matter jurisdiction because the "property transfer contracts" were not "securities" under federal securities laws. Inasmuch as this is an appeal from a final judgment, we have jurisdiction to review the district court's decision under 28 U.S.C. § 1291. We exercise plenary review over a district's ruling on a motion to dismiss for lack of subject matter jurisdiction. *Delaware Valley Citizens Council v. Davis*, 932 F.2d 256, 264 (3d Cir.1991).[6]

6 Although the district court treated defendants' motion to dismiss for lack of subject matter jurisdiction as a Rule 12(h)(3) motion, the parties here have treated it as a 12(b)(1) motion. We exercise plenary review under either. *See Nationwide Insurance Co. v. Patterson*, 953 F.2d 44, 45 (3d Cir.1991) (Rule 12(h)(3) motion to dismiss is subject to plenary review).

[2] It is well established that federal securities laws only apply to the purchase or sale of "securities" as defined therein. *Steinhardt Group Inc. v. Citicorp*, 126 F.3d 144, 150 (3d Cir.1997).

> "[S]ecurity" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, ... *investment contract*, voting-trust certificate, ... any interest or instrument commonly known as a "security", or any certificate of interest or participation in, ... or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1) (emphasis added). The property transfer agreements that TIGC's investors executed certainly appear to be "investment contract[s]," however "[t]he term investment contract has not been defined by Congress, nor does the legislative history to the 1933 and 1934 ***187** Acts illuminate what Congress intended by the term investment contract." *Steinhardt*, 126 F.3d at 150–51. In *SEC v. W.J. Howey Co.*, 328 U.S. 293, 66 S.Ct. 1100, 90 L.Ed. 1244 (1946), the Supreme Court provided a framework for determining when such agreements are subject to federal law. The Court stated:

> [A]n investment contract for purposes of the Securities Act means 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, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.

Howey, 328 U.S. at 298–99, 66 S.Ct. 1100. Thus, the property transfer contracts between TIGC and its investors are securities if they were (1) "an investment of money," (2) "in a common enterprise," (3) "with profits to come solely from the efforts of others." *Id.* at 301, 66 S.Ct. 1100, *Steinhardt*, 126 F.3d at 151.

[3] Defendants agree that the property transfer contracts satisfy the first and third prongs of the *Howey* test. Indeed, they can hardly deny it. There clearly was an investment of money because the contracts required and evidenced the monetary transfer solely for the purposes of receiving the "guaranteed" return of between 138% and 181%. *See Steinhardt*, 126 F.3d at 151 (finding prong one met where an investment was made with the expectation of an 18% return on investment). Similarly, the third prong is clearly satisfied here because the expected return was to be "with profits to come solely from the efforts of others." *Id.* (quoting *Howey*, 328 U.S. at 301, 66 S.Ct. 1100).

[4] **[5]** Our focus under the third prong is whether "the purchaser [is] attracted to the investment by the prospect of a profit on the investment rather than a desire to use or consume the item purchased." *Id.* at 152. TIGC's investors did not intend to consume anything in return for the money they gave to TIGC. Whether the investor has "meaningfully participated in the management of the partnership in which it has invested such that it has more than minimal control over the investment's performance" is also relevant under the third prong. *Id.* TIGC concedes that "the TIGC Board retained exclusive control over the investment decision." Appellant's Br. at 18. Thus, the participants were passive investors who exercised no control over the funds they gave to TIGC. Those investors depended upon the managerial decisions of others. Therefore, we agree that the first and the third prongs have been satisfied, [7] and we will focus our analysis upon the "common enterprise," or second prong, of the *Howey* test.

7 Even though the parties agree that the first and third prong are satisfied, we must independently satisfy ourselves that those prongs are established because the inquiry is jurisdictional, and we have an independent responsibility to insure that subject matter jurisdiction exists. *SeeSteel Company v. Citizens for a Better Environment*, 523 U.S. 83, 94, 118 S.Ct. 1003, 140 L.Ed.2d 210 (1998) (federal courts must decide jurisdictional issues "even when not otherwise suggested, and without respect to the relation of the parties to it.").

[6] We have held that the common enterprise requirement is satisfied by "horizontal commonality." [8] Horizontal commonality ***188** is characterized by "a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors." *Steinhardt*, 126 F.3d at 151 (*quoting* Maura K. Monaghan, *An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis*, 63 Fordham L. Rev. 2135, 2152–53 (1995) (footnotes omitted)). *See also Salcer v. Merrill Lynch, Pierce, Fenner & Smith*, 682 F.2d 459, 460 (3d Cir.1982) (holding that a commodity account is not a "security" because it is not part of a pooled group of funds). Here, it is undisputed that TIGC's solicitation and membership materials stated that TIGC would pool participant contributions to create highly-leveraged investment power that would yield high rates of return while protecting the investors' principal contributions. For example, the Trust's Private Member Material and Manual represents:

8 Circuit courts of appeals utilize two distinct approaches in analyzing commonality; "vertical commonality," and "horizontal commonality." "Vertical commonality" focuses on the community of interest between the individual investor and the manager of the enterprise. *See e.g., Long v. Schultz Cattle Co.*, 881 F.2d 129 (5th Cir.1989) ("A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties") (*quoting S.E.C. v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 n. 7 (9th Cir.1973)). "Horizontal commonality" examines the relationship among investors in a given transaction, requiring a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis. *See e.g., Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459 (3d Cir.1982); *Cooper v. King*, 114 F.3d 1186 (6th Cir.1997); *SEC v. Lauer*, 52 F.3d 667 (7th Cir.1995).
In *Steinhardt*, we declined to decide if we should adopt a vertical commonality analysis when conducting an inquiry under the commonality prong of *Howey*. *Steinhardt*, 126 F.3d at 151. Inasmuch as we conclude that horizontal commonality exists here, we need not now decide if we should also adopt a vertical commonality analysis.

> The Infinity Group Company invests for profit by accepting amounts as low as [$1200] from thousands of people like you, and creating large blocks of funds that are in the millions of dollars. This gives the Trust a leverage position whereby we can command large profits, and have the security of never putting the principal at risk. This is very sophisticated investing that cannot be accomplished unless you have millions of dollars to deposit in a top world U.S. bank.

App. 261a. However, TIGC argues that commonality is nevertheless lacking because the investors did not "share proportionately in the profits or losses of TIGC or the various investment programs," Appellant's Br. at 19 (emphasis omitted). Rather, TIGC asserts that "each participant would execute an individual contract with TIGC providing for a fixed return, payable on demand (principal only) or on a specific date...." *Id.* According to TIGC:

> [T]he property transfers were obligations of TIGC to repay the other party to the contract at a specific time, and did not represent a direct interest in TIGC, any other entity or a specific security or investment vehicle.... The property transfers were not earmarked for any particular purpose, or even any particular type of investment.... Under these contracts, the TIGC Board retained exclusive control over the investment decision and participants were not promised that their funds would be invested in any particular investment program.

Id. at 18 (internal citations omitted).

However, TIGC's denial of horizontal commonality is contrary to the record. By the plan's very terms, the return on investment was to be apportioned according to the amounts committed by the investor. Each investor's apportionment of profits was represented by certain "capital units" obtained in exchange for executing a "property transfer agreement." The number of units an investor purchased was, of course, dependent upon the size of his or her investment and the investor's return was directly proportional to the amount of that investment. TIGC's solicitation materials stated:

> [W]ith the Private Trust, what you will be doing is making a Property Transfer into the Trust in exchange for 1 Capital Unit for every $100 deposit. In turn the Trust guarantees that you will make a certain annual dividend. These dividends are a minimum of 20% up to 181% depending on the amount of Capital Units you hold.

Supp.App. 77. The materials also stated that "[d]ividends are dispersed ... as the ***189** assets of the Trust increase and as the Board of Trustees elects to pay guaranteed dividends," App. 261a.

[7] TIGC seeks to negate the obvious import of its structure by arguing that there are technical characteristics that distinguish the instruments involved here from those that are "securities." We are not persuaded. The defendants' claim that the property transfer contracts do not constitute "investment contracts" because the investors were to receive a fixed rate of return rather than a rate dependent on the success of the investments. The defendants argue:

> [I]f the aggregate value of the investments increased, each contract holder would not share in the appreciation. Rather, they would receive only their fixed, contractually agreed-upon return.... Similarly, if the value of TIGC investments decreased, the contract holder would still be entitled to the agreed-upon, fixed return on his or her property transfer contract.... In the event that the value of the investments dropped below the ability of TIGC to honor its commitment to a specific individual, the participants would not share proportionately ("pro rata") in the shortfall.

Appellant's Br. at 19 (internal citations omitted). However, the definition of security does not turn on whether the investor receives a variable or fixed rate of return. *See El Khadem v. Equity Securities Corp.*, 494 F.2d 1224, 1229 (9th Cir.1974) (that expected profits remain constant while risk of loss varies does not remove a plan from the definition of a security); *National Bank of Yugoslavia v. Drexel Burnham Lambert, Inc.*, 768 F.Supp. 1010, 1016 (S.D.N.Y.1991) (holding that time deposits made for investment purposes in return for a fixed rate of interest were investment instruments rather than consumer or commercial bank loans).

[8] Profits can be either "capital appreciation resulting from the development of the initial investment" or earnings contingent on profits gained from the use of investors' funds. *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975). The mere fact that the expected rate of return is not speculative does not, by itself, establish that the property transfer contracts here are not "investment contracts" within the meaning of federal securities laws. *See Howey*, 328 U.S. at 301, 66 S.Ct. 1100 (explicitly rejecting the theory that a non-speculative enterprise cannot be considered an investment contract; "it is immaterial whether the enterprise is speculative or non-speculative").

Moreover, the transactions here are easily distinguished from those in *Marine Bank v. Weaver*, 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982), where the Supreme Court held that FDIC-protected certificates of deposit offering a fixed rate of return were not securities. There, the Supreme Court stated that Congress "did not intend to provide a broad federal remedy for all fraud." *Id.* at 557, 102 S.Ct. 1220. The Court reasoned that certificates of deposit issued by federally-regulated banking institutions differed from other long-term debt obligations in part because "[i]t is unnecessary to subject issuers of bank certificates of deposit to liability under the antifraud provisions of the federal securities laws since the holders of bank certificates of deposit are abundantly protected under federal banking laws," *Id.* at 559, 102 S.Ct. 1220. The Court noted that a "purchaser of a certificate of deposit is virtually guaranteed payment in full," *Id.* at 551, 102 S.Ct. 1220. Here, TIGC's investors were offered no such protection.[9] "The crux of the *Marine Bank* decision is that federal banking regulations and federal deposit insurance eliminate the risk of loss to the investor, therefore obviating the ***190** need for protection of the federal securities laws," *Gary Plastic Packaging Corp. v. Merrill Lynch*, 756 F.2d 230, 240 (2d Cir.1985).[10] As will become more evident in our discussion of TIGC's "investment" in certain railroad bonds, the investors here were guaranteed nothing despite TIGC's purported guarantee of principal. "The fundamental purpose undergirding the Securities Acts is 'to eliminate serious abuses in a largely unregulated securities market,' " *Reves v. Ernst & Young*, 494 U.S. 56, 60, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990) (quoting *United Housing*, 421 U.S. at 849, 95 S.Ct. 2051 (*distinguishing Marine Bank* where no risk-reducing factor was present)).

9 TIGC's investors are therefore like "the holder[s] of an ordinary long-term debt obligation (who) assume[ ] the risk of the borrower's insolvency." *Id.* at 551–52, 102 S.Ct. 1220.

10 Defendants contend that "just because the property transfers at issue in this case do not constitute securities does not mean they were exempt from any form of regulation whatsoever. Perhaps there are other branches of government, state or federal, with jurisdiction over TIGC, or other regulations or statutes which TIGC's conduct violated." Appellant's Br. at 20. However, they do not identify any applicable regulation or statute. This is consistent with our conclusion that this enterprise required the protections of federal securities laws.

> The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion....
>
> S.Rep. No. 47, 73d Cong., 1st Sess., at 1 (1933).

We take a flexible and realistic approach in determining when a particular scheme requires the protection of federal securities laws.

For example, in *Howey*, the defendant owned large tracts of citrus acreage that it sold to the public. Purchasers of the tracts received land sales and service contracts and, upon full payment of the purchase price, the land was conveyed by warranty deed. However, under the arrangement between Howey and the purchasers, a servicing corporation was given "full and complete" possession of the acreage, and full discretion to grow, harvest, and market crops grown on the tracts with very little accountability to the purchaser. The SEC instituted an action against Howey because the corporation had not complied with the registration requirements of federal securities laws. Howey defended by arguing that registration was not required because it was not selling "securities" under federal law. The "lower courts ... treated the contracts and deeds as separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer," *Howey*, 328 U.S. at 297–98, 66 S.Ct. 1100, and concluded that they did not constitute "securities" under federal law. However, the Supreme Court disagreed because Howey was not merely offering fee simple interests in land coupled with a contract for management services. Rather, the Court concluded that

Howey was offering "an opportunity to contribute money and to share in the profits" of the enterprise. *Id.* at 299, 66 S.Ct. 1100. "[The purchasers were] attracted solely by the prospects of a return on their investment," and the land sales contracts and warranty deeds were merely a "convenient method" by which to apportion profits. *Id.* at 300, 66 S.Ct. 1100. Thus, the Court concluded that the agreements were securities. The Court reasoned:

> The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, *regardless of the legal terminology in which such contracts are clothed.*

Id. (emphasis added). *See also* ***191** *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943) (finding that a defendant selling assignment of oil leases was "not as a practical matter offering naked leasehold rights," instead "the (oil) exploration enterprise was woven into these leaseholds, in both an economic and a legal sense; the undertaking to drill a well runs through the whole transaction as the thread on which everybody's beads were strung.")

Here, the investors' beads were strung upon the gossamer guarantee of seemingly impossibly high returns at no risk. The fact that TIGC promised a "fixed rate of return" based upon the amount invested is irrelevant. We will not embroider a loophole into the fabric of the securities laws by limiting the definition of "securities" in a manner that unduly circumscribes the protection Congress intended to extend to investors. Rather, we must scrutinize these "property transfer contracts" in a manner that "permits the fulfillment of the statutory purpose of compelling full and fair disclosure relative to the issuance of the many types of instruments that in our commercial world fall within the ordinary concept of a security." *Howey*, 328 U.S. at 299, 66 S.Ct. 1100 (internal quotation marks and citation omitted). Our inquiry:

> embodies 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.

Id.

We must consider that Congress "enacted a definition of 'security' sufficiently broad to encompass virtually any instrument that might be sold as an investment," *Reves*, 494 U.S. at 61, 110 S.Ct. 945. The securities laws were intended to provide investors with accurate information and to protect the investing public from the sale of worthless securities through misrepresentations. H.R.Rep. No. 85, 73d Cong., 1st Sess., at 1–5 (1933). As noted above, TIGC accepted nearly $26.6 million from approximately 10,000 investors. TIGC persuaded those investors to part with their cash by guaranteeing the proverbial "blue sky;" fantastic profit at no risk. Of the $26.6 million raised, more than half of the money was used to satisfy the material "needs" of the individual defendants. The balance was poured down empty wells that could hardly be confused with prudent investments. TIGC *realized no return whatsoever* on those "investments." Given the totality of the circumstances here, the property transfer contracts clearly constitute securities, and the district court therefore had subject matter jurisdiction.

IV.

Defendants argue that the SEC failed to establish the scienter required for liability under Section 17(a) of the Securities Act, [11] Section 10(b) of the Exchange Act [12] or Rule 10b–5. [13] They argue that they cannot therefore be liable even if the property transfer contracts were securities.

11 Section 17(a) makes it unlawful for any person in the offer or sale of any security to: (1) "employ any device, scheme or artifice to defraud;" (2) "obtain money or property by means of any untrue statement [or omission] of material fact;" or (3) to "engage in any transaction, practice or course of business which operates ... as a fraud or deceit upon the purchaser." 15 U.S.C. § 77q(a).

12 Section 10(b) of the Exchange Act prohibits "manipulative" or "deceptive" conduct "in connection with the purchase or sale of a security." 15 U.S.C. § 78j(b).

13 Rule10b–5 proscribes (1) the employment of any "device, scheme or artifice to defraud;" (2) the making of "any untrue statement [or omission] of material fact;" and (3) the engagement "in any act, practice, or course of business which operates ... as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b–5.

[9] **[10]** The SEC must establish the requisite scienter to establish securities fraud. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976); *Newton v. Merrill, Lynch,* ***192** *Pierce, Fenner & Smith, Inc.*, 135 F.3d 266, 272–73 (1998); *McLean v. Alexander*, 599 F.2d 1190, 1196–97 (3d Cir.1979). Scienter is "a mental state embracing intent to deceive, manipulate or defraud," *Hochfelder*, 425 U.S. at 193 n. 12, 96 S.Ct. 1375; *McLean*, 599 F.2d at 1197. We have previously held that the scienter required for securities fraud includes recklessness, and we have adopted the definition of recklessness set forth in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.1977). *See also* *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 193 (3d Cir.1981).[14] Accordingly, recklessness includes:

14 The recklessness standard applies to both omissions and misstatements. *McLean*, 599 F.2d at 1197.

> [H]ighly unreasonable (conduct), involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.
>
> *McLean*, 599 F.2d at 1197 (citing *Sundstrand Corp.*, 553 F.2d at 1045).

[11] The SEC argues that scienter is evidenced by TIGC's guarantees of high rates of return that were unsupported by any honest due diligence. The defendants, on the other hand, contend that their actions "were entirely consistent with the fact that they believed their representations (in the Trust literature and elsewhere) [to be] true." Appellant's Br. at 23. However, good faith, without more, does not necessarily preclude a finding of recklessness. Therefore, even if the defendants believed TIGC's investments were sound, they may still be liable for securities fraud if their belief was based upon nothing more than a reckless disregard of the truth. Moreover, we reiterate that TIGC invested less than half of the money obtained under the property transfer contracts. In addition, a minimum of $3,649,000 of the funds was spent on such things as the Bensons' home, a new Mercedes Benz, etc. Nevertheless, the defendants claim that they "attempted to obtain documentation and contractual guarantees from the investment providers" and "were [themselves] the victims of fraud on the part of the investment providers." *Id.* at 29–30. We are not persuaded.

[12] The defendants concede that no profits were ever realized from the funds that were actually invested. Appellant's Br. at 11. One need look no further than one example of an investment that TIGC made to understand why no profit was ever realized and to appreciate the specious nature of the denials of recklessness. In October 1996, TIGC purchased a bond of the Marietta and Northern Georgia Railway that had been issued in 1889. TIGC paid $302,000 for that bond, apparently based upon "unsubstantiated boasts of value ranging from $35 million to $107 million, and without performing any meaningful type of due diligence inquiry to clarify the $72 million discrepancy." Appellee's Br. at 28. TIGC paid $302,000 even though the bond had a face value of only $1000. Despite the unique investment acuity proclaimed in the Trusts' materials, the defendants missed a little glitch in this investment bonanza. The railroad that issued the bond had gone bankrupt in 1895, and it had ceased to exist in 1896. Supp.App. 1–4. The bond was therefore "worthless except for its modest value as a collectible (which [was] estimated at $80–100.)." Appellee's Br. at 29. Thus, TIGC used a portion of those funds that it did not divert to personal use to pay $302,000 for a bond with a face value of $1,000 that had been issued by a railroad that had gone out of business 100 years ago.[15] In referring to this investment the district court stated:

15 This investment was therefore the ultimate "turn around play."

> ***193** [W]e suspect that even a complete neophyte in finance, accounting, or economics would suspect, when confronted with such an investment, that defendants' business was on the wrong track. Instead, TIGC chose in its materials to value the ancient bond at $107 million!
>
> 993 F.Supp. at 330. It is a small wonder that the district court referred to TIGC as a "financial train wreck." *Id.* at 326. Yet, TIGC's offering materials proclaimed that the unique skill it provided would enable the Trust to guarantee very high rates of return with no risk to principal. The solicitation materials boasted that participants would have "an opportunity that has a 100% success rate, for 100% of the people who become associated with my business." Supp.App. 74. Investors were told that their investments

were "guaranteed by a top 100 World Bank" and "the returns (Profits) that (TIGC based) the [return rate of] 138% and 181% on (were) guaranteed by the Trust, making this one of the safest programs available." App. 271a (emphasis omitted).

Even if we indulge the defendants and assume arguendo that they believed in these guarantees, we nevertheless must examine the foundation such a belief would have rested upon. A good faith belief is not a "get out of jail free card." It will not insulate the defendants from liability if it is the result of reckless conduct. *See McLean*.[16] However, under our standard of review, we must view the evidence in the light most favorable to the SEC as verdict winner. *Eisenberg v. Gagnon*, 766 F.2d 770, 778 (3d Cir.1985). In doing so, we readily conclude that the district court did not err in finding that the SEC had established the necessary scienter for securities fraud. The district court stated:

16 We will *assume* that a defendant can genuinely have a subjective belief that demonstrates good faith even though it is the result of reckless conduct. However, it clearly can be argued that a subjective belief based only upon an inquiry that is reckless can never properly be considered a "good faith" belief.

[W]e reject Geoffrey Benson's proffered defense that he was ignorant of the falsity of TIGC's statements, and in all events he acted in good faith in soliciting investor funds and pursuing investments on behalf of TIGC. Even assuming that those statements are true—and we do not, given the mountain of evidence of invidious motive here—ignorance provides no defense to recklessness where a reasonable investigation would have revealed the truth to the defendant.... Similarly, good faith is no shield to liability under the antifraud provisions of the Securities Acts....

But we need not rely on either the ignorance defense, or the existence of recklessness, in Geoffrey Benson's case. His actual intent to defraud may be inferred from his wholly successful, and carefully-crafted, offering materials.... [T]he materials at length depict a mysterious cabal into which only the initiated, like TIGC's trustees, could enter. Benson's texts weave visions of risk-free, high-return investing in a clever tapestry of anti-government, individualist fervor. Although the offering materials often speak of mysteries and the need to maintain secrecy, in fact Geoffrey Benson and his colleagues well knew that the reason these secrets were not mentioned is because there were none. As Geoffrey Benson and O'Connor allowed their offering materials to be disseminated around the country—by fax on demand, through a legion of downline representatives, and via the mails—they had to know that they were funding payments to early investors with new investors' money rather than with investment return. In short, Geoffrey Benson and Geoffrey O'Connor knew precisely what they were doing in these materials, and that was engaging in a hugely successful interstate fraud.

At best, defendants' investment enterprise began as a reckless financial enterprise, and evolved into an intentional scheme to defraud investors of their ***194** money when that money became necessary to prevent TIGC's collapse. At worst, TIGC's Asset Enhancement Program was from its inception a Ponzi scheme, calculated to bilk investors of funds by preying on their excessive greed, their feelings of exclusion from America's current prosperity, and their fears of jackbooted government intrusion.

993 F.Supp. at 330–31.[17] The district court's analysis is consistent with the record. Indeed, the record mandates the court's conclusion.

17 TIGC's materials also offered not so subtle hints that TIGC could assist in "sheltering" assets where others with less expertise had failed. TIGC's materials proclaimed:

If you are thinking about establishing an off-shore Trust or Bank Account please beware! Belize, the Cayman's and may [*sic*] others that used to be off-shore havens are about as safe as throwing your money in the fireplace. The U.S. government has twisted most of these off-shore government's arms to the point where they will give out information and let the U.S. do whatever they want to.

We have access to off-shore facilities that are totally safe when set up properly. If you are serious, and do not mind spending some time and money, you will want to contact us to get some of the preliminary details.

Supp.App. 88–89.

In *McLean*, we stressed that plaintiff:

[c]ircumstantial evidence may often be the principal, if not the only, means of proving bad faith. A showing of shoddy accounting practices amounted at best to a "pretended audit," or of grounds supporting a representation "so flimsy as to lead to the conclusion that there was no genuine belief

> back of it" have traditionally supported a finding of liability in the face of repeated assertions of good faith.... In such cases, the factfinder may justifiably conclude that despite those assertions the "danger of misleading ..." (was) so obvious that the actor must have been aware of it.

McLean, 599 F.2d at 1198 (citing *Sundstrand*, 553 F.2d at 1045) (footnotes omitted). Although defendants assert a good faith belief that their representations were true, "an opinion that has been issued without a genuine belief *or reasonable basis* is an 'untrue' statement which, if made knowingly or recklessly, is culpable conduct actionable under [the securities laws]." *Eisenberg*, 766 F.2d at 776 (emphasis added).

> When the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry, then the failure to investigate further may "support [ ]an inference that when [the defendant] expressed the opinion it had no genuine belief that it had the information on which it could predicate that opinion."

Id. (*citing McLean*, 599 F.2d at 1198). Here, the evidence supporting TIGC's purported belief in its representations is "so flimsy as to lead to the conclusion that there was no genuine belief" in the validity of TIGC's guarantee or the soundness of its investments. *McLean*, 599 F.2d at 1198 (*citing Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (N.Y.1931)). The guarantees were "so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception," *Id.* at 1197 (*citing Coleco Industries, Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir.1977)). Indeed, here, the recklessness can be equated to conscious deception, especially when we consider how the defendants' primary focus was upon improving their own (apparently lavish) lifestyle rather than attempting to get a decent (let alone extraordinary) rate of return on the investments of the participants in the Trust.

The Trust failed: (1) to obtain certified financial statements from the programs in which it invested, (2) to inquire into whether programs were insured or guaranteed by a banking institution, (3) to obtain legal opinions about the legitimacy of the investment ***195** programs and (4) to obtain certificates of good standing. [18]

18 We also note that TIGC's "warning of risk" was less than forthcoming. For example, the solicitation materials stated:

> Yes we do guarantee the returns you will make on your exempt security transfer.... (P)lease do not interpret guarantee as meaning absolutely no risk. There is no such thing. There's a risk in getting out of bed in the morning. Or ... a big rock could fall on Ohio and wipe out TIGC and everything else in the state. Remember, things can happen that are beyond anyone's control.

App. 230a.

We are equally unpersuaded by the defendants' attempts to shift the responsibility to the purported "dishonest and fraudulent activities" of the investment providers. Appellant's Br. at 28. Although several of the investment companies that TIGC did business with are now either defunct or under investigation, the evidence is inconsistent with TIGC as a mere "victim." Rather, it appears that several scoundrels were sleeping in the same bed, and these defendants were amongst them. We doubt that it was a mere oversight that TIGC continued to guarantee high rates of return even after defaults in $7.5 million worth of their investments. Thus, even if the initial guarantees were not recklessly made, the record would still support a finding that TIGC was reckless in failing to modify its guarantees after such massive defaults. Accordingly, we hold that the SEC presented abundant evidence of the scienter requirement of securities fraud. *See McLean*, 599 F.2d at 1197.

V.

Defendants next contend that the district court erred in denying their concededly untimely demand for a jury trial. The SEC filed its Complaint on August 27, 1997. The defendants filed an Answer on September 26, 1997; and relief defendants filed an Answer on October 28, 1997. The defendants did not file their Demand for Jury Trial until January 13, 1998; two and one half months after the final pleading in this case.

Fed.R.Civ.P. 38 states, in pertinent part, "Any party may demand a trial by jury of any issue triable of right by a jury by ... serving upon the other parties a demand thereof in writing at any time after the commencement of the action and not later than 10 days after the service of the last pleading directed to such issue ...," Fed.R.Civ.P. 38(b). Fed R. Civ. P. 39(b) provides, "[N]otwithstanding the failure of a party to demand a jury in an action in which such a demand might have been made of right, the court in its discretion upon motion may order a trial by jury of any or all issues." Fed.R.Civ.P.

39(b). Therefore, a district court may still grant a jury trial, even where the demand was untimely made.

[13] **[14]** We review the district court's denial of the request for a jury trial for abuse of discretion. *William Goldman Theatres v. Kirkpatrick*, 154 F.2d 66, 68 (3d Cir.1946). "An abuse of discretion is a 'clear error of judgment,' and not simply a different result which can arguably be obtained when applying the law to the facts of the case." *In re Tutu Wells Contamination Litigation*, 120 F.3d 368, 387 (3d Cir.1997) (*quoting United Telegraph Workers, AFL–CIO v. Western Union Corp.*, 771 F.2d 699, 703 (3d Cir.1985)). Although we understand that the delay here may have been partly attributable to a change in counsel, it is nevertheless uncontested that the only justification for the delay was attorney inadvertence. Courts in this Circuit generally deny relief when "the only basis for such relief advanced by the requesting party is the inadvertence or oversight of counsel." *See Plummer v. General Elec. Co.*, 93 F.R.D. 311, 313 (E.D.Pa.1981); and cases cited therein. However, this is not a mechanical rule.

[15] Courts consider several factors in determining whether to grant an untimely jury demand. They are:

> ***196** 1) whether the issues are suitable for a jury; 2) whether granting the motion would disrupt the schedule of the Court or the adverse party; 3) whether any prejudice would result to the adverse party; 4) how long the party delayed in bringing the motion; and 5) the reasons for the failure to file a timely demand.

Fort Washington Resources, Inc. v. Tannen, 852 F.Supp. 341, 342 (E.D.Pa.1994). Here, in denying the untimely request, the district court noted that (i) "Defendants offer nothing to excuse their untimeliness except the fact that they switched counsel in mid-November"—a full two months prior to making the demand, and (ii) "the fact that the demand was made only two weeks before trial—and not fully briefed until one week before trial—means that the Commission's case would be greatly prejudiced by our granting the motion." App. 118a. The district court did not abuse its discretion in denying the belated request for a jury trial under these circumstances.

We agree that the defendants did not make an adequate showing that the issues involved in this case were particularly suitable for a jury. Contrary to the defendants' assertion, we have rejected an argument for entitlement to a jury trial based upon the quantum of damages. *William Goldman Theatres*, 154 F.2d at 69 ("evidentiary facts are intricate and will require auditing, if not an accounting[,][w]e can perceive substantial difficulties, though not insuperable obstacles, to the framing of a charge which properly would submit the issue of damages to a jury").

The defendants also argue that the scheduling of the initial preliminary injunction hearing created time pressures resulting in counsel's failure to timely file a jury demand. Specifically, they argue that after new counsel entered their appearance in mid-November, "they faced the time consuming task of absorbing and assessing the facts, the procedural posture of the case, and potential trial strategies," as well as conducting discovery. Appellant's Br. at 32–33. The district court concluded that defendants' explanations "(fell) short" of excusing their untimely demand. App. 118a–19a. We agree.

We disagree, however, with the district court's conclusion that granting the belated jury request would have materially prejudiced the SEC under the circumstances here. Nevertheless, based upon all of the factors we have enumerated, we hold that the district court did not abuse its discretion in denying defendants' untimely demand for a jury trial.

VI.

[16] The defendants contend that the cumulative effect of four alleged evidentiary and procedural errors impaired their right to present and prepare an adequate defense. This aggregation of errors is known as the "cumulative error doctrine." Under that doctrine appellate courts may determine that, although certain errors do not require relief when considered individually, the cumulative impact of such errors may warrant a new trial. In other words, under this theory, the whole is greater than the sum of its parts. However, unlike some of our sister courts of appeals, [19] we have rejected the cumulative error doctrine, at least in the context of a civil trial. *See Lockhart v. Westinghouse Credit Corporation*, 879 F.2d 43, 57 (3d Cir.1989), *overruled on other grounds by Starceski v. Westinghouse Elec. Corp.*, 54 F.3d 1089 (3d Cir.1995).

Moreover, even if we were to apply the doctrine of cumulative error, we would conclude that defendants are entitled to no relief because the individual rulings that they challenge under that doctrine were not erroneous.

19 *See e.g., United States v. Rivera*, 900 F.2d 1462, 1469 (10th Cir.1990) ("The cumulative effect of two or more individually harmless errors has the potential to prejudice a defendant to the same extent as a single reversible error"); *Malek v. Federal Ins. Co.*, 994 F.2d 49, 55 (2d Cir.1993); *Frymire–Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 188 (7th Cir.1993); *Hendler v. United States*, 952 F.2d 1364, 1383 (Fed.Cir.1991).

***197** A.

Defendants claim that the district court erred in "cutting ... fees for defense counsel" two days before the final injunction hearing and thereby "unfairly (hampering) the defense efforts to complete discovery and to mount an effective defense at trial." Appellant's Br. at 35. In November 1997, the district court issued a preliminary injunction authorizing a court-appointed trustee to disburse $125,000 for legal fees and expenses on behalf of the defendants from the previously frozen assets. As a result of receiving information that the defendants were independently attempting to raise $175,000 to defray legal expenses, the SEC successfully moved to modify the district court's original provision of legal fees and expenses. Two days before the final injunction hearing began, the district court granted the SEC's motion in part, and issued an order prohibiting defense counsel from disposing of further trust assets to raise funds for fees or expenses.

[17] **[18]** The authority to freeze assets in receivership, in whole or in part, is committed to the district court's sound discretion. *Commodity Futures Trading Commission v. American Metals Exchange Corp.*, 991 F.2d 71, 79 (1993). A freeze of assets is designed to preserve the status quo by preventing the dissipation and diversion of assets. *Id.* (*quoting SEC v. Capital Counsellors, Inc.*, 512 F.2d 654 (2d Cir.1975)). Here, the district court's order modifying the initial release of legal expenses and fees was prudent inasmuch as the defendants were attempting to raise funds to pay for legal services. [20] In *American Metals*, we found no abuse of discretion where the district court denied a request to pay attorney's fees from frozen assets where it was shown that the defendant had access to other funds not in receivership. Accordingly, we do not find abuse of discretion here.

20 The record indicates that Infinity investors received the following correspondence from the "Freedom For America Ministry and Friends of Infinity":

> The SEC, government, the Judge, or Trustee (It's hard to tell any of them apart) has approved an "allowance" out of YOUR "MONEY" to be paid to us to live on.... Each and everyone of you can help with your gift to FAM, along with the completed form provided. Your gift at this time is important because the government has frozen [NOT SEIZED] all assets of TIGC and related entities which makes it impossible at this time for them to fund a Member Law Suit against the government, or to adequately finance their own offense. Your gift will be used for the following: Administrative and operating ... expenses ... 15%, Private Member Law Suit ... 25%, legal offense fund for TIGC ... 25%, and investments ... 35%. If the average gift is $100.00, FAM would have about $175,000 to fund a TIGC Member Suit, $175,000 to help TIGC with their legal costs, and $245,000 for investment purposes over a period of time.

Supp.App. 145–46.

B.

Defendants argue that the district court erred in "arbitrarily advancing the date for the (final injunction hearing) by two days" because defense was operating under an expedited discovery schedule and "could not afford to lose the two full days in which to prepare" for the final injunction hearing. Appellant's Br. at 35. This claim is wholly without merit.

[19] **[20]** Matters of docket control and scheduling are within the sound discretion of the district court. *Alaska v. Boise Cascade Corp.*, 685 F.2d 810, 817 (3d Cir.1982). Here, the district court notified both parties, over three weeks before the originally scheduled date, that the hearing date would have to be changed due to changes in the district court's criminal docket. We find neither "actual" nor "substantial" prejudice in the rescheduling. The change was only two days, and it impacted both sides.

C.

[21] **[22]** **[23]** Defendants allege error in the court's refusal to admit lay opinion testimony ***198** from John F. Jackman, an insurance specialist whom defendants called to testimony about "legitimate bank instruments and other investment programs which produce extremely high returns with minimal risk." Appellant's Br. at 36. The defendants contend that Mr. Jackman's testimony "was probative of the issue of whether [TIGC was] reckless or acted with an intent to defraud" and would contradict the finding that the promised rates of return were unlikely. *Id.* at 37. We review the exclusion of lay opinion testimony for abuse of discretion. *Government of the Virgin Islands v. Knight*, 989 F.2d 619, 629 (3d Cir.1993). Rule 701 of the Federal Rules of Evidence provides:

> If the witness is not testifying as an expert, the witness' testimony in the form of opinion or inferences is limited to those opinions or inferences which are (a) rationally based on the perception of the witness and (b) helpful to a clear understanding if the witness' testimony or the determination of a fact in issue.

Fed.R.Evid. 701. A lay opinion is rationally based on the witness' perception and "firsthand knowledge of the factual predicates that form the basis for the opinion." *Knight*, 989 F.2d at 629 (*citing* Fed.R.Evid. 701(a) advisory committee's note). Here, it is uncontested that Jackman had no personal knowledge of the investments in question. Therefore, the court properly barred his testimony. Moreover, even though defendants now seize upon Jackman's precluded testimony to support their cries of "foul," it is obvious that excluding his testimony did them far more good than admitting his questionably relevant opinion would have. In his deposition, Jackman testified that it was not possible to guarantee the high rates of return promised by TIGC. Supp.App. 153–154. When he was asked how he would respond to someone who offered the sky-high returns and guarantee of principal promised by TIGC he responded: "I'd say you were nuts, and your [you're] inexperienced, and you don't know what you're talking about, and you're a fool." *Id.* at 156. It is hard to see how the defendants were prejudiced by excluding such testimony.

D.

Finally, the defendants contend that the district court erred in excluding certain "key exhibits" that they failed to list in the pretrial statement. Defendants assert that the admission of the documents would have "demonstrated that the Defendants acted in good faith, with no intent to defraud and had exercised some care in making investments." Appellant's Br. at 35.

[24] **[25]** We review a district court's decision to refuse to admit exhibits not previously identified for abuse of discretion. *Greate Bay Hotel & Casino v. Tose*, 34 F.3d 1227, 1236 (3d Cir.1994). In determining whether there has been an abuse of discretion, we consider four factors: (1) the prejudice or surprise in fact to the opposing party, (2) the ability of the party to cure the prejudice, (3) the extent of disruption of the orderly and efficient trial of the case, and (4) the bad faith or willfulness of the non-compliance. *Id.* (*quoting* *Beissel v. Pittsburgh and Lake Erie R. Co.*, 801 F.2d 143, 150 (3d Cir.1986)). Here, the district court only excluded those documents that the defendants failed to produce, App. 144a–45a, and the district court properly considered the effect that admitting the evidence would have on the SEC. The court stated, "The Commission is entitled not to be surprised. That's why we have all these procedures in Federal Court." Supp.App. 59. We find no abuse of discretion in that.

VII.

Accordingly, for the reasons set forth above, we will affirm the district court's Order for Final Injunction.

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Was It an Act of War? That's Merck Cyber Attack's $1.3 Billion Insurance Question.

By the time Deb Dellapena arrived for work at Merck & Co.'s 90-acre campus north of Philadelphia, there was a handwritten sign on the door: The computers are down.

It was worse than it seemed. Some employees who were already at their desks at Merck offices across the U.S. were greeted by an even more unsettling message when they turned on their PCs. A pink font glowed with a warning: "Ooops, your important files are encrypted. … We guarantee that you can recover all your files safely and easily. All you need to do is submit the payment …" The cost was $300 in Bitcoin per computer.

The ransom demand was a ruse. It was designed to make the software locking up many of Merck's computers—eventually dubbed NotPetya—look like the handiwork of ordinary criminals. In fact, according to Western intelligence agencies, NotPetya was the creation of the GRU, Russia's military intelligence agency—the same one that had hacked the Democratic National Committee the previous year.

NotPetya's impact on Merck that day—June 27, 2017—and for weeks afterward was devastating. Dellapena, a temporary employee, couldn't dig into her fact-checking work. Interns and temps bided their time at their desks before some of them were sent home a week later. Some employees gossiped, their screens dark. Others watched videos on their phones.

In all, the attack crippled more than 30,000 laptop and desktop computers at the global drugmaker, as well as 7,500 servers, according to a person familiar with the matter. Sales, manufacturing, and research units were all hit. One researcher told a colleague she'd lost 15 years of work. Near Dellapena's suburban office, a manufacturing facility that supplies vaccines for the U.S. market had ground to a halt. "For two weeks, there was nothing being done," Dellapena recalls. "Merck is huge. It seemed crazy that something like this could happen."

As it turned out, NotPetya's real targets were half a world away, in Ukraine, which has been in heightened conflict with Russia since 2014. In the former Soviet republic, the malware rocketed through government agencies, banks, power stations—even the Chernobyl radiation monitoring system. Merck was apparently collateral damage. NotPetya contaminated Merck via a server in its Ukraine office that was running an infected tax software application called M.E.Doc.

NotPetya spread. It hopped from computer to computer, from country to country. It hit FedEx, the shipping giant Maersk, the global confectioner Mondelēz International, the advertising firm WPP, and hundreds of other companies. All in all, the White House said in a statement afterward, it was the "most destructive and costly cyberattack in history."

By the end of 2017, Merck estimated initially in regulatory filings that the malware did $870 million in damages. Among other things, NotPetya so crippled Merck's production facilities that it couldn't meet demand that year for Gardasil 9, the leading vaccine against the human papillomavirus, or HPV, which can cause cervical cancer. Merck had to borrow 1.8 million doses—the entire U.S. emergency supply—from the Pediatric National Stockpile. It took Merck 18 months to replenish the cache, valued at $240 million. (The Centers for Disease Control and Prevention say the stockpile's ability to deliver medicine wasn't affected.)

War Exclusion

Merck did what any of us would do when facing a disaster: It turned to its insurers. After all, through its property policies, the company was covered—after a $150 million deductible—to the tune of $1.75 billion for catastrophic risks including the destruction of computer data, coding, and software. So it was stunned when most of its 30 insurers and reinsurers denied coverage under those policies. Why? Because Merck's property policies specifically excluded another class of risk: an act of war.

Merck went to court, suing its insurers, including such industry titans as Allianz SE and American International Group Inc., for breach of contract, ultimately claiming $1.3 billion in losses.

In a world where a hacker can cause more damage than a gunship, the dispute playing out in a New Jersey courtroom will have far-reaching consequences for victims of cyber attacks and the insurance companies that will or will not protect them. Until recently, the big worry associated with cyber attacks was data loss. The NotPetya strike shows how a few hundred lines of malicious code can bring a company to its knees.

As the nascent cyber insurance market has grown, so has skepticism about pricing digital risk at all. Few people understand risk as well as Warren Buffett, who's built conglomerate Berkshire Hathaway Inc.—and one of the world's biggest personal fortunes—on the back of insurance companies such as Geico and National Indemnity Co. "Frankly, I don't think we or anybody else really knows what they're doing when writing cyber," he told investors in 2018. Anyone who says they have a firm grasp on this kind of risk, he said, "is kidding themselves."

Those who could be on the receiving end of cyber attacks don't underestimate the peril. Asked in September what kept him up at night, BP Plc Chief Executive Officer Bob Dudley said that aside from the transition away from fossil fuels, the threat of a catastrophic cyber attack worried him most. "It's the one that you can have the least control of," Dudley said on a call with investors. "That one keeps me awake at night."

Insurer Fears

The depths of these concerns show why the fight between Merck and its insurers is not only about what happened on a summer's day in 2017. It's about what companies and their insurers fear lurks over the horizon.

Union County's imposing 17-story neoclassical courthouse in Elizabeth, N.J., is a 15-minute drive from Merck's global headquarters in Kenilworth. It's also relatively conveniently located for the phalanxes of East Coast lawyers, from firms such as Covington & Burling and Steptoe & Johnson, who come here to do battle over the Merck case.

Their numbers are growing. One Monday in November, a dozen dark-suited lawyers filed into Judge Robert Mega's 14th-floor courtroom. They were there to discuss pro hac vice ("for this time only") applications to allow five additional colleagues to practice temporarily in New Jersey.

Merck has already collected on some property insurance policies that specify coverage for cyber damage while also settling with two defendants in the lawsuit for undisclosed amounts. One that settled, syndicate No. 382 at the insurance marketplace Lloyd's of London Ltd., was in a group that covered losses only if they ranged from $1.15 billion to $1.75 billion. A spokesman for CNA Financial Corp., which is tied to the syndicate, declined to comment.

Repairs and Interruption

The lawsuit in Union County addresses only property insurance claims. The $1.3 billion in losses that Merck claims includes expenses such as repairing its computer networks and the costs of business that was interrupted by the attack. Units of Chubb Ltd., Allianz, and other insurers have denied coverage on grounds that NotPetya was a "hostile or warlike" act or an act of terrorism, which are explicitly excluded by their policies.

As far as Merck is concerned, it was struck not by any of those excluded acts, but by a cyber event. "The 'war' and 'terrorism' exclusions do not, on their face, apply to losses caused by network interruption events such as NotPetya," the company's lawyers wrote in an Aug. 1 filing. "They do not mention cyber events, networks, computers, data, coding, or software; nor do they contain any other language suggesting an intention to exclude coverage for cyber events."

Lawyers for the insurance companies declined to comment for this story, as did Merck's attorneys. Merck declined to comment on the hack or the lawsuit beyond what's in their public filings. Addressing the broader issue, Merck Chief Financial Officer Robert Davis says, "We continue to make sure we fully invest to protect ourselves against the cyber threats we see." He didn't disclose how much Merck spends on cyber security.

The courts in the U.S. struggled with these matters long before cyber came along. Even under clearer circumstances—as when the Japanese bombed Pearl Harbor on Dec. 7, 1941—lawsuits between insurers and victims over similar exclusions tied U.S. courts in knots. In cases involving life insurance payouts after Pearl Harbor, courts in different parts of the country split, with some judges ruling that the exclusions didn't apply and other judges saying they did.

Testing Legal Theory

The NotPetya attack will catapult the U.S. legal system into even murkier terrain. Nation-states for years have been developing digital tools to create chaos in time of war: computer code that can shut down ports, tangle land transportation networks, and bring down the electrical grid. But increasingly those tools are being used in forms of conflict that defy categorization, including the 2014 attack that exposed emails and destroyed computers at Sony Pictures Entertainment Inc. The U.S. government blamed that attack on North Korea. Sony settled claims by ex-employees.

In the Merck lawsuit, the insurers may well see an opportunity to test their legal theories and find out if they can meet their burden of proving that war exclusions should apply. Fighting in eastern Ukraine between Russian-backed separatist forces and Ukraine's military has killed thousands. Speaking about NotPetya, Olga Oliker, a senior adviser to the Washington-based Center for Strategic and International Studies, said in testimony before the U.S. Senate in March 2017, "If this was, indeed, an orchestrated attack by Russia, it is an example of precisely the type of cyber operation that could be seen as warfare, in that it approximates effects similar to those that might be attained through the use of armed force."

Informed analysis doesn't equal the evidence insurance companies really want, however. If there is "smoking gun" proof that would be useful to the insurers' legal arguments, it probably resides out of reach: in classified U.S. or U.K. intelligence assessments that may have been based on intercepted communications and evidence obtained by hacking the attackers' computers. Even so, Philip Silverberg, a lead lawyer for the insurers, wrote to Judge Mega on Sept. 11, "The insurers are confident that there is evidence to demonstrate attribution of NotPetya to the Russian military."

To get it, the insurers will lean on the work of computer forensic experts who've analyzed NotPetya and may be able to testify that it bears the hallmarks of a Russian military operation. That analysis is complicated, because attackers often mask their identities and can mislead investigators. The insurers may get a little help from the Trump administration. In its February 2018 statement, the White House said NotPetya "was part of the Kremlin's ongoing effort to destabilize Ukraine and demonstrates ever more clearly Russia's involvement in the ongoing conflict."

"When the president of the United States comes out and says, 'It's Russia,' it's going to be hard to fight," says Jake Williams, a former National Security Agency hacker who now helps companies hunt for vulnerabilities in their computer networks. "I'll be surprised if the insurance companies don't get a win. This is as solid a case as they're going to get."

Cyber Security

In addition, the insurers are likely to probe whether Merck did as much as it could to defend itself against a NotPetya-like attack: Was the company, for example, vigilant in updating its computer software?

The arguments and counterarguments unfolding in Elizabeth are sometimes arcane and convoluted. But what triggered them is plain to see. The attack that ricocheted around the world on June 27, 2017, was "the closest thing we've seen" to a cyber catastrophe, says Marcello Antonucci, global cyber and technology claims team leader at insurer Beazley Plc. "NotPetya was a wake-up call for everybody."

Scott Stransky was in elementary school in 1992 when Hurricane Andrew blew through the Bahamas, Florida, and Louisiana, killing more than two dozen people and wrecking tens of thousands of homes. At the time, his family was vacationing in Hawaii, flying out just before the islands were battered by Hurricane Iniki, the worst in the state's history.

Such cataclysmic events do more than take lives, destroy homes, and wreck infrastructure. They cut a path of destruction through the insurance business as well: About a dozen underprepared insurers went out of business in Andrew's aftermath. Later in life, Stransky, who studied mathematics and atmospheric science at MIT, went to work helping insurers model their exposure to the next Andrew or Iniki.

Data obsession crosses into Stransky's private life. Sitting in his office in downtown Boston, the hiking and travel fanatic rattles off the number of U.S. national park sites he's visited (399 of 419), interstate borders he's crossed (96 of 107), and times he's stood at spots where three U.S. states meet (12 of 38).

About six years ago, Stransky decided to turn his skills to cyber security. Hacks were getting bigger. The 2013 attack on Target Corp., which exposed the financial or personal data of at least 70 million people, led him to talk to his boss about developing a new form of cyber modeling.

Billions of calculations later, Stransky, who turns 36 in December, is vice president and director for emerging risk modeling at AIR Worldwide, a unit of Verisk Analytics Inc. He leads a team—data geeks, Ph.D.s, even a certified ethical hacker who worked at the U.S. Department of Defense—that creates and stress-tests models designed to assess future cyber costs.

Cyber Risk Models

The tools deployed by the group are especially useful to insurance companies tapping into the lucrative cyber insurance market. The armaments include thousands of insurance claims as well as data from internet sensors that track traffic between corporations and business partners, sniffing out malware or determining if network ports are vulnerable to incursions by outsiders.

For companies and their insurers, the numbers are daunting. The cost to businesses and insurers of a single global ransomware attack could hit $193 billion, with 86% of that uninsured, according to a 2019 report from a group that includes Lloyd's of London. The figure for Andrew's insured losses alone was an estimated $15 billion. Some estimates of total annual business losses from data breaches rise to more than $5 trillion by 2024. "We're always looking to simulate what the Hurricane Andrew of cyber would be," Stransky says. "NotPetya is not even close to the worst-case scenario. It can get much, much worse."

As the Merck case is highlighting, the insurance industry's exposure to cyber damage is almost incalculably hard to grasp. The problem isn't the relatively modest pool of cyber policies that insurers are writing; they amounted in the U.S. to $3.6 billion in premiums in 2018, according to the National Association of Insurance Commissioners. The bigger worry is that cyber attacks could spill over into the vastly deeper pool of property casualty policies that insurers wrote in the U.S. in 2018—$621 billion worth in all.

Buffett's notion—that experts like Stransky are "kidding themselves"—nags at Stransky. Cyber events are in important ways not like weather events. There's far less data because companies often hide what happens to them or downplay the damage. Furthermore, hacks and the defenses against them are not governed by ecology or physics. Hackers have so-called zero-days—computer vulnerabilities known only to them and for which there is no defense. And it's almost impossible to predict what a Russia or an Iran might do based on its past actions.

Stransky concedes all of that, but he remains optimistic that his data work will help clarify the clouded picture faced by insurers and their clients. "I'm not going to say this is the panacea," he says. "It's just one part of the process."

In a darkened room across the river from the Lincoln Memorial in Washington, two dozen analysts watch row upon row of monitors as streams of data on the computer health of 150 companies scroll past. Protected by steel doors with facial-recognition locks, this is the so-called watch floor in Deloitte & Touche LLP's Cybersphere—the place where the accounting firm tracks the minutiae of the world's cyber threats for its customers, scouring for malware and other signs of intruders.

The cyber security business is booming at Deloitte, as it is at companies such as FireEye, CrowdStrike Holdings, and Check Point Software Technologies. Deloitte's U.S. cyber unit employs 4,500 people, and the watch floor sits at its heart. It's overseen by Andrew Morrison, who leads Deloitte's Cyber Strategy, Defense, and Response practice.

Deloitte sends out teams to help companies recover data and network capabilities in the midst of cyber attacks. After NotPetya struck, a Deloitte team launched a recovery operation for A.P. Moller-Maersk A/S, the world's largest container shipping company. The attack left Maersk's container ships stranded at sea, closed ports, and ruptured communications. Within 10 days, Maersk reinstalled its entire computer infrastructure, including 4,000 servers and 45,000 PCs, according to Chairman Jim Hagemann Snabe.

A few years before NotPetya, China's military and intelligence agencies were stealing the secrets of global corporations at an alarming rate, giving a boost to the cyber-security business. Most experts agree that threat has abated in the wake of a 2015 U.S.-China cyber-security agreement and a reorganization of the Chinese military.

Choice Targets

New and increasing threats are coming from ransomware and other malicious code designed to hijack, destroy, or alter data. Victims come in all sizes. Petty criminals, to cite one example, regularly use ransomware to lock up patient data in dentists' offices in capers that bring in a few thousand dollars. But for the most sophisticated cyber criminals, the choice targets are companies that make up a nation's infrastructure: manufacturers, power companies, gas pipeline operators, banks.

And yet Morrison's team is busier than ever. Manufacturers, including aluminum companies with smelters valued at almost $1 billion that could be ruined in a cyber attack, are particularly vulnerable, Morrison says. "Taking down the manufacturing facility, taking down the supply chain, all have dramatic impacts," he says. "Clients generally aren't as well-prepared in that space, because it's legacy equipment run by a shop steward on a machine floor and it's very difficult to secure."

That risk has increased as more industrial companies use interconnected devices that are embedded in their systems. Earlier this year, a ransomware attack hit aluminum producer Norsk Hydro ASA, halting production at some plants that fashion the metal into finished products. As manufacturers upgrade industrial systems, cyber attacks threaten to cripple production and ripple through supply chains.

Given how scary the future looks, the Merck case is, in some ways, an effort by insurers to turn back the clock. They want clarity. The industry is working to write its policy exclusions in such a way as to avoid any confusion over whether a digital attack is covered or not.

Standalone cyber policies give insurers the clarity they want. But property policies historically haven't taken into account the potential damage in a cyber attack. This raises the dread prospect of what's known as "silent cyber"—the unknown exposure in an insurer's portfolio created by a cyber peril that hasn't been explicitly excluded or included.

Tighter Language

Insurers such as AIG or the underwriters governed by Lloyd's are now tightening the language around what events they'll cover. Lloyd's said in July that certain policies must state more clearly whether cyber attacks are covered. AIG said that starting in January, almost all of its policies for businesses should make that clear, culminating a six-year effort.

In Elizabeth, the action has been going on behind closed doors. Witnesses will testify on such subjects as what insurers intended in drafting exclusions for acts of war or terrorism and what Merck believed its coverage meant. Some insurers drafted new war or cyber exclusions for policies after NotPetya, but Judge Mega ruled that insurers don't have to disclose documents showing why they changed their policies after the attack.

In early 2020, experts will testify behind closed doors as to what constitutes an act of war in the cyber age. The case could be settled at some point—or it could drag on for years before going to trial.

The challenge for insurers is to show that NotPetya was an act of war even though there's no clear definition in U.S. law on what that means in the cyber age. Mega will also have to analyze international law, says Catherine Lotrionte, a former CIA lawyer who's taught at Georgetown University. "It's not going to be an easy case for a judge in the U.S. to declare that this was an act of war," she says. "It's not just whether another country did it, but does it meet the legal criteria under international law for an armed attack?"

Whichever way the courts rule, one stark reality is clear: The era of cyber weapons is forcing companies to defend themselves against a scale of threat that, in the conventional world, would have merited government help. With the insurance companies working to protect themselves against cyber risk, and because there's only so much that governments can do, companies such as Merck have no choice but to build their own defenses to manage risk.

—With Kelly Gilblom

Voreacos covers financial investigations, Chiglinsky covers insurance, and Griffin covers the drug industry. They are based in New York.

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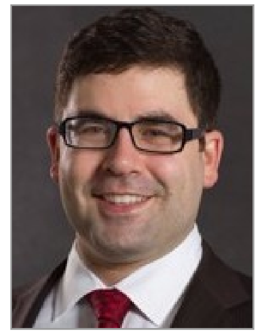
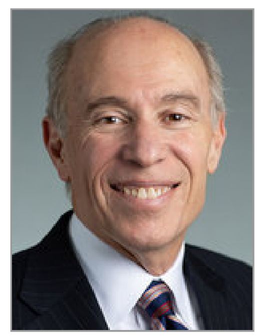
'Act Of War' Questions In Cyberattack Insurance Case

By **Daniel Garrie and Peter Rosen** (April 23, 2019, 3:21 PM EDT)


Daniel Garrie


Peter Rosen

Recently, Mondelez International Inc. sued Zurich American Insurance Co. for denying coverage, under its all-risk property policy's war exclusion, for Mondelez's alleged over $100 million in losses caused by the NotPetya ransomware attack in 2017. This case has the potential to make a significant impact on the cyber insurance market as it is the first time the war exclusion has been litigated in the cyber insurance context and highlights some key issues in applying traditional policy language to cyberattacks.

Does the war exclusion apply to cyberattacks? If so, can Zurich prove NotPetya came from a state actor given the challenge of attributing cyberattacks?

Mondelez was one of dozens of companies to suffer damages during the global NotPetya ransomware attack in 2017. The attack caused $10 billion in damage, according to the U.S. Department of Homeland Security.

Mondelez submitted a claim under its property policy with Zurich that covers "physical loss or damage to electronic data, programs or software, including physical loss or damage caused by the malicious introduction of machine code or instruction." The policy also covered nonphysical losses and expenses caused by the failure of "electronic data processing equipment or media to operate" due to malicious cyber damage.

Eleven months after the claim was filed, and after negotiations, Zurich denied the entire claim on the grounds that the ransomware attack was a "hostile or warlike action" by a "sovereign government or power, military force or their agents" and as such was excluded from coverage under the policy's "act of war" exclusion.

Mondelez then sued Zurich in October 2018 for breach of contract in Illinois state court, in Chicago. Mondelez alleged that courts, insurers and companies have previously applied the "act of war" exclusion only to conventional, physical armed conflict and cyberattacks, such as NotPetya, are not specifically addressed in the policy. Mondelez further alleged that it is Zurich's burden to show that the exclusion extends to cyberattacks and that NotPetya is considered an act of war under its policy.

The relevant portion of the "act of war" exclusion of the policy reads as follows:

> B. This Policy excludes loss or damage directly or indirectly caused by or resulting from any of the following regardless of any other cause or event, whether or not insured under this Policy, contributing concurrently or in any other sequence to the loss:
>
> [...]
>
> 2) a) hostile or warlike action in time of peace or war, including action in hindering, combating or defending against an actual, impending or expected attack by any: (i) government or sovereign power (de jure or de facto); (ii) military, naval, or air force; or (iii) agent or authority of any party specified in i or ii above.

It should be noted that this language covers a broad range of activity that would fall below the threshold for an "armed attack" under the international law of armed conflict. If the court finds that this exclusion applies to cyberattacks, the nature of the attack would almost certainly fall within the exclusion as it would be difficult to argue that NotPetya was not "hostile."

The real question then is whether the action was taken by a state actor. Traditionally, this was an easier question to answer than it is now because most hostile or warlike actions by state actors were physical actions, and thus easier to attribute. However, cyberattacks are almost impossible to attribute with complete certainty.

While it has yet to answer Mondelez's complaint, Zurich will likely attempt to support its denial of coverage by pointing to the fact that in February 2018, the United States, the United Kingdom, Canada and Australia all officially blamed Russia for NotPetya, with the White House referring to it as "part of Russia's effort to destabilize Ukraine." However, it could be difficult for Zurich to put forward technical evidence conclusively attributing the attack to Russia.

According to some cyber warfare commentators, "[o]ur legal and policy frameworks for responding to cyberattacks cannot work unless we have adequate attribution; these frameworks remain incomplete because we lack the basis [sufficient attribution] to actually use them."[1] The Mondelez case highlights the applicability of this concept to the still nascent cyber insurance market. Traditional "act of war" exclusion frameworks are extremely difficult to apply to cyberattacks due to this attribution issue. Further complicating the issue, oftentimes cyberattacks executed for the benefit of a state are actually put into action by citizens, making it even more challenging to determine the state actor's role in the attack.

The outcome in the Mondelez case, especially with respect to how the court interprets and the trier of fact applies the "act of war" exclusion to the NotPetya ransomware attack, could have significant impacts on the cyber insurance market.

Even if the court finds that the exclusion is applicable to cyberattacks as a matter of law, it is possible that the exclusion would not, from a practical perspective, apply to cyberattacks due to the near impossibility of exact attribution. This would force insurers to rethink their approach to war exclusions in property and cyberrisk policies and could set off a massive rewriting of policy language. The outcome of Mondelez could also affect premiums, deductibles and limits as insurers reassess exposure considering the applicability, or inapplicability, of the war exclusion.

Daniel B. Garrie is a neutral at JAMS. He is managing partner at Law & Forensics LLC and a partner at Zeichner Ellman & Krause LLP.

Peter Rosen is a neutral at JAMS. He teaches insurance law at USC Gould School of Law and Pepperdine University School of Law.

[1] Shane McGee, Randy V. Sabett, & Anand Shah, Adequate Attribution: A Framework for Developing a National Policy for Private Sector Use of Active Defense, 8 J. Bus. & Tech. L. 1, 28-29 (2013) (quoting Jeffrey Hunker et al., Institute for Info. Infrastructure Protection, Role And Challenges For Sufficient Cyber-Attack Attribution 5 (2008)).

YES

EXHIBITS

CASE NO. 2018L011008

DATE: 10/10/2018

CASE TYPE: Contract

PAGE COUNT: 14

CASE NOTE

FILED DATE: 10/10/2018 5:45 PM 2018L011008

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

FILED
10/10/2018 5:45 PM
DOROTHY BROWN
CIRCUIT CLERK
COOK COUNTY, IL

MONDELĒZ INTERNATIONAL, INC., Plaintiff,

v.

ZURICH AMERICAN INSURANCE COMPANY, Defendant.

No. 2018L011008

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CIVIL ACTION COVER SHEET - CASE INITIATION

A Civil Action Cover Sheet - Case Initiation shall be filed with the complaint in all civil actions. The information contained herein is for administrative purposes only and cannot be introduced into evidence. Please check the box in front of the appropriate case type which best characterizes your action. Only one (1) case type may be checked with this cover sheet.

Jury Demand ■ Yes ☐ No

PERSONAL INJURY/WRONGFUL DEATH

CASE TYPES:
- ☐ 027 Motor Vehicle
- ☐ 040 Medical Malpractice
- ☐ 047 Asbestos
- ☐ 048 Dram Shop
- ☐ 049 Product Liability
- ☐ 051 Construction Injuries (including Structural Work Act, Road Construction Injuries Act and negligence)
- ☐ 052 Railroad/FELA
- ☐ 053 Pediatric Lead Exposure
- ☐ 061 Other Personal Injury/Wrongful Death
- ☐ 063 Intentional Tort
- ☐ 064 Miscellaneous Statutory Action (Please Specify Below**)
- ☐ 065 Premises Liability
- ☐ 078 Fen-phen/Redux Litigation
- ☐ 199 Silicone Implant

TAX & MISCELLANEOUS REMEDIES

CASE TYPES:
- ☐ 007 Confessions of Judgment
- ☐ 008 Replevin
- ☐ 009 Tax
- ☐ 015 Condemnation
- ☐ 017 Detinue
- ☐ 029 Unemployment Compensation
- ☐ 031 Foreign Transcript
- ☐ 036 Administrative Review Action
- ☐ 085 Petition to Register Foreign Judgment
- ☐ 099 All Other Extraordinary Remedies

By: David M. Kroeger, JENNER & BLOCK LLP (05003)
(Attorney) (Pro Se)

COMMERCIAL LITIGATION

CASE TYPES:
- ■ 002 Breach of Contract
- ☐ 070 Professional Malpractice (other than legal or medical)
- ☐ 071 Fraud (other than legal or medical)
- ☐ 072 Consumer Fraud
- ☐ 073 Breach of Warranty
- ☐ 074 Statutory Action (Please specify below.**)
- ☐ 075 Other Commercial Litigation (Please specify below.**)
- ☐ 076 Retaliatory Discharge

OTHER ACTIONS

CASE TYPES:
- ☐ 062 Property Damage
- ☐ 066 Legal Malpractice
- ☐ 077 Libel/Slander
- ☐ 079 Petition for Qualified Orders
- ☐ 084 Petition to Issue Subpoena
- ☐ 100 Petition for Discovery

** ______

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Pro Se Only: ☐ I have read and agree to the terms of the *Clerk's Office Electronic Notice Policy* and choose to opt in to electronic notice form the **Clerk's Office** for this case at this email address: ______

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1910 - No Fee Paid
1919 - Fee Paid
Jury Demand

(Rev. 12/31/15) CCG N067

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT/LAW DIVISION

MONDELĒZ INTERNATIONAL, INC., Plaintiff,

v.

ZURICH AMERICAN INSURANCE COMPANY, Defendant.

No. 2018L011008

JURY DEMAND

The undersigned demands a jury trial.

David M. Kroeger
(Signature)

☐ Atty. No.: 05003
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Tertiary Email:

Dated: October 10, 2018

IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

MONDELĒZ INTERNATIONAL, INC.,	)	
	)	
Plaintiff,	)	
	)	No. 2018L011008
vs.	)	
	)	Jury Demanded
ZURICH AMERICAN INSURANCE COMPANY,	)	
	)	
Defendant.	)	

COMPLAINT

Mondelēz International, Inc. ("MDLZ"), through its counsel, complains as follows against Zurich American Insurance Company ("Zurich"):

1. In this insurance coverage action, MDLZ seeks relief for Zurich's breaches of its contractual obligations to MDLZ under an all-risk property insurance policy, Zurich's failure to honor promises that induced MDLZ to act to its detriment, and Zurich's bad faith conduct.

Jurisdiction and Venue

2. This Court has personal jurisdiction over Zurich pursuant to 735 ILCS 5/2-209(a)(4), in that Zurich "contract[ed] to insure any person, property or risk located within this State at the time of contracting."

3. Venue is proper in this Circuit pursuant to 735 ILCS 5/2-101, in that a substantial part of the transactions giving rise to the claim occurred here.

The Parties

4. MDLZ is one of the world's largest snack companies. MDLZ manufactures and markets snack food and beverage products for consumers in approximately 165 countries around the world. Its portfolio includes many iconic snack brands: Nabisco, Oreo, LU and belVita

biscuits; Cadbury, Milka, Cadbury Dairy Milk and Toblerone chocolate; Trident gum; Halls candy and Tang powdered beverages.

5. Zurich is an insurance company organized under the laws of New York, with its headquarters in Schaumburg, Illinois. Zurich is part of the Zurich Insurance Group.

Factual Background

6. Zurich sold Property Insurance Policy No. PPR 5834380-04 (the "Policy") to MDLZ. (The Policy is voluminous, and Zurich is already in possession of a copy, so a copy is being maintained at the offices of counsel for MDLZ and will be made available to the Court and Zurich upon request.)

7. The Policy provides annual coverage incepting November 1, 2016, for "all risks of physical loss or damage" to MDLZ's property, specifically including "**physical loss or damage to electronic data, programs**, or software, including physical loss or damage caused by the malicious introduction of a machine code or instruction . . . ."

8. The Policy also specifically provided other types of coverage, including but not limited to "TIME ELEMENT" coverage, including for "Actual Loss Sustained and EXTRA EXPENSE incurred by the Insured during the period of interruption directly resulting from the failure of the Insured's **electronic data processing equipment or media** to operate" resulting from malicious cyber damage.

9. On June 27, 2017, MDLZ fell victim to two separate malicious introductions of "malware" machine code or instruction, which later came to be referred to by some sources as "NotPetya," into two of its servers at different physical locations and at different times. The two malware introductions/occurrences spread from these two servers, stole credentials of numerous

users, propagated across the MDLZ network, and rendered permanently dysfunctional approximately 1700 of MDLZ's servers and 24,000 of its laptops.

10. As a result of the damage caused both to its hardware and operational software systems, MDLZ incurred property damage, commercial supply and distribution disruptions, unfulfilled customer orders, reduced margins, and other covered losses aggregating well in excess of $100,000,000.

11. MDLZ gave prompt notice to Zurich and thereafter worked with Zurich personnel to adjust the insurance claim. As part of this effort, MDLZ provided Zurich with (i) voluminous amounts of information, including information quantifying and substantiating the extent of MDLZ's losses; and (ii) access to MDLZ employees as well as consultants retained by MDLZ to provide explanations pertinent to its claim.

12. During this time, Zurich publicly and, on information and belief, in its non-public dealings with actual and prospective policyholders who were considering the purchase or renewal of insurance coverage from Zurich, portrayed the NotPetya malware as a form of "ransomware" that merited the continued (if not increased) purchase of insurance coverage from Zurich. For example, on March 5, 2018, Alison Martin, Group Chief Risk Officer for the Zurich Insurance Group, published an article containing the following statement:

> "Cybersecurity risks are also growing, both in their prevalence and in their disruptive potential. Attacks against businesses have almost doubled in five years, and incidents that would once have been considered extraordinary are becoming more and more commonplace. The financial impact of cybersecurity breaches is rising, and some of the largest costs in 2017 related to ransomware attacks, which accounted for 64% of all malicious emails. Notable examples included the WannaCry attack—which affected 300,000 computers across 150 countries—and NotPetya, which caused quarterly losses of USD 300 million for a number of affected businesses."

13. Nevertheless, by letter dated June 1, 2018, Zurich informed MDLZ that it was denying coverage under the Policy based on a single Policy exclusion, Exclusion B.2(a), which provides:

> B. This Policy excludes loss or damage directly or indirectly caused by or resulting from any of the following regardless of any other cause or event, whether or not insured under this Policy, contributing concurrently or in any other sequence to the loss:
>
> . . .
>
> 2) a) hostile or warlike action in time of peace or war, including action in hindering, combating or defending against an actual, impending or expected attack by any:
>
> (i) government or sovereign power (de jure or de facto);
> (ii) military, naval, or air force; or
> (iii) agent or authority of any party specified in i or ii above.

Zurich asserted no other exclusion and stated no other ground for denying coverage under the Policy in its June 1, 2018 denial letter.

14. As an insurer seeking to deny insurance coverage on the basis of an exclusion, Zurich bears the burden of proving the applicability of the single exclusion (Exclusion B.2(a)) on which it based its June 1, 2018 denial of coverage.

15. Zurich's invocation of a "hostile or warlike action" exclusion to deny coverage for malicious "cyber" incidents was, on information and belief, unprecedented. Indeed, and also on information and belief, the purported application of this type of exclusion to anything other than conventional armed conflict or hostilities was unprecedented. Accordingly, on this basis alone, Zurich wrongfully denied coverage to MDLZ.

16. Furthermore, the loss and damage for which MDLZ claims coverage under the Policy did not result from a cause or event excluded under Exclusion B.2(a) of the Policy. The two incursions of malicious code or instruction into MDLZ's computers did not constitute "hostile or warlike action," as required by Exclusion B.2(a). Nor was the loss and damage for

which MDLZ claims coverage under the Policy directly or indirectly caused by "hostile or warlike action." In the alternative, Exclusion B.2(a) is vague and ambiguous, particularly given Zurich's failure to modify that historical language to specifically address the extent to which it would apply to cyber incidents, and therefore must be interpreted in favor of coverage.

17. On information and belief, Zurich senior management itself recognized that the June 1, 2018 coverage denial was wrongful and improper, and further recognized the potential for MDLZ to initiate immediate litigation that would publicize Zurich's ill-advised coverage denial in a manner that would adversely impact its dealings with actual and prospective policyholders who were considering the purchase or renewal of insurance coverage from Zurich.

18. Accordingly, to induce MDLZ not to initiate immediate coverage litigation, and in what now appears to be an improper effort to allow Zurich to try to avoid publicity for and/or "mend" its June 1, 2018 coverage denial, Zurich promised MDLZ that it would rescind its June 1, 2018 declination of coverage and resume adjustment of MDLZ's insurance claim. These promises were intended to convince MDLZ to refrain from filing immediate litigation.

19. On July 18, 2018, Zurich sent an email to MDLZ that "formally rescind[ed]" its coverage denial and promised to resume the adjustment of MDLZ's insurance claim. On July 24, 2018, Zurich sent an email to MDLZ committing to advance a $10,000,000 partial payment toward MDLZ's insurance claim. Zurich initially sought to place conditions on the advance, but after pushback from MDLZ a few days later Zurich's Head of Property Claims sent an email representing to MDLZ that the promised advance would be unconditional and "not subject to a 'claw back' provision."

20. In reliance upon Zurich's representations concerning (i) the rescission of its denial of coverage based upon Exclusion B.2(a); and (ii) the resumption of its adjustment of MDLZ's

insurance claim, including the advance of an unconditional $10,000,000 partial payment, MDLZ refrained to its detriment from instituting immediate litigation challenging the June 1, 2018 denial letter. MDLZ instead agreed to meet with Zurich representatives regarding adjustment and payment of its insurance claim. MDLZ would not have done so were it not for these explicit representations and promises from Zurich.

21. However, despite "formally rescind[ing]" its coverage denial and promising to resume the adjustment of MDLZ's insurance claim (including advancement of an unconditional $10,000,000 partial payment), Zurich has in all material respects continued to behave as if it were still asserting the applicability of Exclusion B.2(a) to deny coverage entirely to MDLZ. In particular, Zurich: (i) refused to advance an unconditional partial payment of $10,000,000 on MDLZ's insurance claim; (ii) refused to make any other claim payment whatsoever; and (iii) otherwise failed to resume and finalize the adjustment of MDLZ's claim.

22. By at least October 2018, MDLZ's patience had run out, and Zurich knew that. With knowledge that MDLZ was planning to file this lawsuit if Zurich did not take steps to immediately resolve its insurance claim, Zurich on October 9, 2018 sent MDLZ a letter purporting to "reassert" its June 1, 2018 declination of coverage based on Exclusion B.2(a). Zurich's "reassertion" did not cite any new material facts or developments occurring since Zurich's unequivocal "rescission" of its denial of coverage on July 18, 2018. Zurich's October 9 letter also belatedly sought to raise new coverage defenses in an improper effort to "mend" its June 1, 2018 declination of coverage, which had consciously omitted any other possible grounds for denying coverage, thereby waiving them. Zurich was aware of all of these purported additional coverage defenses as of June 1, 2018, but elected not to include them in its coverage

denial letter of that date. Under the circumstances, Zurich's attempted October 9, 2018 "reassertion" of its denial of coverage is null, void and without effect.

COUNT I
Breach of Contract
(Wrongful Refusal to Pay Insurance Claim)

23. MDLZ restates and incorporates paragraphs 1 through 22 above as if fully set forth herein.

24. MDLZ provided and Zurich received timely notice of MDLZ's insured losses.

25. Zurich investigated and/or had the opportunity to investigate MDLZ's claim for more than 11 months, and to fairly explore whatever bases it may have believed it had for denying or limiting coverage. Zurich based its June 1, 2018 declination of coverage on a single ground: Exclusion B.2(a). Its denial letter asserted no other basis for the denial of coverage.

26. Zurich's June 1, 2018 denial of coverage was wrongful and constituted a breach of its obligations under the Policy.

27. Zurich's purported "reassertion" of its denial of coverage on October 9, 2018, was also wrongful and constituted a breach of its obligations under the Policy.

28. As a direct and proximate result of Zurich's breaches of contract, MDLZ has been deprived of the benefits of the insurance coverage sold by Zurich, and has incurred at least $100,000,000 in damages as a result, subject to any applicable deductibles.

COUNT II
Breach of Contract
(Wrongful Refusal to Withdraw Coverage Denial and Pay Insurance Claim)

29. MDLZ restates and incorporates paragraphs 1 through 22 above as if fully set forth herein.

30. In exchange for MDLZ refraining from the immediate filing of litigation that would have challenged the June 1, 2018 coverage denial and publicized Zurich's wrongful interpretation of Exclusion B.2(a) to the insurance marketplace, and in particular actual and prospective policyholders, Zurich made contractual commitments to MDLZ (i) to rescind its June 1, 2018 declination of coverage; and (ii) resume adjustment of MDLZ's insurance claim, including the immediate advancement of an unconditional partial payment of $10,000,000 to MDLZ.

31. Zurich has refused to honor these commitments, and has instead continued to behave in all material respects as if it were still denying coverage to MDLZ based on Exclusion B.2(a). Zurich has refused to make any payment whatsoever on MDLZ's insurance claim, including the unconditional partial payment of $10,000,000 it had committed in writing to advance.

32. As a direct and proximate result of Zurich's breaches of contract, MDLZ has been deprived of the benefits of the contractual promises made by Zurich and accepted by MDLZ, and has incurred damages as a result.

COUNT III
Promissory Estoppel

33. MDLZ restates and incorporates paragraphs 1 through 22 above as if fully set forth herein.

34. Zurich unambiguously promised MDLZ that it was (i) rescinding its June 1, 2018 declination of coverage; and (ii) resuming adjustment of MDLZ's insurance claim, including the immediate advance of an unconditional partial payment of $10,000,000 to MDLZ. Zurich did so for the purpose of, inter alia, inducing MDLZ not to file immediate litigation challenging its June 1, 2018 denial of coverage.

35. MDLZ relied on Zurich's promises by refraining from the filing of immediate litigation that would have, inter alia, publicized Zurich's wrongful interpretation of Exclusion B.2(a) to the insurance marketplace, and in particular actual and prospective policyholders of Zurich.

36. MDLZ's reliance was expected and foreseeable by Zurich.

37. MDLZ relied to its detriment on Zurich's promises, none of which have been fulfilled, and has been damaged as a result.

38. Having induced MDLZ to rely to its detriment upon explicit promises, Zurich should be held to those promises and should be, inter alia, estopped both from (i) reasserting Exclusion B.2(a) as a basis for denying coverage; and (ii) asserting any other additional ground for denying coverage which could have been asserted on June 1, 2018.

COUNT IV
Vexatious and Unreasonable Conduct
Illinois Insurance Code Section 155

39. MDLZ restates and incorporates paragraphs 1 through 38 above as if fully set forth herein.

40. Zurich has acted vexatiously and unreasonably by, among other things, the following, all in violation of 215 ILCS 5/155:

a. improperly denying MDLZ's insurance claim on June 1, 2018;

b. refusing to honor its explicit promises to MDLZ to (i) rescind its June 1, 2018 declination of coverage; and (ii) resume adjustment of MDLZ's insurance claim, including the immediate advancement of an unconditional partial payment of $10,000,000 to MDLZ; and

c. Improperly "reasserting" its denial of coverage on October 9, 2018.

41. MDLZ has been damaged by Zurich's vexatious and unreasonable conduct, in that it has effectively been denied the benefits of the insurance coverage for which it contracted and for which MDLZ collected a premium. MDLZ has also been improperly forced to incur the burden, expense and further disruption of bringing and pursuing this action.

Prayer for Relief

WHEREFORE, MDLZ respectfully requests that the Court grant it the following:

1. An award of the damages that MDLZ has sustained, in the amount of at least $100,000,000, subject to any applicable deductibles, and such other amounts to be determined at trial;

2. An order enforcing Zurich's promises to MDLZ to (i) rescind its June 1, 2018 declination of coverage; and (ii) resume adjustment of MDLZ's insurance claim, including the immediate advancement of an unconditional partial payment of $10,000,000 to MDLZ, including barring Zurich from both (i) reasserting Exclusion B.2(a) as a basis for denying coverage; and (ii) asserting any other additional ground for denying coverage which could have been asserted on June 1, 2018; and further declaring null, void and without effect Zurich's attempted October 9, 2018 "reassertion" of its denial of coverage;

3. An award of pre-judgment and post-judgment interest on MDLZ's damages, in the full amount permitted by law;

4. An award of the costs, including attorneys' fees, that MDLZ incurs in connection with bringing and pursuing this action, along with the maximum statutory penalty that 215 ILCS 5/155 allows; and

5. Such additional relief in MDLZ's favor as the Court deems appropriate.

Jury Demand

MDLZ demands a trial by jury on all issues triable to a jury.

MONDELĒZ INTERNATIONAL, INC.

Dated: October 10, 2018

By: John H. Mathias, Jr.
One of Its Attorneys

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Jan A. Larson (*pro hac vice application to be submitted*)
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IN THE CIRCUIT COURT OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION

MONDELĒZ INTERNATIONAL, INC.,	)	
	)	
Plaintiff,	)	
	)	No. 2018L011008
vs.	)	
	)	Jury Demanded
ZURICH AMERICAN INSURANCE COMPANY,	)	
	)	
Defendant.	)	

AFFIDAVIT PURSUANT TO ILLINOIS SUPREME COURT RULE 222(b)

David M. Kroeger, being first duly sworn on oath, states as follows:

1. I am a partner at Jenner & Block LLP and serve as counsel for Mondelēz International, Inc., the Plaintiff in this action. I have personal knowledge of the facts set forth in this affidavit, which is made pursuant to Illinois Supreme Court Rule 222(b).

2. I certify that the total of money damages sought in the complaint by Plaintiff Mondelēz International, Inc. exceeds $50,000.

David M Kroeger
David M. Kroeger

Subscribed and sworn to before me
this 10th day of October, 2018

Kathyln F. Gerace
Notary Public

KATHYLN F GERACE
Official Seal
Notary Public - State of Illinois
My Commission Expires Jun 13, 2020

Press Release

Two Celebrities Charged With Unlawfully Touting Coin Offerings

FOR IMMEDIATE RELEASE
2018-268

Washington D.C., Nov. 29, 2018 — The Securities and Exchange Commission today announced settled charges against professional boxer Floyd Mayweather Jr. and music producer Khaled Khaled, known as DJ Khaled, for failing to disclose payments they received for promoting investments in Initial Coin Offerings (ICOs). These are the SEC's first cases to charge touting violations involving ICOs.

The SEC's orders found that Mayweather failed to disclose promotional payments from three ICO issuers, including $100,000 from Centra Tech Inc., and that Khaled failed to disclose a $50,000 payment from Centra Tech, which he touted on his social media accounts as a "Game changer." Mayweather's promotions included a message to his Twitter followers that Centra's ICO "starts in a few hours. Get yours before they sell out, I got mine…"

A post on Mayweather's Instagram account predicted he would make a large amount of money on another ICO and a post to Twitter said: "You can call me Floyd Crypto Mayweather from now on." The SEC order found that Mayweather failed to disclose that he was paid $200,000 to promote the other two ICOs.

Mayweather and Khaled's promotions came after the SEC issued its DAO Report in 2017 warning that coins sold in ICOs may be securities and that those who offer and sell securities in the U.S. must comply with federal securities laws. In April 2018, the Commission filed a civil action against Centra's founders, alleging that the ICO was fraudulent. The U.S. Attorney's Office for the Southern District of New York filed parallel criminal charges.

Without admitting or denying the findings, Mayweather and Khaled agreed to pay disgorgement, penalties and interest. Mayweather agreed to pay $300,000 in disgorgement, a $300,000 penalty, and $14,775 in prejudgment interest. Khaled agreed to pay $50,000 in disgorgement, a $100,000 penalty, and $2,725 in prejudgment interest. In addition, Mayweather agreed not to promote any securities, digital or otherwise, for three years, and Khaled agreed to a similar ban for two years. Mayweather also agreed to continue to cooperate with the investigation.

"These cases highlight the importance of full disclosure to investors," said Enforcement Division Co-Director Stephanie Avakian. "With no disclosure about the payments, Mayweather and Khaled's ICO promotions may have appeared to be unbiased, rather than paid endorsements."

"Investors should be skeptical of investment advice posted to social media platforms, and should not make decisions based on celebrity endorsements," said Enforcement Division Co-Director Steven Peikin. "Social media influencers are often paid promoters, not investment professionals, and the securities they're touting, regardless of whether they are issued using traditional certificates or on the blockchain, could be frauds."

The SEC's investigation, which is continuing, is being conducted by Alison R. Levine of the New York Regional Office and Jon A. Daniels, Luke M. Fitzgerald, and John O. Enright of the Enforcement Division's Cyber Unit. The case is being supervised by Cyber Unit Chief Robert A. Cohen.

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Related Materials

- SEC Order - Mayweather
- SEC Order - Khaled
- Statement on Celebrity Promotions

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SEC's Token Issuer Case May Help Define Crypto Market

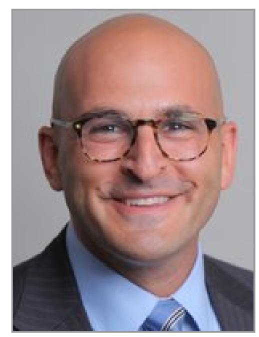
By **Teresa Goody Guillén, Jonathan Forman and Robert Musiala** (June 5, 2020, 6:16 PM EDT)

On May 8, the U.S. Securities and Exchange Commission and Kik Interactive Inc. finished briefing their cross motions for summary judgment, which were previously filed on March 20, with opposition briefs filed on April 24.

Teresa Goody Guillén

The SEC v. Kik briefing totals more than 400 pages of arguments by the parties in the SEC's court challenge to Kik's actions in raising funds through simple agreements for future tokens, or SAFTs, and Kik's 2017 public sale, valued at approximately $100 million, of Ethereum-based ERC20 tokens, known as Kin.

How the court responds to the parties' competing arguments could have significant implications for the legal status of blockchain tokens in the U.S. On one side, Kik warns that the SEC is seeking "an unprecedented and dramatic expansion" of its regulatory authority by "stretch[ing] the definition of a 'security' ... far beyond [its] plain language" and in a way that "would be confusing and potentially inconsistent with the actions of other agencies."

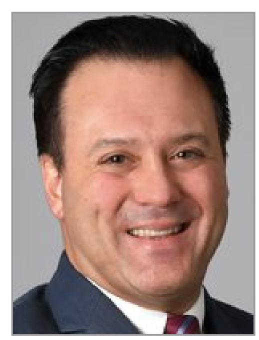


Jonathan Forman

On the other side, the SEC asks the court to apply an analysis similar to the reasoning in the recent decision in SEC v. Telegram Group Inc. and argues that the court should look at the economic reality of the transactions. On May 12, **Telegram announced** that as a result of the court's decision in the Telegram case, it has canceled its TON blockchain project.

This raises the stakes in the Kik case, with the Kik court's decision now set to either affirm, reject or alter the Telegram court's analysis.

Single-Scheme Theory



Robert Musiala

The SEC contends that the SAFTs and public Kin sales were a single transaction with multiple stages. According to the SEC's "single scheme" theory, because Kik did not limit all Kin sales to accredited investors, the SAFT sales did not constitute a private exempt offering but rather were part of a public offering for which registration was required.

Among other things, the SEC emphasizes that the following factors indicate Kik engaged in one single noncompliant offering:

- Kik publicized it was conducting one sale to raise one total amount of money.
- Kik conducted the same marketing to both groups.
- Kik expressly conditioned the SAFT price on the public sale.
- Kik distributed the Kin tokens to the SAFT investors at the same time as the public sale.

According to the SEC, Kik "took no steps to ensure that the SAFT participants were not underwriters of Kin" and that, as in Telegram, "Kin were never intended to come to rest in the hands of the SAFT participants, but to be dispersed to the broader public."

Kik differentiates the public sale of Kin from the SAFTs, which it entered into with accredited investors pursuant to Rule 506(c) of Regulation D and for which it filed a Form D with the SEC.

According to Kik, the two sales should not be lumped together because they "involved sales of different assets to different groups of purchasers over different time periods." Kik argues the registration of a security is transaction-specific, and therefore the SAFTs and public sale must be evaluated independently.

Integrated Offering

The SEC alternatively argues that even if the SAFTs and the public sale are treated as two offerings, they should be integrated and considered one offering under the SEC rules.

The SEC emphasizes that the SAFTs and Kin sales "were part of a single plan of financing, involved issuance of the same class of securities (i.e., identical and fungible Kin), were made at or about the same time, involved functionally similar consideration, and were for the same general purpose."

In contrast, Kik contends there are two separate transactions: (1) a private sale governed by SAFTs to accredited investors of the contractual rights to purchase then-nonexistent Kin tokens at a point in the future, if and when Kik successfully launched Kin, and (2) a sale of goods to the public governed by terms of use conducted after the infrastructure for Kin already existed.

According to Kik, the Kin sales did not involve the issuance of the same class of securities, and were conducted at a different time than the SAFTs. Kik also argues that the SAFTs and Kin sales required different consideration (U.S. dollars for the SAFTs and Ether for Kin) and were not made for the "same general purpose."

Two Independent Offerings

The SEC offers a second alternative argument that if the SAFTs and the public Kin sale are considered two independent offerings, both required registration and independently violated Section 5 of the Securities Act.

The SEC argues that Kik offered and sold Kin via the SAFTs, and therefore Regulation D required Kik to comply with Rule 502(d) to exercise reasonable care to ensure that the SAFT purchasers were not underwriters under Securities Act Section 2(a)(11). According to the SEC, the SAFT purchasers effectively acted as underwriters, and Kik's failure to prevent this renders the Rule 506(c) registration exemption unavailable, rendering the SAFTs an unregistered public securities offering.

Separately, the SEC avers that Kin are investment contracts and the public Kin sale was an unregistered public offering of securities in violation of Section 5.

Kik argues that the SAFTs were exempt under Rule 506(c) of Regulation D, and if the Regulation D exemption is not available, the SAFTs were nonetheless exempt pursuant to Section 4(a)(2) of the Securities Act as "transactions by an issuer not involving any public offering" in which the investors are able to fend for themselves.

As to the token distribution, Kik contends that the SEC fails to establish an investment contract under the Howey test, as discussed below.

Howey Analysis

The central issue of the case is whether the Kin sales are investment contracts based on the Howey test, which requires (1) an investment of money (2) in a common enterprise (3) with a reasonable expectation of profits (4) based on the entrepreneurial or managerial efforts of others.

The parties do not dispute that there was an investment of money and focus instead on prongs 2 through 4 of the Howey analysis.

Common Enterprise

The SEC argues that there was a common enterprise under two alternative tests:

- Horizontal commonality exists because the fortunes of SAFT purchasers and Kin purchasers were tied together by Kik's pooling of the funds that the investors collectively paid Kik to increase Kin's value, fund Kik operations, deploy the Kin Foundation and execute development for Kin integration into Kik.
- Strict vertical commonality exists due to Kik's large stake in Kin (30% of Kin tokens), and Kin investors understood that their fortunes would rise and fall with those of Kik.

Kik presents the following arguments in contending that there was no common enterprise:

- Kik did not contractually owe Kin purchasers anything beyond delivering Kin tokens.
- Purchasers did not hold an interest in the sale proceeds or in pro rata distribution of profits.
- Owning a common, fungible asset, where each individual may sell the asset at any time and price of their choosing, does not create commonality.
- Kik marketed Kin as a currency for consumptive use, not an investment opportunity.
- The Kin Foundation was "intended as an independent, nonprofit, and democratic governance body for members of [the Kin economy]" to support and foster the growth of the economy — but not to manage or control the economy or to create demand for Kin.

Expectation of Profits

In arguing that there was an expectation of profits, the SEC makes the following arguments:

- Kik marketed Kin to traditional investors such as venture capital funds.
- Kik promoted the limited supply and liquidity of Kin and Kin's potential to increase in value, including on secondary markets, but did not identify any specific use for Kin as a proposed medium of exchange.
- The minimum viable product could not be bought or sold with Kin.
- Investors bought Kin in such large quantities that their purchases can only be logically explained by an expectation of profits and not by a desire to use or consume.
- The SAFT participants had a profit incentive because they bought Kin at a 30% discount from the public sale price of Kin.

In arguing that an expectation of profits did not exist, Kik argues the following:

- The SEC established no statements in which Kik assured purchasers that it would provide or guarantee liquidity.
- Kin has been functional as a medium of exchange from the day of its launch.

- Large purchases of Kin do not equate to investment intent. For example, a purchaser who wanted to integrate Kin into a digital application would need a sizable supply of Kin to begin distributing it to users.

- The minimum viable product enabled purchasers to link their digital wallets, view their balances, and access and send premium content, and such functionality was used.

- Within the many applications that integrate Kin, there are 4.3 million users spending Kin each month, with more than 11 million different users having spent Kin tokens and more than 26 million different users having earned Kin from these applications.

- Facts regarding the SAFTs are irrelevant to whether Kik led purchasers to expect profits in the public Kin sale.

Efforts of Others

In arguing that Kin purchasers relied on the entrepreneurial or managerial efforts of others, the SEC contends that:

- Kin had no inherent value or even historical existence.

- Kin only existed and could gain value only through efforts to develop the ecosystem and drive up demand for the token.

- Kik promised to take numerous value-enhancing actions for Kin after it distributed the token, including to (1) integrate Kin into Kik Messenger, build new products and develop the Kik ecosystem that would increase the value of Kin; (2) supplement and improve the current Kin blockchain network; and (3) create and influence the Kin Foundation to promote demand for Kin.

- "[T]he record overwhelmingly demonstrate[d] that public investors reasonably expected 'profits from the entrepreneurial or managerial efforts of others'" when they purchased Kin (e.g., averring that based on Kik's statements during its marketing campaign, Kin purchasers would expect that Kik's continued efforts had the potential to "make a lot of money" for both Kik and the purchasers).

In arguing that Kin purchasers did not rely on the efforts of others, Kik argues the following:

- Purchasers who expect profits from market forces as opposed to the promoter's efforts do not satisfy the "efforts of others" prong of Howey.

- The SEC does not identify any promises by Kik that create an expectation of profits from the efforts of others.

- The Kin Rewards Engine was designed and launched by the Kin Foundation, which should be viewed as separate and distinct from Kik.

- Kik's efforts are infrastructural, not managerial.

When Kin were distributed to the public on Sept. 26, 2017, the Kin Network was already fully functional as a medium of exchange for digital services and could also be used inside Kik Messenger.

Kin's consumptive use was demonstrated by consumptive use after launch.

Takeaways and Conclusion

Similar to the Telegram case, the arguments in the Kik case are very fact-specific. As in Telegram, the SEC seems to particularly highlight the extent to which a company represented to SAFT purchasers that the company would engage in post-launch efforts to support the network and encourage adoption and the extent to which the company would retain the power after launch to support the market price of the token.

The outcome of the Kik case is likely to further define the status of blockchain token models in the U.S. market, particularly whether the Telegram court's application of the Howey test to SAFT sales and blockchain token sales will be supported or distinguished in whole or in part, and the corresponding implications for future actions by the SEC and market participants.

No matter the outcome, the court's decision is expected to provide greater clarity on the legal boundaries that developers of blockchain-based networks should consider when designing products and solutions that involve or rely on Ethereum ERC20 tokens or similar cryptographic assets.

While some questions are certain to remain open — or be further challenged on appeal — any measure of clarity the decision provides will be a welcome development for an industry that continues to advance while navigating a gray legal environment.

Teresa Goody Guillén and Jonathan A. Forman are partners, and Robert A. Musiala Jr. is counsel, at BakerHostetler.

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