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***United States v. Leonard*: "Totality of Circumstances" Determines what Constitutes a "Security"**

I. Facts and Procedural History

On December 20, 2005, Paul Dickau and Nanci Silverstein, among others, were sentenced in the United States District Court for the Eastern District of New York to forty-three months and six months imprisonment, and ordered to pay $499,989.64 and $14,490 in restitution, respectively, after having been found guilty by a jury of securities fraud and conspiracy to commit securities and mail fraud. Both were involved in selling interests of at least $10,000 to investors in two limited liability companies formed to finance the production and distribution of motion pictures.[1] The materials the defendants used to promote the investments, however, grossly understated the commissions they were to receive. While the materials given to prospective investors suggested that 69% of moneys went to film production and pre-production, and 20% went to sales commissions and sales office overhead and bonuses, the defendants actually received sales commissions of between 42% and 45% on each investment sold.[2] It was this discrepancy that led to their prosecution.

Dickau and Silverstein appealed their convictions claiming that insufficient evidence supported the determination that the investment interests they sold were "securities." The basis of their appeal was that the interests were not "securities" within the meaning of the federal securities laws because the purchasers exercised "significant investor control" over the production companies, and were not merely "passive investors."[3] They also appealed their sentences, claiming that the district court erred in its determination of the loss amount caused by their conspiracy and fraud.

II. Findings of the Second Circuit

A panel of the Second Circuit in a unanimous opinion authored by Judge Katzmann affirmed the jury conviction, but vacated the sentence and remanded it to the District Court. In affirming the conviction, the Second Circuit fell in line with other circuits in that when determining whether an investment is a "security" for the purposes of the Federal securities laws, courts must look at the totality of the factual

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1 *United States v. Leonard*, No. 05-5523-cr(L), slip op. at 3 (2d Cir. June 11, 2008).

2 *Id*. at 4.

3 *Id*. at 3.

circumstances surrounding the investment, and not just the written investment agreement between the parties.[4]

The Court of Appeals did however vacate the sentences given to Mr. Dickau and Ms. Silverstein on the grounds that the district court erred in computing the "loss amount" caused by the conspiracy and fraud.[5] The district court had determined the "loss amount" to be the entire cost of the securities sold by the defendants, reasoning that individual investors would not have invested at all had they known how high the sales commissions to the defendants were. The Court of Appeals ruled that the investments, however "illiquid" and difficult to value, were not "worthless" and that the district court should determine its true value and re-sentence the defendants accordingly.[6] [7]

III. What Constitutes a "Security" for the Purpose of the Federal Securities Laws

At the heart of the defendants' appeal was whether the interests they were selling were "securities" as that term, defined in the Securities Exchange Act of 1934, as amended (the "1934 Act"), has been interpreted by the courts. Section 10(b) of the 1934 Act makes it unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device."[8] In *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946), the Supreme Court defined an investment contract (security) for the purposes of the 1934 Act as

> a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, 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.

The crucial language is "solely," because the ultimate determination to be made is whether the person selling the investment was seeking a "passive investor" who would rely "solely" on the seller to do all the work in producing a return on the investment, or whether investors were expected to contribute in a "meaningful way."[9] If the latter were true, then the investments would not be "securities."[10]

The defendants argued that investors never expected profits "solely" from the efforts of others, because the investors were expected to be actively involved in the affairs of the film production companies.[11] Both the district court and appeals court acknowledged that the text of the investment documents "appear[ed] to provide for too much investor control to allow the jury to conclude that the units were se-

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4 *Leonard*, slip op. at 12.

5 *Id.* at 16-17.

6 Under the version of the Federal Sentencing Guidelines applicable to the defendants, the total offense level was measured in part by the "loss amount" caused by the fraud or deceit.

7 *Leonard*, slip op. at 17.

8 Securities Exchange Act of 1934, 15 U.S.C. § 78j(b). The "manipulative device" here were the misleading promotional materials disseminated by the defendants to prospective investors.

9 *Leonard*, slip op. at 7, *quoting SEC v. Aqua-Sonic Prods. Corp.*, 687 F.2d 577, 582 (2d Cir. 1982).

10 *Leonard*, slip op. at 7-8.

11 *Id.* at 7.

curities."[12] However, the Court of Appeals held that this was not to be the end of the inquiry. The court stated that the test for determining whether an investment is a "security" requires the court to go beyond the mere text of the agreement between the parties.[13] In actuality, the investors "played an extremely passive role in the management and operation of the two companies in which interests had been sold by the defendants."[14] They played no role in shaping the organizational agreements, and were not involved in writing the script, selecting a director, cast, or crew, scoring the film, or editing it. The investors also had "no particular experience in film or entertainment."[15] These factors, in concert with the fact that "the members' managerial rights and obligations did not accrue until the [companies] were 'fully organized,'" allowed the jury to properly conclude that "notwithstanding the organizational documents drafted to suggest active participation by members, the defendants sought and expected passive investors . . . and therefore the interests that they marketed constituted securities."[16]

IV. Agreement Among the Circuits

The Second Circuit is in agreement with the Fourth, Fifth, and Eleventh Circuits in how to decide what constitutes a "security" for the purposes of federal securities law. Courts must look at the totality of circumstances surrounding the transaction, and not simply accept a literal reading of the written agreement between the parties.[17] A party cannot avoid having investments characterized as something other than a "security" merely because the contract between the promoter/seller and investor suggests active involvement by the investor. The courts will look at all the "totality of the circumstances"[18], including the actual involvement contemplated by the parties, any evidence of such involvement (or lack of involvement), and anything else can be gleaned from the factual circumstances surrounding the investment in arriving at a characterization of an investment.

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12 *Leonard, slip op.* at 10.

13 *See Reves* v. *Ernst & Young*, 494 U.S. 56, 61 (1990) (in which the Supreme Court instructed lower courts to "prize substance over form" in evaluating what constitutes a security); *Leonard*, slip op. at 10-11.

14 For example, of the 250-300 investors in one of the companies, five served on the management committee and seven served on the finance committee. Of the 350-400 investors in the other company, ten served on the management committee and seven served on the finance committee. *Id.* at 10.

15 *Leonard*, slip op. at 11.

16 *Id.* at 11, 12.

17 *See SEC v. Merch. Capital, LLC.,* 483 F.3d 747, 755 (11th Cir. 2007) (holding that "[t]he Supreme Court has repeatedly emphasized that economic reality is to govern over form and that the definitions of the various types of securities should not hinge on exact and literal tests." (*quoting Williamson v. Tucker*, 645 F.2d 404, 418 (5th Cir. 1981)); *Robinson* v. *Glynn*, 349 F.3d 166, 170 (4th Cir. 2003) (holding that "[w]hat matters more than the form of an investment scheme is the 'economic reality' that it represents, and that the question is whether an investor, as a result of the investment agreement itself *or the factual circumstances that surround it*, is left unable to exercise meaningful control over his investment.) (internal citation omitted) (emphasis added); *Williamson*, 645 F.2d at 423-24 (holding that investors may be so lacking in requisite expertise, so numerous, or so dispersed that they become utterly dependent on centralized management, counteracting a legal right of control.).

18 *Leonard*, slip op. at 12.

V. How to Properly Determine the "Loss Amount" Under the Sentencing Guidelines for An Offense Involving Fraud or Deceit

At sentencing, the district court determined that the investments had an actual value of zero to the investors misled by the defendants, reasoning that they would not have invested at all had they known the true percentage of the sales the defendants were receiving as a commission.[19] The Court of Appeals found the sentence given to the defendants "unreasonable."[20] This was because the determination of the "loss amount" was incorrect, a procedural error under the Sentencing Guidelines.[21] Despite the fact that investors may not have purchased interests in the film companies had they known the true percentage of the sales commissions, the investments themselves still had some value.[22] While the court of appeals was "mindful that illiquid securities for which there is no public market can be extremely difficult to value[,]" it ruled that the district court did have "to make a 'reasonable estimate' of the loss amount, . . . an exercise best committed to the sound discretion of the district court."[23] The case was remanded to the Eastern District of New York to make that determination and to re-sentence the defendants accordingly.

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If you have any questions about the issues addressed in this memorandum, please do not hesitate to call or e-mail Charles A. Gilman at (212) 701-3403 or cgilman@cahill.com; Jon Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

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19 *Leonard*, slip op. at 16.

20 A sentence can be vacated by the court of appeals as "unreasonable" when some steps taken by the sentencing court in determining or imposing the sentence do not comport with the substantive or procedural requirements of the law. *See United States v. Pereira*, 465 F.3d 515, 519 (2d Cir. 2006).

21 *Leonard*, slip op. at 14-16.

22 *Id.* at 16 ("After all, the investors did obtain an interest in a company engaged in producing and distributing a motion picture.").

23 *Id.* at 17.