Ohio Securities Bulletin

JAMES A. RHODES
Governor

J. GORDON PELTIER
Director of Commerce

KENNETH E. KROUSE
Commissioner of Securities

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ATTORNEY'S LIABILITY UNDER SECTION 1707.43

By Barry W. Moses*

A recently reported Franklin County Court of Appeals decision involved the question of a corporate attorney's liability to the purchaser of an unregistered security, sold by other representatives of the corporation. The statute in question was section 1707.43 O.R.C., dealing with a purchaser's remedies in an unlawful sale.

In Leeth v. Decorator's Manufacturing, Inc.,[1] plaintiff Leeth had purchased an unregistered security-an investment contract-from the defendant corporation.[2] James McCord, also named as a defendant, served as a secretary, director, and attorney for the corporation. Plaintiff brought suit under section 1707.43 O.R.C. for recovery of the purchase price, and the sole issue on appeal was the liability, if any, of defendant James McCord.

Section 1707.43 O.R.C. gives the purchaser of an unregistered security (or one purchased in a sale made in violation of Chapter 1707) a remedy for the purchase price against the seller and against ". . . every person who has participated in or aided the seller in any way in making such sale or contract for sale . . ."[3] McCord's liability would, thus, arise only if his conduct or activity constituted participation or assistance in the sale of this unregistered security.

Note that the issue of liability did not hinge directly upon the defendant's relationship to the corporation as "attorney", "director", or "secretary".[4] Rather, the court, in analyzing what constitutes "participation", looked solely at the defendant's conduct, virtually ignoring the official positions defendant held with the company. Thus, the analysis focused on the activity of the defendant in his actual function of aiding or participating in the sale.[5]

McCord's "conduct" in this case was limited to:

1) Making a personal investment in the corporation for which he received 40 shares of the company;

2) [illegible]ing the incorporation documents for the corpora[illegible] initial sale of stock;

3) Reviewing the security so as to be aware of its terms and contents;

4) Stopping by the company's offices to have discussions "about what was going on", and

5) Having a telephone conversation with plaintiff, which consisted of the following: Plaintiff asked McCord if he was an officer and director of Decorator's Manufacturing, and McCord answered, "Yes".

The court determined that this conduct was not sufficient to constitute active assistance or participation in the sale. Thus, with defendant being deemed to have not participated or aided in the sale, he was not held liable.[6]

A key element in the court's analysis was apparently the nature of the contact between defendant McCord and plaintiff. The court compared this case with Crane v. Courtright,[7] which also involved a suit under section 1707.43 O.R.C. In Crane, the defendant was found to have participated in the sale of an interest in an oil well to the plaintiff by:

1) Supplying geological information directly to the plaintiff;

2) Reporting findings and progress of test drillings to the plaintiff;

3) Encouraging the plaintiff to purchase the security; and

4) Acting as an intermediary in the sale.

In Crane, the defendant's contacts with the plaintiff concerning the sale were more direct, while in Leeth, defendant's (McCord's) contacts were limited to a single conversation (initiated by plaintiff) in which McCord answered plaintiff's questions.

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*[illegible]oses is an Assistant Attorney General, employed in the Financial Institution Section of that office. Prior to [illegible]1981, Mr. Moses served as a staff attorney in the Enforcement Section of the Ohio Division of Securities.

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Two Nationwide Plaza - 3rd Fl.
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Contact between plaintiff and defendant was also a key element in determining "participation" in another Ohio case, Hild v. Woodcrest Ass'n.[8] In Hild, the defendant was an accounting firm which had worked with the seller of the securities in question. The plaintiff brought suit under section 1707.43 O.R.C., asserting that the accounting firm had participated and assisted in the sale.[9]

The defendant accounting firm was retained by the general partner of the seller to develop financial and investment information and to prepare a Private Placement Memorandum for the purpose of attracting potential investors. The accounting firm then contacted its own clients (including the plaintiff) who it thought would be interested in making this type of investment.

In Hild, direct contact between plaintiff and defendant was again the key test in determining whether "participation" had taken place within the meaning of section 1707.43 O.R.C. Such a test would seem to be a sound basis for determining liability, and would seem consistent with the spirit of the statute. Yet the courts have found liability under this section in cases involving no direct contact between plaintiff and defendant. In Miller v. Griffith,[10] the defendant, president of the corporation, did not come into contact with the plaintiff prior to the sale of the security. His only contact with the plaintiff was the fact that he had signed the stock certificate. The court held that by signing the certificate, the defendant had "contributed to this transaction and participated in the consummation of the transaction", and thus, was liable to the plaintiff.[11]

As a general rule when the corporation is selling securities, a corporate attorney will not be liable to a purchaser under section 1707.43 O.R.C., unless his or her conduct amounts to direct contact between the attorney and purchaser. Mere preparation of legal documents by corporate attorneys is usually not considered sufficient "participation" to impose liability.

Moreover, the fact that the defendant is an officer, director or holds some other official position with the issuer of the unregistered corporate security, by itself, is usually not sufficient "participation" to render him personally liable. This is probably true even when an attorney for the corporation performing the usual duties, is also a director.[12]

[1] 67 Ohio App. 2d 29 (1979).
[2] For an "investment contract" qualifying as a "security" in Ohio, see section 1707.01(B) O.R.C.; for Ohio court interpretations of "investment contracts," see State v. George, 50 Ohio App. 2d 297 (1975).
[3] Section 1707.43 O.R.C.
[4] 67 Ohio App. 2d 29, 32. (1979).
[5] Id at 32.
[6] Id at 34.
[7] 2 Ohio App. 2d 125 (1964) [hereinafter Crane].
[8] 391 N.E. 2d 1047, 59 O. Misc. 13 (1977) [hereinafter Hild].
[9] Id at 1057.
[10] 196 N.E. 2d 154, 92 Ohio Law Abs. 488 (1961).
[11] Id at 157.
[12] 67 Ohio App. 2d 29, 34; See also, 44 A.L.R. 3rd 3[illegible] section 18[a]; Hughes v. Bie (Fla, App 1966); 183 [illegible] 62 A.L.R. 3d 252.

Editor's Note: *The Ohio Legislature recently passed Senate Bill 363 which enables the Ohio Division of Securities to participate in the Central Registration Depository (CRD). Under this law and Administrative Rules 1301:6-3-15 and 1301:6-3-16, broker-dealers will be able to obtain or renew a salesman's license in a number of states by making a single filing.*

As of this date, CRD computer terminals have been installed and programed in twenty states. The system is expected to become operational in Ohio in early 1982.

The state of Georgia has been closely involved with the CRD since its inception several years ago. David B. Poythress, Georgia's Secretary of State, discusses the importance of the CRD to the securities industry.

CENTRAL REGISTRATION DEPOSITORY

by David B. Poythress*

While the fundamental need for regulation of the securities industry is not subject to serious debate, the existing regulatory framework poses major administrative hurdles to brokers and their counsel, particularly those who must deal with as many as 50 state "Blue Sky Laws." While state securities laws still vary considerably, adoption of the Central Registration Depository (CRD) is a major step toward uniformity.

The CRD system allows a securities dealer to register all of its agents in one central location in a matter of days rather than having to file separate applications for each jurisdiction, a process that ordinarily takes weeks to complete. The plan, conceived jointly by the North American Securities Administrator's Association (NASAA) and the National Association of Securities Dealers (NASD), calls for a computer-based data management system located in Washington, D.C. Broker-dealers and counsel can deal with the single office, which is manned by NASD employees, and can accomplish whatever agent registration transaction they desire with any or all states participating in the system. Some 30 states have made application to participate in the CRD.

The twofold purpose of the CRD is to eliminate duplicative paperwork, and its attendant cost to the industry and government, and to provide better recordkeeping systems for state regulators. Industry estimates project that the CRD will save securities dealers in the United States some thirty million per year when fully operational.

Benefits to government are also impressive. After a dealer has filed the single application for each of its agents and has paid the aggregate filing fee, the CRD staff will perform a ministerial review for accuracy and completeness and then transmit the information by communication line to each state in which the agent will be registered. The application can be reviewed on a video terminal and, if approved, the CRD will automatically remit to the state the appropriate filing fee by electronic funds transfer – a major advance over hand-drawn checks in terms of the state's own money management. For its own records, the state may print the application information on paper, or more likely, convert it to some permanent computer storage medium such as disk, microfilm or micro-fiche. A state could also choose to rely exclusively on the CRD computer and not retain any of its files locally.

In its initial phase, the CRD is intended to accept only agent registration. New issue registration – of somewhat more direct interest to counsel – will be accepted in a later phase of development. Other potential uses of the CRD system now being considered include registration of broker-dealer firms, investment advisors, issuer agents, and intra-state broker-dealers and agents; explanations of disciplinary action on registered persons; a computerized securities law library, including cases and precedents regarding frequently-encountered problems; a NASAA enforcement alert system; and a nationwide automated system linking State Securities Commissions, the S.E.C., other federal agencies, the stock exchanges, and the NASD.

The benefits to both the industry and government from a central, uniform filing system are obvious and substantial. The CRD is only the beginning of what will, doubtless, become a major trend toward uniformity of procedures among states securities administrators.

Further information concerning CRD system can be obtained by writing to the National Association of Securities Dealers, Inc. for their publication entitled NASAA and the CRD System (April 14, 1980).

***David B. Poythress is Secretary of State and Commissioner of Securities for the state of Georgia. Mr. Poythress received his law degree from Emory University in 1967. Prior to becoming Secretary of State in 1979, Mr. Poythress served as Deputy State Revenue Commissioner and Commissioner of the Georgia Department of Medical Assistance.**

PERSPECTIVE

Individuals wishing to submit articles to the Bulletin for publication in the "Perspective" column, should direct them to the attention of Nancy Ivers Ferguson, Editor, Ohio Securities Bulletin, Two Nationwide Plaza, Columbus, Ohio 43215.

The Division of Securities sponsored both fee changes. The decrease in the broker-dealer renewal fee reflects the fact that a smaller percentage of Division resources are committed to broker-dealer regulation than was the case in 1979, when the present renewal fee was enacted.

The increased registration fee for forms 9 and 39 corrects a typographical error which was enacted in 1979. The qualification fees charged on forms 9 and .091 are now identical.

NASAA HOLDS CONFERENCE

Five employees of the Division attended the North American Securities Administrators Association's 64th Annual Conference in Atlanta on October 11-14, 1981. Representing the Division were David LeGrand who serves on NASAA's Enforcement Committee, Paul Tague who serves on the Merit Standards Advisory Committee, Don Meyer who serves on the Small Business Financing Committee, Clyde Kahrl who serves on the Tender Offer Committee, and Jim Warneka who serves on the Oil, Gas and Mineral Interests Subcommittee. Committee members met with their respective committees on Sunday, October 11, 1981.

The Monday morning program was led off by John M. Fedders, Director of Enforcement for the S.E.C., who gave his first public address since his appointment to that position. Mr. Fedders was followed by John R. Evans, Commissioner of the S.E.C. who addressed NASAA and its guests at the Monday luncheon.

The remainder of the program on Monday, Tuesday and Wednesday consisted of panel discussions and committee meetings. Topics discussed included investment instruments, the proposed adoption of Regulation D, option products, industrial revenue bonds, and the Central Registration Depository.

The conference was well attended by attorneys, regulators, issuers, and brokers from throughout the United States, including Ohio.

ENFORCEMENT

BROKER-DEALER CASES
by Scott Roberts, Staff Attorney

The examination section of the Division of Securities, conducts routine examinations of Ohio broker-dealers to determine compliance with the Ohio Securities Act, and its corresponding administrative rules. When non-compliance is discovered, it is brought to the attention of the enforcement section of the Division.

The enforcement section then considers a number of courses of action, including suspension or revocation of the broker-dealer's license.

Most cases referred to the enforcement section involving Ohio broker-dealers, involve some violation of subsections (E) (F) or (I) of Ohio Administrative Rule 1301:6-3-15. These subsections are discussed below:

(1) Rule 1301:6-3-15(E) requires that a licensed dealer maintain a net worth of not less than $25,000.00. Section (D)(4) of this Rule defines "net worth" to mean "the difference between total assets and total indebtedness after both have been adjusted to eliminate or adjust assets of doubtful or uncertain value." The purpose of the net worth requirement is to protect a dealer's customers by assuring them that a dealer has the finances to reimburse them in the event that the dealer mishandles a customer's account.

Rule 1301:6-3-15(D)(2) states an exception to the $25,000 net worth requirement. If a dealer does not handle customers' funds, he is permitted to have a net worth of only $10,000 and still be licensed as a securities dealer. For instance, if dealer A purchases stock in corporation C pursuant to customer B's order and if the customer sends the money for the stock to the corporation directly and not through dealer A, the Division considers the dealer fully disclosed, i.e., he does not handle customers' funds. For this reason, the Division lowers the net worth requirement from $25,000 to $10,000.00.

(2) Rule 1301:6-3-15(F) requires all Ohio dealers to keep and maintain adequate books and records that fully disclose all transactions entered into by a dealer in Ohio. In the Division's opinion, adequate books and records consist of a general ledger and a receipts and disbursements journal.

Such records must show, with respect to each customer, the securities the dealer holds for safekeeping or otherwise on behalf of a customer. If a dealer carries an agency account on his books, the dealer must identify the principal for whom the agency account is maintained, and keep written evidence establishing the dealer's authority to keep the agency account.

Each dealer is also required to maintain a record showing the location of all branch offices, the personnel assigned to each office and to prominently display his signed and dated securities license in a conspicuous location.

(3) Rule 1301:6-3-15(I) requires every licensed dealer to annually submit to the Division of Securities, a financial statement audited by an independent public accountant. All annual reports are to be sworn to by the dealer. Such an oath shall attest to the correctness of the financial statement and to the dealer's lack of any proprietary interest in any account classified as that of a customer.

In lieu of this report, a dealer may also submit a manually signed and verified duplicate of a report which he has filed with the Securities and Exchange Commission or the National Association of Securities Dealers.

The Division is also authorized under this section to require other or additional reports during any calendar year and may require that such reports be audited by an independent public accountant and be under the oath and affirmation of the dealer. Pursuant to the authority granted to it by this section, the Division's policy is to require Ohio dealers to submit an unaudited 6 month financial statement.

Section 1707.19 of the Ohio Revised Code authorizes the Division of Securities to revoke or suspend a dealer's license if he fails to meet any one of the preceding requirements. In the Division's opinion, investors are only adequately protected if a dealer maintains a sufficient net worth, which worth is accurately disclosed by an audited financial statement that is based on accurate books and records.

BETTY SUE ASSOCIATES, INC.

On September 25, 1981, the Division issued a Cease and Desist Order against Betty Sue Associates, Inc. The Order recited sales of limited partnership interests in thirteen different New York partnerships. Betty Sue Associates, Inc. had acted as broker-dealer and received commissions for the Ohio sales, but was not licensed to sell securities in Ohio.

UPDATE ON ROSS CASE

As reported in the last issue of the Bulletin, on September 21, 1981, Frederick L. Ross pleaded no contest in Franklin County Common Pleas Court to six counts of violating the Ohio Securities Act. The counts had charged Ross with knowingly making or causing to be made, false representations for the purpose of selling securities, in violation of section 1707.44(B)(4) O.R.C.

Although Ross pleaded no contest to the securities charges, he maintained a challenge to the validity of the grand jury process and the indictment.

On Friday, October 9, 1981, Judge G. W. Fais overruled Ross' challenges and accepted his plea of no contest. Prior to sentencing, the court requested a pre-sentence investigation into Ross' background.

On November 18, 1981, Ross was sentenced to six to thirty years in the Ohio Penitentiary and was fined a total of $18,000. Ross was released on $10,000 bail, pending appeal.

STATE OF OHIO
DEPARTMENT OF COMMERCE
Two Nationwide Plaza – 3rd Fl.
(Corner Chestnut & High Sts.)
Columbus, Ohio 43215
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