No. 98-655

In the Supreme Court of the United States

OCTOBER TERM, 1998

LEONARD S. SANDS, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

An issuer may offer to sell securities to the public on the condition that any money raised by the offering will be returned to investors unless a minimum amount of securities is sold by a specified deadline. The question presented is:

Whether the offeror should be deemed to have received the "total amount due" by the deadline, as required under applicable regulations in order for the minimum-sale condition to be satisfied, when a large check representing funds necessary to make up the required minimum was returned unpaid and had not been collected by the time, some months after the deadline, that the issuer closed the offering and took possession of the invested funds.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-18a) is reported at 142 F.3d 1186. The opinion of the district court on the parties' motions for summary judgment (Pet. App. 19a-56a) is reported at 902 F. Supp. 1149. The findings of fact and conclusions of law entered by the district court after trial (reproduced in petitioners' Lodging Appendix) are not reported.

JURISDICTION

The judgment of the court of appeals was entered on April 28, 1998. A petition for rehearing was denied on July 20, 1998 (Pet. App. 59a-60a). The petition for a writ of certiorari was filed on October 19, 1998 (a Monday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Sands formerly controlled petitioners First Pacific Bancorp (Bancorp) and PacVen, Inc (PacVen). Pet. App. 7a. Beginning in the early 1980s, state and federal regulators repeatedly rated Bancorp's wholly owned subsidiary First Pacific Bank, Inc. (the Bank) "unsatisfactory" because of its inadequate capital, earnings, and liquidity and its increasing amounts of "classified" assets and past-due loans. *Ibid*. In seeking to alleviate those problems, Sands violated federal securities laws in a number of ways. The question petitioners seek to raise in this Court involves only one set of fraudulent transactions, which we describe below.[1]

In April 1987, Bancorp commenced a public offering of securities with the announced intention of "downstreaming" the proceeds of the offering to its subsidiary the Bank. Pet. App. 7a. The offering documents provided that all funds would be returned unless the offeror received investments totalling at least $1.5 million by October 10, 1987, but that if that minimum were reached the offering could remain open until a

[1] In addition to the transactions described in the text, petitioner Sands also overstated the Bank's assets by millions of dollars by fraudulently inflating the value, on the Bank's books, of a complex financial instrument known as a Residual Interest Wrap Note (RIWN) and of worthless certificates of deposit (CDs) issued by the National Bank of Liberia. The district court summarized the RIWN and Liberian CD schemes in the introduction to its post-trial findings of fact and conclusions of law. Pet. Lodging App. xi-xiii (RIWNs), xiii-xiv (CDs). Petitioners do not dispute in this Court the lower courts' findings and conclusions with respect to those aspects of the case.

maximum of $2.55 million worth of securities were sold. *Ibid.*[2]

As of Friday, October 9, 1987, the last business day before the minimum-sale deadline, the offer had attracted subscriptions totalling only $188,000. Pet. App. 8a; Pet. Lodging App. 20. Faced with that failure to meet the minimum-sale condition, Sands improperly channeled $500,000 from his other company, PacVen, into the Bancorp offering, using as conduits companies owned by co-defendant Charles Knapp.[3] Pet. App. 8a & n.3. On the same day, the escrow agent for the offering received a check for $1 million drawn on the Bank of Montreal Bahamas Ltd. and endorsed by "Paul Kutik, Chairman." Pet. Lodging App. 20; see Pet. App. 8a.[4]

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[2] It is unclear from the opinions below whether the legal deadline was October 10 (Saturday) or October 11 (Sunday). Compare, *e.g.*, Pet. App. 7a with Pet. Lodging App. 15. The precise date is immaterial for present purposes.

[3] The diversion was improper because it was contrary to two provisions of the registration statement under which PacVen's public investors had purchased their shares. The registration statement provided that proceeds not being used in business opportunities for PacVen were to be held "in interest bearing accounts or investments in commercial financial institutions until such time as it appears that they will be required," and it represented that PacVen had "no arrangement, understanding or intention" to invest in any business opportunity with any "firm or business organization * * * affiliated" with an officer, director, or principal shareholder of PacVen. See Pet. App. 8a n.3, 25a, 36a-38a; Pet. Lodging App. x-xi. Both Sands and Bancorp were affiliates of PacVen. Pet. Lodging App. xi, 19-20.

[4] Petitioners refer to the check as the "Savoy check" (see Pet. 4), a term not used by the courts below. The court of appeals noted that Kutik was the chairman of "Savoy Reinsurance Company." Pet. App. 8a. The district court found that the check "[a]pparently * * * represented funds of others." Pet. Lodging App. 20.

Taking account of both the PacVen funds and the Kutik check, Sands informed the Federal Reserve Bank that the Bancorp offering had met its $1.5 million minimum investment threshold as of October 9. Pet. Lodging App. 21.

The $1 million Kutik check never cleared the bank on which it was drawn, and was returned unpaid in November 1987. Pet. App. 8a, 45a.[5] On December 30, 1987, with the Kutik check still unpaid, Sands himself paid $1 million into the offering, which brought the total purportedly invested back up to $1.688 million. *Ibid.*; Pet. Lodging App. 21-23. The offering was then pronounced closed, and the proceeds were delivered to the Bank. Pet. App. 8a; Pet. Lodging App. 23.

2. The Securities and Exchange Commission brought this action against petitioners and others, alleging violations of various provisions of the federal securities laws. Pet. App. 6a. The district court held on summary judgment that Sands and Bancorp committed securities fraud when they closed the Bancorp offering and distributed investor funds to the Bank (rather than returning them to investors), because Bancorp had failed to raise $1.5 million in bona fide sales to unaffiliated investors by the specified deadline. *Id.* at 41a-45a. That finding rested on petitioners' handling of the unpaid $1 million Kutik check and Sands' subsequent investment of his own money.[6]

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[5] Petitioners assert (Pet. 4-5, 14) that the check was promptly resubmitted for collection and that it was "in the process of clearing" when Sands put his money into the offering. No finding or record evidence supports that assertion. See Pet. Lodging App. 20-21.

[6] The undisclosed insider investments in the Bancorp offering were fraudulent because they had the potential to mislead other investors into believing that there was substantial market interest

The court rejected petitioners' contention that there was a material disputed issue as to whether petitioner Sands knew on October 10, 1987—the deadline for meeting the condition—that the Kutik check would not be paid. Pet. App. 45a. The court saw "little significance" to that issue, because even if Sands had no such knowledge on that date, "he did know that the minimum number of units had not been sold in November 1987 when the $1 million check was returned." *Ibid.* The court observed that, despite the failure to meet the minimum sales requirement, "[t]he investors' funds were not returned at that time or [at] any time thereafter." *Ibid.*

After trial on the remaining issues, the district court entered detailed findings of fact and conclusions of law to the effect that petitioners had also committed fraud in making the PacVen diversion. Pet. Lodging App. 12-20. The court also made further findings concerning the fraud in the handling of the Kutik check. *Id.* at 20-23. In particular, the court observed that, "[w]hile there appears to be some dispute about why [the check] never cleared, it is undisputed that the escrow bank * * * never received any cash from its attempts to negotiate this $1 million check. The check was returned

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in the offered securities, whereas in fact virtually all of the money received came from Sands himself or from PacVen, an entity he controlled. See Pet. App. 44a; Pet. Lodging App. 179; see also note 9, *infra.* Petitioners' conduct violated Section 17(a) of the Securities Act of 1933 (the Securities Act), 15 U.S.C. 77q(a) (fraud in the offer or sale of securities); Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. 78j(b) (fraud in connection with the purchase or sale of securities); and Commission Rules 10b-5, 17 C.F.R. 240.10b-5 (general securities fraud), and 10b-9, 17 C.F.R. 240.10b-9 (fraud in connection with offerings that require sale of a minimum amount of securities).

to its maker." *Id.* at 20.[7] The court therefore concluded that, by the minimum-sale deadline, "the offering had in fact raised only $688,000." *Ibid.* And it noted that "[o]f this total, $500,000 was from PACVEN, a SANDS company. Thus, the offering had failed." *Ibid.* (record citation omitted). Finally, the court found that "[d]espite the failure of the offering to raise the minimum amount of money by (or within a reasonable time after) the October 11, 1987 deadline, SANDS and BANCORP never returned the $188,000 received from *bona fide* investors." *Id.* at 20-21; see note 2, *supra*.

The district court accordingly sustained all of the Commission's claims against petitioners, either on summary judgment or after trial.[8] As remedies for

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[7] See also Pet. Lodging App. 21 ("[O]n October 19, 1987, the escrow bank backed out of the escrow account the $1 million check endorsed by Paul Kutik, leaving the BANCORP offering $812,000 short of the minimum.").

[8] In addition to its holdings concerning the handling of the Kutik check, the court granted summary judgment on the Commission's claims that petitioner PacVen did not make required filings disclosing its investment in the Bancorp offering, and that Sands did not make required filings disclosing his additional investment in Bancorp. Pet. App. 45a-49a. After trial, the court ruled in favor of the Commission on its claims that (1) Sands committed fraud by surreptitiously diverting $500,000 from PacVen to the Bancorp offering (Pet. Lodging App. 15-20, 179), (2) Sands and PacVen made false and misleading filings about that diversion in violation of federal antifraud and reporting provisions (*id.* at 181-188), (3) Sands and PacVen failed to keep accurate books and records as required by the Exchange Act (*id.* at 188-192), (4) Sands and Bancorp made false and misleading filings concerning the acquisition of certain assets with little or no value in exchange for Bancorp preferred stock in violation of the Exchange Act's antifraud and filing requirements (*id.* at 192-206), and (5) Bancorp attempted to sell some of those worthless assets by fraudulent means in

these multiple violations, the court enjoined petitioners from engaging in future violations of the securities laws; ordered disgorgement of $688,000 (plus interest), representing the $188,000 that was improperly obtained from investors in the Bancorp offering and the $500,000 improperly diverted from PacVen into that offering; and barred Sands from acting as an officer or director of any public company. Pet. Lodging App. 209-223; Pet. App. 57a-58a.

3. The court of appeals affirmed. Pet. App. 1a-18a. With regard to the Bancorp offering, the court explained that since $1 million of the $1.688 million supposedly raised in the offering was money secretly put up by Sands after the Kutik check failed to clear, while $500,000 of that amount was fraudulently diverted from PacVen, "only $188,000 of the funds came from bona fide investors." *Id.* at 8a. As to the Kutik check, the court held:

> Bancorp had to receive "the total amount due" to it, i.e., $1,500,000, by the October 10 deadline. A check is merely a "promise to pay." *See* Black's Law Dictionary 237 (6th ed. 1990). As this case vividly demonstrates, the receipt of a "promise to pay" $1,000,000 is not equivalent to the receipt of the actual "amount due" because the check may fail to clear. Had the check cleared in the regular course of business but after the deadline, it could be argued that the result should be different, but we need not decide *that* issue. On the facts of this case, Bancorp did not raise the $1,500,000 amount by the October 10 deadline as was required by the terms of the offering.

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violation of the antifraud provision of the Securities Act (*id.* at 206-208).

Id. at 10a. The court accordingly sustained the district court's judgment in its entirety. *Id.* at 10a-16a, 18a.

ARGUMENT

1. Petitioners contend (Pet. 5-16) that the $1 million investment purportedly represented by the Kutik check must be treated as having been actually "received" by Bancorp for purposes of the Commission's Rule 10b-9, 17 C.F.R. 240.10b-9, which regulates securities offerings that include a minimum-sale requirement. Even if that contention were correct, it would not change the outcome of this case. As the courts below found (Pet. App. 8a; Pet. Lodging App. ix, 20), only $188,000 of the funds invested in the Bancorp offering by the minimum-sale deadline were raised from bona fide investors. In order to meet the $1.5 million minimum specified in the offering, petitioners were therefore required to count not only the $1 million promised by the Kutik check, but also the $500,000 purportedly invested by companies controlled by Charles Knapp (Pet. App. 8a & n.3).

After trial, however, the district court found that the $500,000 "investment" was diverted to the offering from PacVen, was not a bona fide investment by unaffiliated purchasers, and therefore could not properly be counted toward the minimum. Pet. Lodging App. 15-20, 23-24, 171-172.[9] Petitioners have not challenged

[9] Petitioners do not contend in this Court that a minimum-sale condition may be satisfied other than by sales to bona fide purchasers not affiliated with corporate insiders. See Pet. App. 12a; *Svalberg* v. *SEC*, 876 F.2d 181, 182-184 (D.C. Cir. 1989) (undisclosed purchase of securities by corporate insider for purpose of meeting offering minimum is fraudulent because investors are misled as to the depth of public interest in the offering); *A.J. White & Co.* v. *SEC*, 556 F.2d 619, 621-623 (1st Cir.) (failure to disclose

that determination either in the court of appeals or in this Court. Thus, even if one assumes that the $1 million represented by the Kutik check was a bona fide independent investment and was received by the minimum-sale deadline, the offering nonetheless failed to meet the minimum-sale condition. A decision favorable to petitioners on the question they seek to present would accordingly result in no change in the judgment in this case.[10]

2. The court of appeals did not reach the issue whether mere receipt of a check by the deadline can constitute receipt of the "total amount due" within the meaning of Rule 10b-9 if the check then clears in the ordinary course of business. Instead, the court held that, because the Kutik check was never paid, Sands and Bancorp knew by the closing date of December 30, 1987, that the minimum-sale condition had not, in fact,

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that offering minimum was met through purchases arranged by corporate insiders and paid for by loans was fraudulent), cert. denied, 434 U.S. 969 (1977); *In re Gallagher & Co.*, 50 S.E.C. 557 (1991), aff'd, 963 F.2d 385 (11th Cir. 1992) (Table) (undisclosed purchase of securities by corporate insider for purpose of meeting sales minimum is fraudulent).

[10] The finding that the $500,000 "investment" was improperly diverted from PacVen independently supports the entire disgorgement award, which required repayment of the $188,000 invested by bona fide investors in the Bancorp offering, plus the $500,000 diverted from PacVen. Nor would a different conclusion regarding the Kutik check provide any basis for disturbing the other equitable relief awarded in this case. That relief rests not only on the violations committed in the Bancorp offering, but also on violations committed in connection with the fraudulent valuation of the RIWNs and Liberian CDs carried on the books of the Bank. Petitioners have not challenged in this Court the district court's findings and conclusions with respect to the RIWN and CD violations. See note 1, *supra*.

been satisfied on October 9, and that they committed fraud when they nevertheless failed to refund investors' money and proceeded with the closing.[11]

Petitioners argue that receipt of a check constitutes "presumptive payment" in ordinary commercial practice (Pet. 6), and that there should be no requirement that an investor's check clear before the deadline in order to count the investment toward a minimum-sale requirement. The courts below did not hold to the contrary. The district court concluded only that petitioners were required to return investor funds when the requisite minimum independent investment had not been received "by (*or within a reasonable time after*)" the deadline. Pet. Lodging App. 20-21 (enphasis added).[12] Likewise, the court of appeals expressly noted that it "need not decide" whether the result in this case would have been different if the Kutik check

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[11] Sands' payment could not, in any event, have met the minimum-sale requirement because, as discussed in note 9, *supra*, it is fraudulent to use an undisclosed payment from a corporate insider to meet such a requirement. Sands' contention (Pet. 14-16) that his payment of $1 million in lieu of the Kutik check amounted to nothing more than buying Kutik's position in the stock is insubstantial. As the court of appeals explained (Pet. App. 11a):

> Because Kutik's check never cleared, his "position" in the offering amounted to zero. Sands' purchase of the 500 units, which Kutik had merely *wished* to purchase, occurred after the deadline and, therefore, after the Bancorp offering had already failed for inability to raise the $1,500,000 minimum.

[12] The Commission has long taken the position that a minimum-sale contingency is not satisfied unless the requisite securities are "fully paid for by the specified deadline." Exchange Act Release No. 11532 (July 11, 1975) (quoted by the court of appeals at Pet. App. 10a n. 5). The Commission has not questioned that receipt of a check may satisfy this "full payment" requirement, so long as the check thereafter clears in the ordinary course.

had been received by the deadline and had then cleared "in the regular course of business." Pet. App. 10a. The courts' holding was therefore not that petitioners could not treat receipt of the Kutik check as "presumptive" payment, but that they could not legitimately continue to indulge the same presumption once they knew, weeks after the check might have been expected to clear, that it had, in fact, been returned unpaid. That conclusion is plainly correct, does not conflict with any decision of this Court or of another court of appeals, and does not warrant any further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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