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81-6231

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

AQUA-SONIC PRODUCTS CORP., et al.,

Defendants;

MARTIN HECHT and INVENTEL CORP.,

Defendants-Appellants.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION,
APPELLEE

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I N D E X

TABLE OF CITATIONS

CASES (cont'd)

MISCELLANEOUS

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COUNTERSTATEMENT OF THE ISSUES PRESENTED

The district court, in this action brought by the Securities and Exchange Commission to enjoin certain promoters from selling securities in violation of registration and antifraud provisions of the federal securities laws, found that the instruments which they offered and sold were securities in the form of investment contracts. Specifically, the promoters offered and sold licenses -- authorizing the licensees to market professional dental products which would be developed and manufactured by the promoters -- coupled with sales agency agreements under which the

licensees' marketing responsibilities would be performed by the promoters. The defendants-appellants, claiming that purchase by the licensees of the sales agency agreement was optional, contend that the licensees' profits would come from their own efforts in marketing the products, and accordingly that an essential element of an investment contract was not present. They also argue that, even if the sales agency agreement is treated as being inseparable from the license, the profits would still come from the licensees' efforts since they were allocated certain rights under the terms of the sales agency agreement.

The questions presented are:

1. Was the district court clearly erroneous in finding that the license and the sales agency agreement constituted an inseparable package representing an investment in the combined enterprise of developing, manufacturing and marketing the products, where

(a) the enterprise was promoted as a highly-leveraged tax shelter, providing significant tax benefits that could be maximized only by utilizing the sales agency,

(b) utilization of the sales agency would relieve the licensees of marketing responsibilities that were unattractive, and

(c) all licensees purchased the sales agency agreement?

2. Was the district court clearly erroneous in finding that the licensees were incapable of exercising control over the enterprise, where, notwithstanding the rights nominally allocated to them under the sales agency agreement, they were not able to exercise control over the development, manufacturing and significant marketing functions of the enterprise?

COUNTERSTATEMENT OF THE CASE

A. Course of Proceedings and Disposition Below

This is an appeal by defendants-appellants Martin Hecht and Inventel Corporation ("Inventel") from an order of permanent injunction entered October 13, 1981, by the District Court for the Southern District of New York (Sweet, J.) (A41-44) in an action brought by the Securities and Exchange Commission to enjoin violations of the federal securities laws. 1/

On September 30, 1980, the Commission filed a complaint against Aqua-Sonic Products Corp. ("Aqua-Sonic"), its president Melvin Hersch, Ultrasonic Dental Products, Inc. ("Ultrasonic"), Dentasonic N.V. ("Dentasonic"), appellant Inventel, and the individual promoters and controlling persons behind the corporate entities, Leon Schekter, M. Joshua Aber and appellant Martin Hecht, alleging violations by the defendants of the registration provisions of the Securities Act of 1933 and antifraud provisions of the Securities Act and the Securities Exchange Act of 1934 (Index No. 1; E646-622). 2/ The complaint alleged that the defendants fraudulently offered and sold unregistered securities in the of licenses granted by defendant Aqua-Sonic giving the licensee the exclusive right to market within a particular territory certain professional dental pro-

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1/ References to documents contained in the Appendix are to the pages as numbered, e.g., "A__" or "E__"; references to documents contained in the Supplemental Appendix are to "SA__"; references to documents identified in the Index to the Record are to the number assigned the document, e.g., "Index No. __"; references to the trial transcript are cited as "Tr. __"; references to depositions admitted at trial are cited as "(witness) Dep. p. __"; references to exhibits and page numbers in the exhibits are designated "Ex. ___ p. __"; and references to appellants' printed brief are cited as "Br. __."

2/ Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933, 15 U.S.C. 77e(a), 77e(c) and 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5. Relevant statutes are set forth in the statutory appendix, pages a-1 -- a-6, infra.

ducts known as "Steri-Products," products to be developed and manufactured by Aqua-Sonic, to be promoted by a national advertising campaign arranged by Aqua-Sonic and to be marketed by defendant Ultrasonic acting as the licensees' exclusive sales agent.

All defendants moved for dismissal on the ground of lack of subject matter jurisdiction, contending that the Aqua-Sonic license and sales agency arrangement did not constitute a security within the meaning of the federal securities laws. In an opinion dated June 5, 1981, the district court denied the defendants' motion, relying on one of the terms -- "investment contract" -- in the statutory definitions of security, a term which the district court recognized has been held by the Supreme Court to encompass "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others," citing United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975); and Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946). The district court noted that the Supreme Court in Forman had emphasized (421 U.S. at 851-852) the need, in determining whether there has been a sale of a security, to apply the statutes in light of "the substance -- the economic realities of the transaction -- rather than the names that may have been employed by the parties." Concluding that "a sharp dispute" of fact existed regarding the economic reality of the interest offered by the defendants, the district court refused to dismiss the complaint (E663-667). 3/

3/ Following this ruling, orders of permanent injunction were entered by consent, without the admission or denial of the allegations in the complaint, enjoining defendants Schekter, Aber, Dentasonic and Aqua-Sonic from violating the registration and antifraud provisions (Index Nos. 112-114, 135). Final consent orders were also entered

(footnote continued)

Following seven days of trial the district court entered an opinion on August 11, 1981. The district court concluded that the economic reality of the enterprise was one in which there was an expectation of profits -- in the form of tax benefits and income from prospective sales -- to be derived from the efforts of others. The court stated that "the Aqua-Sonic licensees were dependent, passive and incapable of latent investor control" (A34). Based upon the evidence, including evidence that the Aqua-Sonic licensees stood to reap substantial tax benefits as well as relieve themselves of marketing responsibilities by contracting with Ultrasonic to effect sales of Steri Products, the court found that, while the sales agency arrangement was "purportedly an optional feature," in fact the investors were offered an interest in a combined enterprise in which "Aqua-Sonic was responsible for the development and production of the products" and "Aqua-Sonic, Ultrasonic and the Advertising Fund [were responsible] for the marketing and promotion of the products" (A25). The court concluded that the license and sales agency arrangements were securities. In view of the defendants' concession that, if these interests were securities, they had violated the registration provisions, the district court found violations of those provisions (A27).

With respect to the charges of fraud, the defendants had conceded that their promotional materials were fraudulent by virtue of omitting information relating to the role and financial interests of the promoters,

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3/ (footnote continued)

against defendants Ultrasonic and Melvin Hersch, without their admitting or denying the Commission's allegations; these orders accepted those defendants' stipulations and agreements that they would not violate the registration and antifraud provisions (Index Nos. 115, 116).

the interest in the venture of the law firm rendering a tax opinion used in the promotional materials, the financial condition of the corporate entities, and the use of the proceeds of the offering. In addition, the district court found that the information on which the tax opinion was based was sufficiently superficial to render the tax opinion misleading, that financial projections provided investors were without foundation, and that misrepresentations were made concerning the marketability and need for the Steri Products (A28).

In light of the violations found, the likelihood that Mr. Hecht would engage in future sales of investment contracts through Inventel, and Mr. Hecht's disregard during the period of the offering of legal opinions that the transactions should conform to the requirements of the federal securities laws, the district court permanently enjoined them against further violations of the registration and antifraud provisions.

B. The Facts

1. Overview: the investment offered by defendants

The Steri Products were conceived as improvements on an existing device used in the dental profession. The existing device, which employs ultrasonic waves to clean teeth by removing calculus and other stains, uses tap water, fed through a hollow tip, as a coolant and flushing agent. The Steri Products were intended by their inventor, Arthur Kuris, to deliver prepackaged sterile water or medication, instead of tap water, to be used in the cleaning process. One of the two products, the Steri Prophy Unit, was to be complete and self-contained. The other, the Steri Satellite Unit, was to be an adjunct to an existing ultrasonic device. Patent applications were filed on the two Steri Products in July 1976 and October 1977. In 1978, during the period when the securities offering

took place, Mr. Kuris' working models of the products were in fact incapable of delivering fluids that were sterile or of mass production. As of trial, these devices still had not been produced for sale.

Appellant Martin Hecht is an attorney, and, together with co-defendants Schekter and Aber, was a partner in the law firm of Schekter, Aber and Hecht ("SAH") in 1978 and part of 1979. Mr. Hecht served as the securities law specialist for the firm. In addition to performing legal services, the members of the firm jointly engaged in the business of promoting tax-sheltered offerings under the auspices of Mr. Hecht. In order to produce and market the Steri Products, Arthur Kuris met with Mr. Hecht and his law partners. Mr. Hecht devised a plan to promote the venture as a tax shelter. In order to offer that tax benefit, SAH proposed to finance the venture through the sale to investors of licenses to sell Steri Products in specific geographic territories in the United States, coupled with an exclusive sales agency arrangement under which the products would be sold by Ultrasonic rather than by the licensees. The scheme was effected through a group of interlocking corporations owned or controlled by Arthur Kuris and the SAH partners.

SAH drafted the offering materials used to solicit investors. Those materials, which were contained in a folder provided to the investors, included an information memorandum on behalf of Aqua-Sonic (generally describing the Steri Products, the territorial license arrangement, the licensee's marketing obligations, the fees involved and the tax treatment to be accorded the investment), a tax opinion prepared by SAH, and cash flow illustrations based on certain market penetration projections. Also included was information relating to a national advertising campaign to be paid for by the licensees. The information memorandum stated that

the licensee could retain a sales agent or undertake marketing of the products himself through direct sales to dentists, but that the more common practice in the industry was selling to dental supply wholesalers or "dental depots", which in turn sell directly to dentists. Included in the offering materials was an offer by defendant Ultrasonic to act as an exclusive sales agent and a contract to perform the licensee's marketing obligations imposed by the license agreement.

The offering was managed by Mr. Hecht, who, acting through appellant Inventel, solicited a network of salesmen who placed the licenses. Ultimately, 50 persons purchased approximately one-half of the over 100 available licenses. Significantly, each licensee also subscribed to the sales agency arrangement. The typical offering price for the entire package, consisting of the cost of the license, the sales agent's fee and the contribution to the advertising fund, was to be paid in three parts: $10,050 cash, payable in 1978, three recourse promissory notes totalling $10,050 plus interest, payable in 1979, and three long-term nonrecourse promissory notes totalling $170,000 plus interest, payable out of the proceeds of sales of Steri Products. 4/

Included in the offering materials was a separate three-page "confidential" summary labelled "for professional use only," which highlighted the tax advantages of the investment, promising immediate tax shelter for licensees arising principally from the non-recourse method of financing employed. Investors were assured that during the first three years, they would receive a four dollar income tax deduction for every dollar invested in the Aqua-Sonic license itself. The summary showed supplemental tax shelter from the

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4/ Certain insiders and salesmen who invested in the offering paid substantially less in cash and recourse financing.

sales agency agreement, at an additional out-of-pocket cost of only $1800, of about $35,000 in additional tax deductions -- resulting in a 6 for 1 tax advantage for the entire license and sales agency package. As 1978 drew to a close, and because changes in the tax laws substantially lowered the projected tax benefits, SAH determined to require a contribution by all licensees to the newly-created advertising fund, with a corresponding reduction in the amount of the sales agent's fee. Following the tax law amendments, and after a substantial number of the Aqua-Sonic licenses had been sold, SAH issued a supplemental tax opinion, and a revised "confidential" summary was distributed to investors. With the revised tax treatment recommended by SAH for the advertising contributions, the estimates for tax shelter -- flowing from an investment consisting of the license, the sales agency and the advertising fund -- were revised downward, but the summary still promised a 3 for 1 tax shelter for the investment package.

The offering produced about $900,000 revenue to the offerors, half in cash and half in recourse financing. Of that amount, only some $50,000 was expended to develop the Steri Products. With respect to the remainder, approximately $160,000 was paid to Mr. Kuris, and the bulk was paid to salesmen, promoters, lawyers and accountants or corporations controlled by the promoters as expenses associated with the offering. At the time of the trial -- 2 1/2 years after the offering -- no operational Steri Product was in existence, none had been produced and none had been sold. No promotion of Steri Products had taken place, and the sales agent had done nothing to sell the product.

Appellants argue that the federal securities laws do not apply to the offering because their promotional materials did not recommend a sales agent and because certain obligations were imposed on the Aqua-Sonic licensees.

In their view, what was offered was simply a franchise imposing significant marketing responsibilities on the licensees in order to obtain a return on their investment and a separate "optional" service contract. Alternatively, they assert that, even treating the license and sales agency arrangement as a combined package, the rights retained by the Aqua-Sonic licensees over the marketing function under the sales agency agreement were significant and preclude the finding of an investment contract.

The evidence, which we describe in detail in the remainder of this statement of facts, shows that defendants offered a package in which the expectation of profits was from the efforts of others. In part 2, we discuss the interlocking entities which were created by and under the control of Mr. Hecht and SAH, demonstrating that Aqua-Sonic and Ultrasonic were distinct only in form but not in substance. In part 3, we describe the promotional materials distributed to investors, including the license and sales agency agreements, and their representations as to the substantial tax benefits which were to be derived by investors who acquired the entire package, as well as the market evaluation report and cash flow illustrations on which the favorable tax treatment was premised. As we show, the use of non-recourse financing afforded the investors large tax deductions flowing from a relatively small out-of-pocket investment. In part 4, we describe the offering process employed by Mr. Hecht and the expectations and experience of certain representative investors who purchased with an anticipation of profits from the tax shelter and product sales. The investors were specifically induced to acquire the Aqua-Sonic license because of the existence of the sales agency agreement through which they could delegate their marketing responsibilities under the license. Finally, in part 5, we describe the fraudulent representations made to inves-

tors with respect to the use of proceeds, the role and financial interest of SAH, the state of development and industry need for the Steri Products and the tax benefits from the investment.

We believe it essential to set forth the evidence in considerable detail because of the complexity of the defendants' scheme and because the appellants are challenging the district court's findings of fact.

2. The Interlocking Entities

As indicated in our overview, Mr. Hecht was instrumental in devising the plan to finance the Steri Products venture as a tax shelter. He was responsible, in his own words, for "all tax-oriented transactions" at the SAH firm (SA17). Indeed, the Steri Products venture was one of several tax-oriented transactions devised during this period for the purpose of marketing new products (A141, 181; SA46-52; E289, 290; E427-428). As a fee for its services in the Steri Products offering, SAH was to receive 9 percent of the cash portion of the offering proceeds (E285).

In order to maximize the tax benefits of the venture to all concerned, SAH eventually "evolved" four corporations, three of which were to develop, manufacture and sell to dentists the Steri Products (A109-110; A117-119; SA18-19). The inactive one of those corporations was defendant Dentasonic, owned by Messrs. Schekter, Aber, Hecht, and Kuris (A105-106). 5/ Mr. Kuris sold to Dentasonic his United States and Canadian

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5/ Dentasonic is a Netherlands Antilles corporation, formed offshore at the direction of SAH in order to shelter its income (SA20-23; E305; E427-430).

patent rights in the two Steri Products for $406,500 (A105; E383-389). 6/

Another of those corporations formed by SAH is defendant Aqua-Sonic Products Corporation, the licensor, a New York corporation to which Dentasonic sold the United States patent rights to the two Steri Products for $26 million (E218-239). As security for the $26 million sales price, Dentasonic held a continuing security interest in all the assets of AquaSonic, and received an irrevocable proxy to vote all the outstanding stock of Aqua-Sonic (A99; E244-270). In addition, at least until March, 1979, a member of SAH was required to co-sign all checks on the Aqua-Sonic bank account (A169-171; A236-237).

In early 1978, Mr. Aber recruited David Glasser to be president of Aqua-Sonic (A164-168; E306-308). Mr. Glasser was a business executive with no experience in the manufacture or selling of dental products (A101-102). In the summer of 1978, Mr. Glasser resigned the presidency of Aqua-Sonic on advice of counsel that the proposed offering might subject him to personal liability on several counts (A172-173; E504-505) -- he told Mr. Schekter that he understood the offering might be in violation of federal and state securities laws, as well as the federal antitrust laws and food and drug laws (A174-176). Mr. Glasser was replaced as president of Aqua-Sonic by defendant Melvin Hersch, an acquaintance of Mr. Hecht's, in August 1978 (A222-225). Mr. Hersch

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6/ The parties had originally discussed paying Mr. Kuris $400,000 in cash and $7,000,000 in notes (E356). However, they agreed to reduce the cost to Dentasonic in return for Mr. Kuris' ownership participation in that company; Mr. Kuris became an 18% shareholder in Dentasonic late in 1978 or early in 1979 (SA23; E382; E404; E431-434). In addition, Aqua-Sonic entered into a two-year consulting agreement with an entity known as Creative Ultrasonics, which was wholly owned by Mr. Kuris, to obtain Mr. Kuris' assistance in the development of the Steri Products for the sum of $72,000 per year (A68-69; E271-280).

then signed documents formalizing the relationships between Aqua-Sonic, Dentasonic and appellant Inventel (A226-228).

A third corporation, defendant Ultrasonic Dental Products, was to be the sales agent to market the Steri Products. A New York corporation, it was formed at the request of SAH by Mr. Kuris' friend and attorney, Leonard Suroff (A114-115). Mr. Suroff became its president and director (A115). Until Mr. Suroff's resignation in late December 1978, SAH retained control over Ultrasonic by requiring a member of SAH to co-sign all checks issued on the Ultrasonic bank account (A116). SAH's control over Ultrasonic is demonstrated by SAH's decision in October 1978 to require contributions by all investors to the advertising fund and by unilaterally and retroactively effecting a corresponding reduction in the amount of the sales agency fee from $30,600 to $16,600. Mr. Suroff, the president of Ultrasonic, was not approached to negotiate this reduction; he was simply informed that Ultrasonic's fees would be halved to finance the advertising fund (A123). In December 1978, Mr. Suroff resigned as president of Ultrasonic on advice of counsel (A126-127) because of a Commission inquiry into this matter (A124). Mr. Hecht then recruited, as a successor to Mr. Suroff as president of Ultrasonic, Melvin Ehrlich, a professor of physics (A179, 184-185).

Finally, Mr. Hecht had SAH incorporate a Delaware corporation, appellant Inventel, in which he, Mr. Aber, and Mr. Schekter were the original shareholders. 7/ Aqua-Sonic agreed to pay Inventel $2.2 million for "financial and marketing consultation" (E281-284). As discussed more fully at pages 26-27, infra, Mr. Hecht marketed the Aqua-Sonic offering through defendant Inventel.

7/ In February 1979, Inventel redeemed the shares of Messrs. Schekter and Aber (A106; E302, SA65; E308-312).

3. The Promotional Materials

SAH prepared, and Mr. Hecht reviewed, all the offering materials used to solicit investors (A47-56; SA58-60). Three separate versions of those offering materials were distributed to prospective investors: a first version which was employed from April through August 1978; a second version used from August through October 1978; 8/ and a final version used during the remainder of 1978 (A55). 9/ Each investor who had executed earlier versions of notes and contracts executed

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8/ The August revision of the offering materials was precipitated by a preliminary memorandum of outside legal counsel to SAH that the offering might constitute an offer of securities (SA62; E355).

Mr. Hecht had taken the first version of the offering materials to the law firm of Baer Marks & Upham (SA24), to request legal advice regarding the applicability of the federal securities laws to the offering (E212). In a memorandum dated May 31, 1978, an associate and two of the partners at Baer Marks (E215-216) concluded that the offering could be considered to be a security because the investor is induced to acquire the opportunities held out in the offering "as a whole" (E208-209).

Following receipt of this opinion, SAH directed one of its own associates to prepare another opinion, an opinion which concluded that the offering was not a security (A95-96; E412-423).

Mr. Hecht testified that this second version of the offering materials was designed to highlight the licensee's responsibilities under the Aqua-Sonic license (SA62).

9/ The final version of the offering materials was necessitated by changes in the tax law enacted in the Revenue Act of 1978. This revision was also prompted because, under the original tax opinion, the sales agent's fee, although fully deductible, had to be apportioned over two taxable years, and those investors who purchased late in 1978 would not be able to obtain a significant tax advantage from this arrangement (E353-354). Consequently, SAH devised the advertising fund contribution to off-set the loss of available tax shelter from the sales agency relationship and permit investors to take immediate tax advantage of their contribution to the advertising fund (ibid). See page 24, infra.

the final versions of the offering documents (A57-58). Because all investors were ultimately given this final version, we describe the offering materials in that form, except as noted. The offering materials were bound together in a folder labelled "Aqua-Sonic Products Corp" (A48-49).

a. The information memorandum

The license granted by Aqua-Sonic was described in a document entitled "Information Memorandum Relating to Exclusive Rights" (Ex. 2602A; Ex. 2616B; E507-E607). The information memorandum described the Steri Products, the scientific need for the products, the background of the inventor and the status of pending patent applications for the Steri Products.

It stated that the Steri Products meet a "recognized need" to counteract "microbial contamination of ordinary tap water in commercially available dental * * * equipment." It continued that "[r]esearch has established that there is a definite causal relationship" between such contamination and infections such as the flu, common colds, streptococcal sore throats, hepatitis, pneumonia, and tuberculosis. It asserted that non-sterile water in existing dental equipment permits entry of bacteria into the blood stream, which often causes a heart condition known as endocarditis, and in certain susceptible persons more acute heart conditions. The information memorandum stated that two "pre-production models of * * * systems which deliver sterile water" have been developed for which there are pending patent applications (E513A).

The memorandum continued, "Prototype models of the units have been constructed and testing has been completed. Production models are being readied for manufacture" (E514A). In addition, the memorandum stated that the inventor had contracted with Aqua-Sonic to provide consultation

services in connection with the development and manufacture of the units (E514A). Under the proposed license agreement, appended to the information memorandum, Aqua-Sonic represented that it would manufacture and supply the licensee with Steri Products for sale (Exhibit A to Ex. 2616B; E523-529).

The information memorandum described the license being sold as an exclusive right to sell Steri Products and related parts and supplies, for a period of eight years (with a five year renewal option). Licensees were to be assigned a specific territory within the United States, one of over 100 such standard territories available; 12 larger territories were available at additional cost (E516). The memorandum affirmed that the licensee would be an "independent contractor * * * solely responsible for all expenses and costs * * *" (E516A). It further stated that the licensee would "be responsible for the vigorous and satisfactory promotion, distribution and sale" of the Steri Products and that the licensee must undertake to actively supervise any sales agent retained to assist in the promotion, distribution and sale. The memorandum warned that the license was subject to cancellation by Aqua-Sonic if these conditions are not fulfilled.

The license fee quoted for a standard territory was $159,500, payable in three installments: $9,150 in cash due in 1978; $9,150 in recourse promissory notes, plus interest, due on January 15, 1979; and $141,200 in non-recourse promissory notes, plus interest, due January 1, 1985. The non-recourse note was required to be prepaid out of a portion of the proceeds from the sale of the Steri Products, parts and supplies; in respect to that note, Aqua-Sonic would retain a security interest in any such proceeds as well as any merchandise delivered to the licensee by the licensor.

The information memorandum stated that the licensee may sell Steri-Products directly to members of the dental profession or, "as is more common practice in the dental supply industry, Licensee may sell to Dental Depots who, in turn, will sell to members of the dental profession" (E518). Nonetheless, the pricing figures quoted in the information memorandum automatically assumed that all sales would be made through dental depots and deducted a 35 percent depot fee for such sales expenses (E514A-515). Similarly, other cash flow illustrations prepared by the accounting firm of Marks Shron & Company and appended to the information memorandum as an exhibit, also assumed that all sales would be made through dental depots "in accordance with current practice in the dental industry" (E583A, Note 5 to Exhibit 2). See discussion of the illustrations at pages 19-22, infra.

The final version of the information memorandum, used after October 1978, incorporated by reference agreements between Aqua-Sonic and two advertising agencies for a national advertising and promotional campaign for Steri Products (E634-636A). A "Steri Products Advertising and Promotional Fund" was established, to be used by the agencies in creating, developing, mounting and placing national and/or regional advertising and promotional campaigns on behalf of the Steri Products, subject solely to the approval of Aqua-Sonic. Licensees were required to contribute $14,000 to the fund, again in three installments: $400 in cash; $400 in a recourse promissory note, plus interest, due on January 15, 1979; and $13,200 in a non-recourse promissory note, plus interest, due on December 1, 1984 and required to be prepaid out of portions of the proceeds of sales of Steri Products, parts and supplies (E634A-635). Licensees who had purchased prior to the November 1978 final version of the offering materials were not required

to pay an additional sum; the amount which they had already paid for the sales agent's fee (see page 19, infra) was unilaterally reduced by the amount of the advertising contribution, and each such licensee executed new closing documents (A58, 62-63). Such investors executed new closing documents reflecting this reduction (ibid).

Finally, the information memorandum contained a 3 1/2 page summary of the federal income tax aspects of the transaction based upon an analysis "prepared by tax counsel to the licensor, Schekter, Aber & Hecht, P.C." (E518A-520A). An initial tax opinion of SAH dated April 1978 was appended to the information memorandum and was included in all versions of the offering materials (E586-600); a supplemental tax opinion by SAH dated October 24, 1978, was included only in the final version, where it was an attachment to a letter by the then president of Aqua-Sonic, Melvin Hersch (E637-640A). The substance of these tax opinions will be discussed more fully at pages 22-26, infra.

b. The Offer to Act as Sales Agent

The offering materials included a document entitled "An Offer To Act As Sales Agent By Ultrasonic Dental Products, Inc." (Ex. 2602B; E608A-631). In that document, Ultrasonic offered to act as exclusive sales agent for a period of one year for the promotion, distribution and sale of Steri Products in the territory to which the licensee subscribed. Ultrasonic offered to use its best efforts and to devote the time necessary to promote, market, distribute and sell the Steri Products and to perform the licensee's responsibilities under the Aqua-Sonic license agreement (E611A, 613 ¶¶2, 10(a), (b)). All orders were to be subject to the licensee's approval as to items, price and credit (E614A ¶4). The sales agency agreement was terminable any time at the option of the licensee upon 90 days'

written notice to the sales agent (E614 ¶12(a)).

The sales agent's fee was non-refundable (E612 ¶5), and in the first and second versions of the offering materials, was set at $30,600, payable in three installments as follows: $900 cash due in 1978; $900 in a recourse promissory note, plus interest, due on January 15, 1979; and $28,800 in a non-recourse promissory note, plus interest, due on December 1, 1984, required to be prepaid out of portions of proceeds of sales of Steri Products, parts and supplies; a secondary security interest (subordinate to Aqua-Sonic's security interest) was retained in any Steri Products owned by the licensee and in the proceeds of all sales. In addition, the licensee contracted to pay the sales agent 20 percent of the sales price of all Steri-Product sales paid for by customers (less any sales taxes and shipping costs) (id. ¶6). In the final version of the sales agency agreement, the sales agent's fee was reduced to $16,600, payable $500 in cash, $500 in a recourse promissory note, and $15,600 in a nonrecourse promissory note, under the same terms as the earlier versions.

The Ultrasonic offer promised that, by entering into the proposed sales agency agreement, the licensee would obtain "substantial tax advantages in connection with [the] acquisition of a license" (E609). Appended to the offer were another set of cash flow illustrations by Marks Shron & Company reflecting income and tax treatment for the complete offering package, based upon the SAH tax opinions included in the information memorandum. See discussion pages 23-24, infra.

c. The financial projection illustrations

Financial illustrations projecting certain cash flow from the license and demonstrating the tax shelter represented to be available from the Aqua-Sonic offering were included in the offering materials. These illus-

trations, covering the period 1978 through 1985, were prepared by the accounting firm of Marks Shron & Co. at the request of Mr. Hecht (A142-148). Although not disclosed in the offering materials, Marks Shron received a fee of one percent of the cash and recourse note portion of the offering proceeds for its services in connection with the offering (A156-157; SA28-31).

Three separate sets of illustrations were disseminated: one was appended to the initial versions of the information memorandum and portrayed cash flow based on the purchase of the Aqua-Sonic license alone (E580-584); a second, also in the initial versions, was appended to the Ultrasonic offer and projected the cash flow for the venture based upon purchase of both the license and the sales agency agreement (E624-629A); and a third, which superseded the previous two, was included in the final version of the offering materials, and presented integrated projections based upon purchase of the Aqua-Sonic license, including both the mandatory contribution to the advertising fund, and the sales agency agreement (E641-645A).

The tax treatment in the Marks Shron cash flow illustrations was based upon the SAH tax opinions. The illustrations were also based upon two significant assumptions concerning projected sales of the Steri-Products projected to begin on January 1, 1979: with respect to the Steri Prophy Unit, Marks Shron assumed yearly sales of 88 units per territory, which would require, nationwide, an annual 50 percent market penetration by that unit (or one-half of the total nationwide sales of all new ultrasonic units); with respect to the Steri-Satellite Unit, Marks Shron assumed yearly sales of 253 units per territory, based on a 7 percent annual market penetration by those units, for a total market penetration of 50 per-

cent over the seven year period of the projected sales. 10/ The retail price per unit suggested by Aqua-Sonic in the financial illustrations was $1100 per Steri-Prophy Unit and $300 per Steri-Satellite Unit, and an estimated wholesale cost to licensees of $262 and $81 per unit, respectively. All financial illustrations assumed that the sales were to be effected only through dental depots, at a cost of 35 percent of projected sales revenues. Finally, all illustrations reflecting the use of the Ultrasonic sales agency assumed the continuation of the sales agency agreement for the entire eight year term of the Aqua-Sonic license, after payment of a "one-time sales agency fee" (E629, Note 8 to Exhibit 2).

The integrated cash flow illustrations for the entire investment package, included in the final version of the offering materials, projected a total tax loss deduction of $38,400 in 1978. For years 1979 and later (in which it was assumed sales would take place at the projected rates),

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10/ All of the premises of the illustrations were supplied to Marks Shron by SAH (A149-155; SA26-27).

In regard to the market penetration estimate, Mr. Hecht obtained an opinion in April 1978 from Ray A. Wilson, a professional marketing consultant in small industrial/commercial products, who reviewed the Marks Shron sales projections concerning the Steri Products. In a letter addressed to Aqua-Sonic, Mr. Wilson wrote that an " assumed market penetration of 7% (average) of the market place (average territory) per year, for seven (7) years, appears to be feasible and attainable" (E41).

Certain investors received that report before they made that decision to invest in the offering (A337 (Freschi); E41; SA111 (Gaertner); Ex. 615; see also Ex. 833 (R. Zimmerman)).

Subsequently, Mr. Wilson testified that in the one day that he was given by Mr. Hecht to prepare his evaluation, he misread the projections, and assumed that they were both based on a 7 percent market penetration over a period of 7 years, a penetration which he described as "conservative" (A399). He had stated in the Commission's investigation of this matter, that the 50 percent market penetration in the first year assumed for the Steri Prophy Unit was a success rate which he "could not agree with" because it was not feasible (E65-69).

they estimated a positive yearly cash flow of $11,500, before taxes. A significantly greater cash flow of $46,300 was projected in 1985, the final year of the illustrations, since all nonrecourse notes were assumed to be completely amortized by the end of 1984.

d. The SAH tax opinions

The peculiar structure of this investment was tailored to suit the SAH opinion concerning the tax advantages of the proposed arrangement. These tax advantages were the principal selling feature of the investment, since investors were advised that they could obtain continuing benefit from their investments, initially from substantial tax shelter in the first two years of their investment and later from actual sales of the products. Indeed, investors with sufficient income to take advantage of the tax shelter were advised that they could recoup more than their entire cash outlay in the first year because of immediate advantageous tax deductions built into that year. In addition to the initial tax shelter, the Marks Shron projections concerning the likely sales success of the venture offered investors the prospect of a positive cash flow for the later years, even after amortization of the non-recourse notes.

The initial SAH tax opinion, dated April 1978, and containing 29 pages, was included in all the offering materials (E585-600), and advised the advantageous application of the federal tax laws based on five significant conclusions concerning the tax analysis of the proposed transaction. First, it concluded that the acquisition by the licensee of the Aqua-Sonic license would result in favorable tax treatment under special Internal Revenue Code provisions relating to sale of a franchise. This was premised upon SAH's conclusion that the entire purchase price of the license, $159,500, including the amount of the non-recourse note, could be amortized over the eight year life of the license.

Second, the opinion concluded that, specifically because of the favorable financial illustrations prepared by Marks Shron, endorsed by the Wilson report, a licensee could be deemed, for tax purposes, to have acquired the Aqua-Sonic license in order to make a profit; hence, under the Internal Revenue Code, the taxpayer could deduct losses attributable to the enterprise even if no profit was ever in fact realized.

Third, the opinion stated that the licensee could deduct all expenses associated with the enterprise, particularly interest expenses, because the enterprise could be viewed as a trade or business of the taxpayer. Based upon the terms of the Ultrasonic sales agency arrangement, the opinion concluded that the controls retained over the sales agent by the licensee in that agreement permitted a conclusion that the licensee would be actively engaged in a trade or business.

Fourth, the opinion concluded that the non-recourse note portion of the payment for the Aqua-Sonic license was a bona fide indebtedness and, therefore, could be included in the purchase price of the license for purposes of amortization. The opinion reasoned that the note transaction was not a sham since it was reasonably related to the fair value of the license, and since the parties genuinely contemplated payment of the note. This conclusion was dependent again on the Marks Shron financial illustrations of a realistic positive cash flow to establish that a potential fair market value for the license could be in excess of the face value of the non-recourse note and that actual payment of the non-recourse note was not speculative because it was secured by valuable consideration.

Fifth, the opinion concluded that the full amount of the sales agent's fee, including the amount of the non-recourse note, was deductible as an ordinary business expense over the one year life of the sales agency

contract and, since the contract spanned two taxable years, was apportioned over the two taxable years. The opinion recognized that the deductibility of the sales agent's fee was dependent on the bona fide nature of the non-recourse note, but concluded, again based upon the Marks Shron illustrations concerning the Aqua-Sonic license, that there was sufficient collateral to ensure payment of the note for the sales agency agreement.

The April 1978 initial SAH opinion concluded that a then-current Internal Revenue Code provision limiting losses in certain business activities only to the amount "at risk" did not apply to the proposed transactions for the purchase of Aqua-Sonic licenses. The supplemental SAH tax opinion dated October 24, 1978, and included in the final version of the offering materials, substantially revised the previous opinion because of the passage of the Revenue Act of 1978. Under the new law, the revised SAH opinion stated, these deductions would be limited to the amount that the licensee was at risk, i.e., simply the amount of the cash and recourse financing, instead of the entire amount including the non-recourse notes. 11/

The supplemental opinion, which contained 8 pages (E637-640A), introduced the proposed tax treatment of the mandatory contribution to the advertising fund, concluding that despite any provisions of the Revenue Act of 1978,

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11/ For taxable years after 1978, the Revenue Act of that year expanded the nature of business activities for which the deduction of business losses is limited by the amount "at risk" in the venture. The supplemental opinion stated that it was SAH's view that under the amended law, deductions taken in 1978 (and not previously subject to the "at risk" provisions of the Internal Revenue Code) would not be limited by the revised "at risk" provision; in addition, the opinion stated that no adverse tax treatment would result from deductions taken for years prior to 1979 which exceed the "at risk" amount. For any taxable year after 1978, however, the effect of these provisions was to severely limit the amount of deductions available to investors from the nonrecourse financing devised by SAH.

the full amount of that contribution -- which included a non-recourse note -- was deductible as a business expense in 1978. In support of its conclusion, SAH argued that, "because it is impossible to ascertain how much will be spent for advertising each year of the Fund Agreement", it was reasonable to deduct the expense when incurred in 1978. SAH advised deduction of the entire advertising fund contribution, including the amount of the non-recourse note, because it viewed the Marks Shron illustrations as supporting the conclusion that the non-recourse note was nevertheless a bona fide indebtedness.

The net effect of the tax consequences, as SAH analyzed them, was summarized in the offering materials in a "confidential" summary labelled "for professional use only" (E29-31; E57-60). This summary reflected only the tax benefits of the offering, without regard to any revenue from sales. The summary contained in the initial versions of the offering materials distinguished between the tax shelter available to a licensee with and without the sales agency arrangement. The tax deductions initially projected for the Aqua-Sonic license alone for the years 1978-1980 totaled $80,900 (including the amortized portion of the license fee and accrued interest on the non-recourse notes) -- a tax deduction of 4 dollars for every dollar invested in cash and recourse notes. The tax deduction initially projected for the Aqua-Sonic license and the sales agency agreement together for the years 1978-1980 totalled $115,800 (including, in addition to the amounts projected for the license, the full $30,600 sales agent's fee plus accrued interest) -- a tax shelter of 6 for 1.

Using the best treatment possible under the Revenue Act of 1978, the final version of the "confidential" summary distributed to investors flatly assumed that all persons would utilize the sales agent, but projected a $38,400 tax

deduction in 1978 (based on all available tax shelters, including the amortized amount of the license fee, the full amount of the mandatory contribution to the advertising fund, a pro rata portion of the reduced sales agent's fee, and accrued interest) and only a $20,100 tax deduction in 1979, the amount of all deductions, now limited by the amount at risk. The special tax treatment devised by SAH caused the final version's estimated tax deductions for the license, the sales agent's fee, and the advertising fund to be revised downward, but it still promised a 3 for 1 tax shelter for the investment package.

4. The Selling of the Licenses and the Role of Licensees

Mr. Hecht managed the Steri-Products offering, which he effected through Inventel. 12/ At various meetings held throughout the country at which the Steri Products were demonstrated, Mr. Hecht solicited a network of salesmen to place the offering (SA32-34, 38-39; E292-295). As the year continued, Mr. Hecht agressively contacted various accountants and financial advisers to act as salesmen in order to reach people who needed tax shelter (SA35-37). 13/

Ultimately, 14 salesmen participated in distributing the offering (A243; SA9; SA38-39; E321; E377-379). The salesmen stressed to prespective investors the importance of the availability of the sales agency:

12/ Mr. Hecht asked a friend, Daniel Topper, to assume the title of president of Inventel in order to conceal Mr. Hecht's own role in Inventel from legal clients of SAH who were solicited (SA44; E287). In fact, Mr. Hecht performed almost all the functions of Inventel (SA63).

13/ Salesmen were promised a commission of up to 30 percent of the cash and recourse note portion of the offering proceeds (SA32-34, 45). As a further inducement for salesmen, Mr. Hecht offered the "syndicator" or "inside deal" (SA40-43, 45). Insiders and salesmen had the opportunity to purchase the offering for a fee described as "net-net" (SA45); that is, they paid the cost of the license less the 30 percent "sales" commission and the 10 percent portion of the offering which was committed to fees for SAH and Marks Shron.

salesman George Pentazzi told one investor that "the company would handle" the sales (A245); another investor was told at a group sales presentation led by salesman Steven Chios that the selling of the product "would be done by the people that were selling" the license (A401).

Mr. Hecht's most successful salesman, Rex Zimmerman, is an insurance agent and financial and tax consultant in Phoenix, Arizona (E71-75). 14/ Mr. Zimmerman had known Mr. Hecht for some time in connection with various investments (E76-77). In presenting the Aqua-Sonic offering to his clients, Mr. Zimmerman told them that they should invest in it for the tax shelter and for potential income, and pointed out that the sales agency offered the opportunity "to see that the function of that business was carried out" (A299-304).

The testimony of eleven of the purchasers is contained in the record. Their testimony shows that they were attracted to the offering package because of its tax shelter and its income potential, and by the fact that they could receive those benefits without additional effort on their part by retaining the sales agent to discharge their responsibilities under the Aqua-Sonic license. There were 50 eventual purchasers of the Aqua-Sonic licenses. 15/ All Aqua-Sonic licensees also signed the sales agency agreement (A58; A188).

The offering of Aqua-Sonic licenses was terminated by 1979 (A55). After the offering was completed and the January 1, 1979 initial starting date for projected Steri Product sales had passed without any production, Mr. Hersch tried to reassure the investors that their investment goals were still

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14/ Mr. Zimmerman and his partner were eventually responsible for introducing thirteen licensees to the Aqua-Sonic offering (E373-376A).

15/ The district court found that the offering had been placed with 50 investors. Because certain investors purchased several territories, the precise number of beneficial owners is not immediately apparent. However, a list prepared by Aqua-Sonic's accountants lists 49 investors (E377-379).

feasible, by sending various letters to the licensees reiterating Aqua-Sonic's "excitement" and "confidence" about the business (E32, dated January 19, 1979; E33, dated February 28, 1979).

One such letter stated that "preliminary test results indicate * * * [the products] are operating in full conformity" with projections, and would be produced shortly (E39, dated August 2, 1979). In April 1980, Aqua-Sonic sent a letter to licensees reporting a need for redesign in order "to provide additional power," but promising the production of units for field testing purposes and demonstrations soon (E24). Late in 1980 or early in 1981, Aqua-Sonic again sent a letter, indicating a continuing problem of "resonance" requiring additional redesign, with units to be ready for testing in February 1981 (E63). At the time of trial in June 1981, the units were still not functioning, and an LTS engineer estimated that it would take almost another year to achieve full production (A208-212, 214-216).

The investors thus actually found themselves unable to force Aqua-Sonic to fulfill its responsibilities under the license agreement to manufacture and supply the Steri Products for sale.

The experience of the following purchasers is typical.

a. Donald Zimmerman

Donald Zimmerman is a self-employed physical therapist in Visalia, California (A255), who is salesman Rex Zimmerman's brother (A256). He first heard about the Aqua-Sonic offering in the summer of 1978 from his brother, who suggested that the Aqua-Sonic license would be a good means to make money and obtain a tax shelter (A256-259).

Donald Zimmerman purchased an Aqua-Sonic license for a territory located in midwestern California, about an 1 1/2 hour drive from his home (A278). In making his decision to invest in the offering, the availability of the sales agency was a significant factor (A265-266). While Mr. Zimmerman acknowledged

his awareness of his responsibilities under the sales agency agreement, he testified that he retained the sales agent because he did not feel that he was "adequate" for those responsibilities (A260).

After several projected starting dates for Steri Products sales had passed, Donald Zimmerman initiated inquiries concerning the status of the planned Steri Products distribution in his territory (E23, 25). Other than the form letters sent to all investors, Mr. Zimmerman received no direct response to his letters (A267-268). His final attempt to determine the status of the Steri Products was a letter mailed in January 1981 (E21); his letter, addressed to Aqua-Sonic's previous address, was returned marked "not deliverable as addressed unable to forward" (E522).

b. William Freschi

William Freschi is a resident of Kentfield, California, and is president of a subsidiary of the Chase Manhattan Bank, TCMS, a computer firm which he had formed and subsequently sold to Chase Manhattan (A333-334, 346). Mr. Freschi was introduced to the Aqua-Sonic offering by Steven Chios, a salesman of investment opportunities who had been recruited by Mr. Hecht (SA35; A336). Mr. Freschi purchased the Aqua-Sonic license in order to obtain immediate tax shelter and later financial returns (A335-338). 16/

Mr. Freschi selected a territory in Pennsylvania based on an article he had read in the Wall Street Journal which discussed the poor quality of water in that part of the country (A361). In selecting the Aqua-Sonic license and his territory, Mr. Freschi did not want to operate a business (A338).

16/ When asked whether he had read and understood certain disclaimers in the offering materials (A352-360), Mr. Freschi testified that he regarded some of them as a form of "standard caveat" (A354), and as to others, he testified that in his estimation, they were "contrary to the document and the information that was in the document" (A359).

Rather, he viewed the sales agency agreement as "essential" to marketing the product (A345).

He understood the relevant features of that agreement: that under that agreement he would have no direct marketing responsibility, and that, although the agreement was cancellable at his option, the full sales agent's fee of $16,600 was non-refundable and his obligation to pay the fee survived any cancellation of the contract (A342-344). Hence, he viewed the cancellation option as unrealistic, particularly because he "would be hard pressed to replace [the sales agent]" (A344). While he anticipated engaging in limited oversight of the sales agent, he recognized that he could not do anything to remedy a failure by the sales agent to perform its duties (A346-350).

Mr. Freschi had several communications with Mr. Hersch concerning what he later described as Mr. Hersch's "incredible inability to show any progress with the company" (A340-341; E43). Following notification to Mr. Freschi by the California tax authorities that they had disallowed his tax deductions for his investment in the Aqua-Sonic offering, Mr. Freschi demanded proof that the Aqua-Sonic offering was not a "scam" (E43). When he received no satisfactory reply, Mr. Freschi visited Mr. Hersch in New York City in September 1980 (A238-240; A340-341). Mr. Freschi was not mollified by that visit, or its results. Neither the office nor Mr. Hersch's demeanor indicated to Mr. Freschi that any of Mr. Hersch's efforts were being devoted to Aqua-Sonic (A340-341). Subsequent to that meeting, Mr. Hersch sent Mr. Freschi a hand-written note enclosing various documents which he said would describe the present status of the company; of all the documents sent to Mr. Freschi at the time in November 1980, none had been prepared after 1979 (A341; E42).

c. Donald Gaertner

Donald Gaertner is the vice-president for employee relations of Republic Corporation in Palos Verdes, California, a job to which he devoted 55-60 hours

per week (E46-47). He was introduced to the Aqua-Sonic license by George Petropoulos, an accountant who was recruited as a salesman by Mr. Hecht (E48-49; SA36), and whom Mr. Gaertner had previously told that he was looking for tax shelter and an income-producing investment (A363-364; E49).

Mr. Gaertner purchased part of an Aqua-Sonic license, and acquired a territory covering a portion of eastern Maryland. He signed the sales agency agreement, which he believed to be mandatory, since that agreement was offered as part of the package including the Aqua-Sonic license (A367-368; E50-55). He viewed a sales agent as essential (E56) and would have limited his own involvement to oversight of the agent (A369-370). Although the sales agency agreement was with Ultrasonic, Mr. Gaertner assumed that Aqua-Sonic was responsible for the sales force (A365-366).

In September 1980, Mr. Gaertner wrote a letter to Aqua-Sonic inquiring about the progress being made in preparation "to mass market or manufacture the product," the attempts being made "to organize a sales force," the company's "marketing plan" and "long range business strategy", as well as projections for a realistic return on his investment (E61). The letter was returned marked "moved, left no address" (E62).

d. Dorothy Baxa

Dorothy Baxa is a 70 year old widow and former school teacher, residing in Scottsdale, Arizona, who had total assets of about $300,000 to $400,000 (E87; E104-107; A308). Rex Zimmerman was her financial advisor and tax consultant (E88, SA14-15). She considered investing in the Aqua-Sonic license because she wanted an investment which would provide income as well as tax shelter (SA15). However, she did not want to run a business, and she testified that she would "never" have invested if she had had sales responsibilities (SA15, E89; E100).

Mr. Zimmerman introduced her to the Aqua-Sonic offering at his offices; after explaining the offering to her and without showing her the materials detailing the licensees' responsibilities under the sales agreement, he obtained her signature on a blank application (A280-284; E94-95). Mrs. Baxa's application, as received by Aqua-Sonic, showed that she had no experience in the marketing of dental products (E106). He later told her that her personal review of the documents was not important (A288) and, in fact, only gave her the offering materials after she had signed the final version of the closing documents (A284-288; Baxa Dep. 26-27).

Mrs. Baxa's territory was selected by Mr. Zimmerman; he chose a larger territory, Nassau County, New York, at a total cost of $276,500 including $30,571 in cash and recourse financing (E90-91; E104; E458). Mrs. Baxa understood that a sales agent would be responsible for sales in that territory, and that she would receive a percentage of profits (E92-93). Mr. Zimmerman told her she "could sit back and take the checks to the bank" (E94).

Later, Mrs. Baxa repeatedly sought information from Mr. Zimmerman about the stage of development of the Aqua-Sonic products (A289-291). At each inquiry, she was told that the products were "coming along" and would be on the market shortly (id.). On August 5, 1979, she called Mr. Hersch directly concerning the status of the products. Mr. Hersch told her that the products had been well received at dental trade shows, that the fluid in the Steri Products required FDA approval, and that he expected the products to be on the market by January 1, 1980 (E92-97; E103).

5. The fraudulent conduct

Appellants do not contest the trial court's findings of fraud. Nonetheless, in describing the fraud, they persist in their position below, inconsistent with the district court's findings, that the fraud consisted only

of the omission of information relating to the use of proceeds and the relationships of the promoters. They refuse to acknowledge (Br. 15) that the district court also found that the Aqua-Sonic offering was fraudulent because the promoters misrepresented the stage of development of the Steri Products, the industry need for the products and the tax benefits to be obtained from the investment. We summarize below the bases for the district court's findings of fraud.

a. Use of Proceeds

The total proceeds of the offering in cash and recourse financing were about $900,000 (A235). 17/ Of that sum about $797,500 was received by Aqua-Sonic (E439, Note 2). With respect to the proceeds received by Aqua-Sonic, the table set out in the margin, compiled from the record, lists Aqua-Sonic's expenditures, principally at Mr. Hecht's or SAH's direction (A64-66; A225-226; SA4-5). 18/ Only about $55,000, or 7 percent of the Aqua-Sonic's pro-

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17/ This total reflects the fact that about 15 persons -- promoters, insiders, and salesmen -- paid a "net-net" price for the Aqua-Sonic license -- typically $4500 in cash and recourse financing in comparison to a cost of $18,300 paid by outside investors for a standard territory (A98; E377-379; E458-459).

18/

Paid to	Amount Paid as of March 31, 1981
Dentasonic	$ 77,000
Inventel	200
SAH	78,000
Marks Shron & Co.	9,500
Arthur Kuris (consultation fees)	160,000
Sales Commissions	217,000
Development of Steri Products	55,000
Melvin Hersch (salary expenses)	135,000
Miscellaneous Legal Fees & Expenses	30,000
Total	$761,700

(A160-161; A229-234; E128-164; E363-372; E377-379; E435-503). At the time of trial in June 1981, there remained a balance of $1,200 in the Aqua-Sonic bank accounts (A24); the $34,600 remainder of the proceeds collected by Aqua-Sonic in the offering was unaccounted for.

ceeds, was expended for development of the Steri Products (E128-164; E335-336 [Minimatic, LTS, Engler Engineering]), notwithstanding Aqua-Sonic's responsibility under the license agreement to manufacture and supply those products to the licensees. The bulk of the proceeds -- almost 90 percent of the total -- was spent to cover the expenses of the offering and was paid to the promoters and to corporate insiders. No disclosure of this commitment of the proceeds was made to investors in the promotional materials.

b. The role and financial interest of SAH

The law firm of Schekter, Aber and Hecht furnished the tax opinion letter and supplement thereto which were included in the offering materials disseminated to prospective investors. These opinions stated that SAH was counsel to defendant Aqua-Sonic, without disclosing the substantial financial interest and control relationship of the principals of the firm in the enterprise. In particular, the investors were never informed that SAH had formed or caused the formation of Aqua-Sonic and Ultrasonic, had appointed their officers, were, for a time, co-signators on their bank accounts, and had designed the entire venture so that a substantial portion of any profits received by Aqua-Sonic would flow directly to them through their interests in Dentasonic and Inventel.

c. The state of development of the Steri Products

The information memorandum described the Steri Products as "being readied for manufacture," and stated that "models of the units have been constructed and testing has been completed." The offering materials also included photographs of apparently complete and workable units (E424-425A). In addition, the offering materials contained a letter dated August 22, 1978 to Mr. Kuris from Dr. Henry Goldman on the letterhead of Boston University Medical Center (E177), which stated that Dr. Goldman was already successfully using an ultrasonic unit developed by Mr. Kuris.

No testing had ever been performed to determine if the units were capable of delivering water that is sterile or even water significantly less contaminated than ordinary tap water -- the very purpose of the product (A205, 216). Dr. Goldman's letter concerning his experience with such units was based upon his experience with a predecessor unit which was not itself capable of maintaining sterility, and which, unlike the purpose of the Steri-Products, required the addition of an antiseptic to the water supply in order to attain sterile fluids (A380, 393-394). Indeed, Dr. Goldman did not even receive a model of either of the Steri-Products units until August 1979, more than one year after dissemination of his letter (A381-386). The Steri Satellite Unit which Dr. Goldman received in 1979 broke immediately (id). The testing of the Steri Satellite later done by an engineering firm for Aqua-Sonic in late 1979 and 1980 demonstrated that substantial refinements of the design of the unit were required in order to keep the water sterile (A205-218).

The offering materials included a letter from an engineering firm (Logical Technical Service Corp. or "LTS") concerning the manufacture of the Steri Products. The letter confirmed, "after review of the samples submitted", an understanding between the firm and Aqua-Sonic that LTS "will produce, completely assemble and package" the Steri Products (E299). This letter deceived investors concerning the state of readiness for manufacture of the Steri Products. LTS never even received Mr. Kuris' prototypes of the Steri Products until late December 1978 -- several months after the date of the letter -- and, after examining them, concluded

that they could not be mass produced in that form (A200-201; E405-406). 19/ Tooling -- an expensive and time consuming process requiring substantial capital expenditure -- was necessary in order to produce versions of the units even approaching the wholesale cost assumptions quoted in the offering materials (A205-206). Yet, SAH specifically struck the reference to the need for tooling and the fact that there was no agreement as to wholesale costs from the LTS letter of understanding distributed to investors. 20/

d. The industry need for the Steri Products

The information memorandum stated that there was a "recognized need" in the dental products industry for the Steri Products because of a "definite causal relationship" between contaminated water employed in ultrasonic dental procedures and certain enumerated diseases. In fact, an article included in the offering materials from the Journal of Periodontology contradicts these statements in the information memorandum, stating that definite scientific proof of transmission of infectious diseases

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19/ Shortly after LTS received the prototypes, LTS informed Aqua-Sonic that the prototypes could not be mass produced and that considerable development was still required (A202-203). In March 1979 Aqua-Sonic directed LTS to produce 50 prototype satellite units (E405), an order which was filed in July 1979 (E26). But these units were neither sterile nor capable of being mass-produced (A204-205).

20/ Mr. Hecht had arranged for Mr. Kuris to agree with LTS for the development and manufacture of the two Steri Products units (A120-122; E300). An earlier version of this letter of agreement between LTS and Aqua-Sonic had referred to the fact that manufacture of the Steri Products would require tooling, which had not been done, and that price estimates for the finished units were still to be negotiated (E380A). SAH arranged for the deletion of these references (A60-61).

through such dental procedures "is still lacking." 21/ The lack of a scientific basis for the claims made in the information memorandum was independently supported by the testimony of Dr. Goldman, an acknowledged expert. 22/ Indeed, the lawyer at SAH who initially drafted the offering materials stated that he had relied in part for his statements on industry need on an article in the National Enquirer (A70-74; E381).

In addition, in the absence of scientific proof for the benefits of employing sterilized water in ultrasonic dental procedures, the use in the offering materials of Dr. Goldman's letter, which expressed his own preference for using sterilized water for "operation" procedures, is misleading. In fact, Mr. Hecht knew from demonstrations in June 1978 of the Steri Products, which he had conducted to solicit salesmen, that there was substantial doubt within the dental community about the sterilization concept (SA53-57). This resistance was not disclosed to investors.

e. The tax benefits

The key feature of this tax shelter enterprise was the use of non-recourse notes to pay the bulk of the cost of the Aqua-Sonic license, the

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21/ The technically worded article, entitled "Microbial Contamination of Dental Units and Ultrasonic Scalers" (E407-411), discussed an investigation into the degree of microbial contamination present in various dental prophylaxis units. The authors concluded that there is an unusually high level of contamination in water hoses to which ultrasonic devices are attached, and attributed this contamination to contamination found in aerosols formed in the ultrasonic cleaning process. Significantly, however, the article contradicted the information memorandum, by stating that while there is a possibility of infection, "definite proof of transmission of infectious diseases by aerosols in dental operatories is still lacking * * *".

22/ Dr. Goldman, a professor of oral pathology at Boston University Dental School and its past dean (E165), testified that he was aware of no research which established any relationship between contamination of water in dental units and any of the diseases mentioned in the information memorandum (A395-397).

sales agent's fee, and the advertising contribution. The opinion of SAH was the linchpin for selling the tax benefits. SAH's tax opinions endorsed the legitimacy of the non-recourse notes under the tax laws. SAH stated that the face amount of those notes could be included in calculating allowable tax deductions (subject to the at risk provisions) for amortization of the license fee, for the advertising costs, and for the sales agency.

In addition, the initial SAH tax opinion represented that the Aqua-Sonic venture should be considered a profit-making trade or business, which would permit deduction of the advertising contributions and the sales agent's fee as ordinary and necessary business expenses as well as afford favorable tax treatment for the license fee.

The SAH tax opinions disclose that these conclusions concerning the nonrecourse notes and the "trade or business" issue were premised on the validity of the Marks Shron financial illustrations, as confirmed by the Wilson market evaluation. The tax opinions do not disclose, however, SAH's knowledge that the assumptions in those illustrations concerning sales potential of the product are misleading, if not simply false: first, it was assumed that sales were to begin on January 1, 1979, an assumption which SAH knew was false because of the primitive state of development of the Steri Products; second, the market penetration estimates -- particularly the annual 50 percent market penetration projected for the Steri Prophy Unit -- are obviously exaggerated because of the known resistance in the dental community to such a product.

The Marks Shron illustrations upon which the tax opinions are based state that they are unverified; the Wilson evaluation which purported to verify

the assumptions in the illustrations was later repudiated by its author (see note 10 supra). Thus, the district court properly found that the Wilson "market report upon which the tax opinion was based * * * was sufficiently superficial with respect to market factors, prices and amortization to make the tax opinion on which it was based misleading." Likewise, he correctly determined that "the [Marks Shron] financial projections were * * * empty of objective support * * *" (A28).

ARGUMENT

THE DISTRICT COURT PROPERLY FOUND THAT THE APPELLANTS OFFERED AN INVESTMENT PACKAGE INVOLVING THE DEVELOPMENT AND MANUFACTURE, TOGETHER WITH THE MARKETING, OF THE STERI PRODUCTS, AND THAT THE INVESTORS IN THAT ENTERPRISE WERE DEPENDENT, PASSIVE AND INCAPABLE OF INVESTOR CONTROL.

The district court found that the offering by defendants involved the offer and sale of securities in the form of investment contracts. In doing so, the court applied the well recognized criteria for determining the existence an investment contract: (1) an investment of money; (2) in a common enterprise; (3) with a reasonable expectation of profits from the entrepreneurial or managerial efforts of others. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975). See Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 299 (1946).

On appeal (Br. 18), as at trial, the only dispute centers on the existence of the third element of this test. The district court based its conclusion that the offering was a security on all the relevant evidence -- including the promotional materials and evidence of matters which the court termed as including "the capitalization, stage of development of the Steri Products, tax consequence, and method of operation." Reviewing that evidence, the district court found, first, with respect to the scope of the enterprise, that while the Ultrasonic sales agency was "purportedly an optional feature of the Aqua-Sonic offering," in economic reality it was an inseparable part of a combined enterprise in which

> "Aqua-Sonic was responsible for the development of and production of the products and Aqua-Sonic, Ultrasonic and the Advertising Fund for the marketing and promotion of the products."

(A25). Second, with respect to the scope of investor control over this combined enterprise, the district court found that due to

> "the nature of the products being offered, the character of the sales agency and the nature of the industry

> to be served, the Aqua-Sonic licensees were dependent, passive and incapable of [even] latent investor control * * *."

A34. Consequently, the district court found that a reasonable investor's expectation of profits from the enterprise arose from the undeniably significant efforts of others.

Appellants contend that the existence of a "right to control" the enterprise by the licensees precludes the finding that the Aqua-Sonic offering involved an investment contract. Specifically, they argue that the federal securities laws do not apply to the Aqua-Sonic offering (1) because licensees were not legally compelled to utilize Ultrasonic as a sales agent, and appellants' carefully crafted promotional materials contained a self-serving disclaimer of recommending the sales agency agreement, and (2) because the sales agency agreement prescribed certain rights for the licensees. Appellants urge that a finding of an investment contract is precluded by the existence of such provisions.

Appellants' superficial and formalistic approach to the investment contract analysis ignores repeated admonitions by the Supreme Court to evaluate the economic reality of an offering. As the district court here recognized, it was required to determine what the objective expectations of a reasonable Aqua-Sonic licensee were, in the context of all the attractions to invest. The district court found, in light of tax and other considerations, that notwithstanding the purportedly optional nature of the sales agency, its truly compelling attractions constrained a reasonable investor to utilize it. The enterprise in which the licensees invested therefore consisted of the combination of development, manufacture and marketing of the Steri Products, and the bare legal "right to control" some aspects of the marketing activities conducted by the sales

agent was not dispositive where, as the district court found, the circumstances rendered it unreasonable, if not impossible, for investors to exercise control over the development, manufacture and significant marketing operations. While appellants challenge the district court's finding, both as to the scope of the enterprise and as to the investors' capability of exercising control over the enterprise, those findings are not clearly erroneous. 21/

A. The district court properly found that the Aqua-Sonic offering involved an integrated enterprise to develop, manufacture and market the Steri Products.

The determination of whether an offering involves a security must be based on the economic realities of the transaction. This was emphasized in Securities and Exchange Commission v. W.J. Howey, supra, which interpreted the statutory term "investment contract" used in the definition of security in Section 2(1) of the Securities Act. The Supreme Court in Howey considered whether the offering of small tracts of citrus trees, coupled with an optional service contract, was a security. The offering was made to persons residing in distant localities, who lacked the equipment and experience to cultivate, harvest and market the citrus fruit. All but fifteen percent of the purchasers had taken the service contract.

21/ Contrary to appellants' contention (Br. 2) that the question of whether there was an investment contract in this case goes to subject matter jurisdiction, appellants' arguments go to the merits of the cause of action. See Fogel v. Chestnutt, [Current] Fed. Sec. L. Rep. (CCH) ¶98,388 (2d Cir. 1981). Thus, the standard of review of the district court's factual findings remains the clearly erroneous standard. See Securities and Exchange Commission v. Commonwealth Chemical Securities, Inc., 574 F.2d 90, 97 (2d Cir. 1978).

In any event, even if the issue of whether the Aqua-Sonic offering involved an investment contract presented a question of jurisdiction, the standard of appellate review would be the same; factual findings relating to jurisdiction must be accepted unless they are clearly erroneous. Williamson v. Tucker, 645 F.2d 404, 413 (5th Cir.), cert. denied, 70 L. Ed.2d 212, 102 S. Ct. 396 (1981).

The lower courts treated the land contract and the service contract formalistically, considering each aspect separately.

The Supreme Court relied on a tenet it derived from state blue sky laws: "[f]orm was disregarded for substance and emphasis was placed uopn economic reality." Id. at 298. In concluding that the offering involved a security, the Court considered the "desire[s]" of the purchasers, and whether it was "economically feasible" for them individually to develop the citrus plots. The fact that some purchasers had declined the service contract did not affect the Court's decision. The Court stated that it is enough "that the respondents merely offer the essential ingredients of an investment contract." Id. at 301 (emphasis added).

In the intervening years, the Supreme Court has repeatedly reaffirmed that the guiding principle of its analysis in that case was to disregard form for substance and focus on the economic realities of the transaction. International Brotherhood of Teamsters v. Daniel, 439 U.S. 551, 558 (1979); United Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 848; Tcherepnin v. Knight, 389 U.S. 332, 336 (1967). Appellants here, in arguing that only the formalities of the transaction are relevant to whether the offering involved a security, are attempting to place an unacceptable limit upon the factors relevant to the determination of the existence of an investment contract.

In order to decide whether an offering involves an investment contract, the district court must consider the inducements to purchase. Securities and Exchange Commission v. W.J. Howey, supra, 328 U.S. at 299-300. Courts must search out what "the expectations of a 'reasonable investor'" were, in the context of all the attractions to invest. Piambino v. Bailey, 610 F.2d 1306, 1320 (5th Cir.), cert. denied, 449 U.S. 1011 (1980); Glen-Arden Commodities v. Costantino, 493 F.2d 1027, 1034-1035 (2d Cir. 1974). As

the Supreme Court stated in Securities and Exchange Commission v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-353 (1943), "The test * * * is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." 22/

The appellants dispute the district court's finding that the package they offered involved an enterprise which consisted of the development, promotion and marketing of the Steri Products. Rather appellants view the marketing feature offered through the Ultrasonic sales agency agreement as distinct from the Aqua-Sonic license since their promotional materials stated that employment of a sales agent was "optional" and that Aqua-Sonic made no recommendation concerning any sales agent (Br. 19, 24, 30). In their view, what was offered was simply a franchise and a separate service contract (Br. 24-25). This contention ignores economic reality, including the inducements held out to prospective investors. 23/

The inducements to retain Ultrasonic as sales agent presented in the Aqua-Sonic offering were compelling. The Ultrasonic offer was part of a single package of offering materials distributed in a folder labelled only "Aqua-Sonic Products Corp." No other sales agency was offered.

22/ This is an objective test, based on the expectations of a "reasonable" investor. Nonetheless, evidence of the subjective intent or motivations of the actual offerees or purchasers is relevant circumstantial evidence of the expectations of the hypothetical "reasonable" investor. Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 863 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). See 2 Wigmore, Evidence §461 (3d ed. 1940). Accordingly, appellants are mistaken in contending (Br. 35-36) that such evidence may not properly be considered.

23/ This contention also ignores the Supreme Court's admonition in Howey that it is the "offer of the essential ingredients of an investment contract" which controls. The purported optional nature of the sales agency agreement should not be accorded weight where

(footnote continued)

Indeed, some investors were told that they had no choice but to retain Ultrasonic. 24/

Further, as pointed out in the testimony of investor witnesses, the marketing responsibilities imposed on licensees under the Aqua-Sonic license were unattractive to persons engaged in full-time occupations, particularly persons who had no prior experience in marketing dental products. Ultrasonic's offer to sell the Steri Products in the far-flung territories to which the investors subscribed enabled them to delegate their marketing responsibilities. Moreover, the tax incentives available to persons who elected the Ultrasonic sales agency agreement made any other method of marketing impracticable. After a small initial capital outlay by the licensee, Ultrasonic

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23/ (continued)

investors were presented the opportunity to purchase an entire package containing the requisite touchstones of an investment contract. See Securities and Exchange Commission v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288, 1290-1291, 1293 (S.D.N.Y. 1975).

24/ See pages 26-27,31, supra. Appellants claim, in a footnote inserted by them in their quotation of the district court's findings, that they had no responsibility for such statements made to investors by their salesmen (Br. 13n**). The district court expressly found, however, that Mr. Hecht had "recruited a number of individuals as commissioned salesmen." A23. Appellants do not otherwise dispute as clearly erroneous, or not supported in the record, the district court's finding that the salesmen were in fact appellants' agents. In the absence of a determination that the district court's findings are "clearly erroneous," they must be accepted for purposes of review. Williamson v. Tucker, supra, 645 F.2d at 413; Securities and Exchange Commission v. Commonwealth Chemical, supra, 574 F.2d at 97.

Since the salesmen were the promoters' agents, see Restatement (Second) of Agency (1958) §§2(3), 3(2), 14 N comment a, 15, they had authority to make representations reasonably ancillary to the normal placement of an Aqua-Sonic license. Id. at §§ 35, 50. Where the agent exceeds his authority, the principal nonetheless is liable for misrepresentations made to third parties who had no knowledge that the representations were false. Id. at §§ 161, 161A(a)(iv), 162, 257(b), 259(1), 260(2). Even the presence of routine and formal disclaimers of liability, such as those contained in the information memorandum and license agreement (E508; E521; E528A-529), will not insulate the principal from equitable relief rescinding the transaction. Id. at 161, 161A, 162, 260 comment c. See also Sabo v. Delman, 3 N.Y.2d 155, 143 N.E.2d 906, 908-909 (1957); Angerosa v. White Co., 274 N.Y. 524, 11 N.E.2d 325 (1937). The same principle should apply in the present case where the Commission sought to enjoin future violations of the registration and antifraud provisions.

permitted the payment of the remainder of its fee with non-recourse financing. According to the SAH tax opinion, the entire amount of the sales agent's fee was deductible, even though a relatively small portion of the fee represented a cash outlay or firm obligation. In contrast, an investor undertaking the marketing responsibilities himself would lose these compelling tax advantages, except in the unlikely event that he could find a replacement who would accept a non-recourse note in payment. These tax advantages were stressed prominently throughout the promotional materials as well as by the Aqua-Sonic salesmen. Thus, the supposed optional nature of the Ultrasonic sales agency is illusory. 25/ Indeed, the fact that every investor, regardless of his circumstances, chose to invest in the entire package offered by Aqua-Sonic is strong evidence that the Steri Products marketing aspect was integrated into the proposed enterprise. 26/

25/ The district court considered it

> "significant, * * * in terms of relief and in terms of contemporaneous construction, to note that after the defendants received the Mandel [Baer, Marks] memo, indicating the possible applicability of the securities laws, the language casting responsibility on the licensee was further strengthened and reinforced while none of the operative features of the enterprise was altered."

A31 (emphasis added). Expedient disclaimers at one point in an otherwise well-integrated investment package should not serve to alter the reasonable expectations of investors who were induced to sign the sales agency agreement as part of the package. See Glen-Arden Commodities, Inc. v. Costantino, supra, 493 F.2d at 1034-1035.

26/ While appellants do not raise a question as to whether the offering satisfies the second, or "common enterprise," element of the investment contract test, it follows from the district court's conclusion as to the scope of the enterprise that this element is satisfied. A common enterprise existed here because, as the district court found, all investors could obtain returns only with both the successful development and manufacture of the Steri Products by Aqua-Sonic, and the successful marketing and promotion of the Steri Products by Aqua-Sonic, Ultrasonic and the advertising fund. This provided what courts

(footnote continued)

b. The district court properly found that the rights of the Aqua-Sonic licensees under the sales agency agreement did not alter their expectation of profits from the entrepreneurial and managerial efforts of the promoters.

The test for determining whether the investors' participation in the operation of an enterpise precludes a finding of an investment contract was set forth in Securities and Exchange Commission v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1239 (E.D.N.Y. 1976), aff'd memo, 556 F.2d 559 (2d Cir.), cert. denied, 434 U.S. 855 (1977) (emphasis added):

> "the existence of a security turns on an analysis of the nature and extent of the investors' participation in, and control over, the fate of their investments. While the exact degree of investor participation and control necessary to remove a promotional enterprise from the coverage of the securities laws cannot, because of the virtually limitless permutatons of such schemes, be stated in advance, 'the efforts by those other than the investor [should be] the undeniably significant ones . . . which affect the failure or success of the enterprise.'"

Quoting from Securities and Exchange Commission v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974), and Securities and Exchange Commission v. Glenn W. Turner Enterprises, 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973). 27/

26/ (footnote continued)

have characterized as the "common thread", the "inextricable" or "inescapable" link between the promoter's enterpreneurial or managerial skills and the investors' expectation of profits. Securities and Exchange Commission v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1240-1241 (E.D.N.Y. 1976), aff'd memo, 556 F.2d 559 (2d Cir.), cert. denied, 434 U.S. 855 (1977); See Piambino v. Bailey, supra, 610 F.2d at 1318; Securities and Exchange Commission v. Koscot Interplanetary, Inc., 497 F.2d 473, 479 (5th Cir. 1974); Continental Marketing Corporation v. Securities and Exchange Commission, 387 F.2d 466, 470 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968); Securities and Exchange Commission v. Brigadoon Scotch Distributors, Ltd., 388 F. Supp. 1288, 1291-1292 (S.D.N.Y. 1975).

27/ The Supreme Court has noted that courts of appeals have clarified the Howey formulation of the third element of the investment contract test

(footnote continued)

The district court concluded that the investors' expectations of profits in the form of tax shelter and sales revenue arose from the "'undeniably significant' efforts of others." Appellants challenge this finding because of the investors' right to discharge the sales agent on 90 days' notice and because of the other rights allocated to the Aqua-Sonic licensees under the terms of the sales agency agreement. But these rights affect only the marketing element of the enterprise and, as we have demonstrated in Part A, the enterprise consisted of development, manufacture and marketing of the Steri-Products. Based on the economic realities of this enterprise, including "the nature of the products being offered, the character of the sales agency and the nature of the industry to be served," the district court found that the investors were "dependent, passive and incapable of latent investor control." This finding is not clearly erroneous.

The investors were dependent upon the unique abilities of the promoters to develop the product. 28/ Because of the primitive state of the Steri Products, licensees had to rely on Mr. Kuris' unique abilities to refine the products and Aqua-Sonic's ability to manage the capital entrusted to it in order to produce a marketable product at competitive prices. Indeed, the very novelty of their product in the industry only heightened the investors' reliance upon the promoters of the Aqua-Sonic offering, since they were not in the position of

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27/ (continued)

(a requirement, as set forth in Howey, that profits be expected "solely" from the efforts of others), but has expressly declined either to adopt or reject the clarified formulation. United Housing v. Forman, supra, 421 U.S. at 852 n.16. However, the Supreme Court's characterization of the Howey test in United Housing v. Forman omits the word "solely" and refers simply to the "entrepreneurial or managerial efforts of others." Id. at 852.

28/ Appellants assert (Br. 20, 37-38) that the district court applied the "risk capital" theory enunciated in State v. Hawaii Market Center, Inc., 485

(footnote continued)

> "a traditional franchisee who can obtain needed raw materials elsewhere and who purchases for the most part only a name and a business style from the franchisor and is thus a relatively independent economic entity."

Securities and Exchange Commission v. Galaxy Foods, supra, 417 F. Supp. at 1241; accord Baurer v. The Planning Group, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶98,365 (D.C. Cir. 1981). 29/

Investors were dependent on the national advertising campaign to foster acceptance and use of the Steri Products. The structure of this promotional campaign, designed for its tax benefits, placed sole approval of the advertising program and materials in the hands of Aqua-Sonic (E635). Like the development and manufacturing of the Steri Products, this advertising arrangement removed national promotion from the reach of individual licensees.

The controls ostensibly retained by the licensees over the sales agent were illusory. The right to cancel the contract, approve the price of the products, review credit terms, and supervise the sales agent are insignificant,

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28/ (continued)

P.2d 105 (Haw. 1971) to this case because it considered the rudimentary stage of the Steri Products and the projected use of the proceeds of the offering to develop them. Appellants misapprehend the district court's comments on the "risk capital" theory. The district court expressly refused to "embrace" that test as a substitute for the Howey standards, but did state: "I am not reluctant to conclude that a risk capital approach is helpful * * *" (A35). Noting an observation by the district court in Oregon that "risk capital" is possibly a manner of approaching the criterion for "undeniably significant efforts of others," Stanley v. Commercial Courier Service, 411 F. Supp. 818, 823 (D. Ore. 1975), the district court here observed that the risk capital theory simply pointed up the investors' passivity in commercial terms.

29/ The meager extent of the investors' actual control over this phase of the enterprise can be seen from their frustrated efforts to obtain information concerning the status of the product. The telephone calls, letters, and even visits to the promoters by the investors did not produce any progress in the development of the products. (See pages 29-32, supra) On the contrary, in mid-1979 Aqua-Sonic abruptly cancelled the work in progress (A211-212, 216; Tr. 664).

given the structure of the enterprise. 30/ Although the licensees could cancel the agreement on 90 days' notice, cancellation would forfeit their entire investment in the sales agency. In addition, the amount of the sales agent's fee was non-refundable, obliging licensees to continue to pay off the non-recourse notes to Ultrasonic out of the proceeds of future sales while financing and shouldering the burden of marketing the products themselves. Thus, the cancellation option in the sales agency contract was plainly unrealistic. Under these circumstances it is spurious to consider whether the investors were individually capable of functioning as a sales agent. The economic reality dictated that they would not. 31/

30/ Appellants urge this Court to consider the testimony of Messrs. Suroff and Ehrlich, the two presidents of Ultrasonic, that they envisioned the operation of the sales agency to be principally national in scope, and that licensees themselves would be responsible for local promotion and sales of the Steri Products (Br. 16, 30-31). This testimony is directly contradicted by Ultrasonic's responsibilities under the sales agency agreement, in which it accepted appointment as sales agent "for the promotion, marketing, distribution and sale of Steri Products in the Territory" of the licensee (E617A). Moreover, Mr. Schekter, the partner at SAH responsible for the offering materials, viewed the sales agency function as "limited to working for his principal within his territory, not on national or regional levels" (Ex. 2300 p. 258). Mr. Schekter saw the advertising campaign arranged by Aqua-Sonic as independently responsible for national and regional promotion (id. at 258-259).

Moreover, even apart from the question of the reliability of any testimony regarding future intentions -- intentions contrary to the very terms of the sales agency agreement -- upon which appellants rely, there is no evidence that these witnesses participated in the sales process or otherwise communicated with any investor concerning the proposed operation of the sales agency prior to the termination of the offering (Tr. 271-273). Thus, the evidence on which appellants rely is irrelevant to the trial court's determinations either of the expectations of a reasonable investor, or of the actual control investors were able to exercise.

31/ Appellants repeatedly assert that the district court found the investors "fully capable" of performing their marketing responsibilities under the license agreement (Br. 19, 24, 25, 29, 34). This is a rather facile reading of what is, in reality, a quite neutral conclusion by the district court, which stated (A31):

(footnote continued)

The minimal rights allocated to the licensees by the terms of the sales agency agreement with respect to price and any credit terms are unimportant in contrast to those delegated to Ultrasonic. As the district court found, "the sales agency agreements authorize Ultrasonic to perform all significant marketing functions, including finding customers, taking orders, collecting proceeds, and paying expenses and taxes" (emphasis added). And further, the licensee's control over the price was not significant; as the district court observed (A23), under the sales agency contract Ultrasonic was free to reduce the sales price unilaterally so long as the reduction came from its 20 percent sales commission (E612 ¶6). Since Ultrasonic was still to be compensated through prepayments on the nonrecourse notes for any sales irrespective of its sales commission, this provision permitted Ultrasonic independently to influence the success of the marketing in any territory, by allowing it up to a 20 percent flexibility in its sales price.

31/ (continued)

> "[f]indings [could not] be made concerning the ability of the licensees to conduct their proposed business in the absence of actual experience * * *. In fact, no sales of the product occurred and no opinion evidence was offered that such sales could or could not have occurred in the contemplated manner * * *. [T]here was insufficient evidence upon which it could be found, as opposed to surmised, that the licensees were not capable of vigorously promoting the sale of Steri Products as they warranted to."

This refusal to find that licensees were incapable of performing the tasks associated with marketing alone, must be contrasted with the district court's finding (A34) that investors were "incapable of latent investor control" over the enterprise viewed as a whole. Since it is this latter enterprise -- consisting of development, manufacture and marketing -- which was offered to investors, the possibility that investors might have been capable of performing the marketing function if it had been offered alone is irrelevant.

Finally, appellants' insistence (Br. 19) that the licensees bore the "ultimate responsibility" for the success of their licenses is further negated since the very structure of the professional dental products industry forced merchandisers of such products to rely upon the efforts of the dental depots to retail the product to dental professionals.

In addition to a dependence on the promoters for profits from prospective sales, the investors were dependent on the promoters to obtain the expected tax shelter benefits. As the district court recognized, investors were entirely dependent upon the bona fide operation of the development, manufacturing and marketing phases of the enterprise to obtain the favorable tax treatment they sought (A35-36). The favorable tax treatment of their investment required the existence of an active, profit-oriented business venture in order to deduct the ordinary and necessary business costs of advertising and of employing a sales agent and to amortize the costs of the Aqua-Sonic license. 32/

32/ Under the Howey/Forman test, courts have concluded that an investment contract exists, where the inducement to purchase includes an expectation of profits from both tax benefits and other profits secured through the entrepreneurial or managerial efforts of others. Securities and Exchange Commission v. International Mining Exchange Inc., 515 F. Supp. 1062, 1069 (D. Colo. 1981) (leasehold interests in gold mining claims with tax benefits from operation of gold mine, together with profits from sale of options on gold to be mined, both of which could be obtained only from the managerial efforts of others); Stowell v. Ted S. Finkel Investment Services, Inc., 489 F. Supp. 1209, 1221 (S.D. Fla. 1980), affirmed, 641 F.2d 323 (5th Cir. 1981); (limited partnership interests in coal mining venture with tax benefits from financing arrangements and profits from operation of mine through managemental efforts of others); Bridgen v. Scott, 456 F. Supp. 1048, 1061 (S.D. Tex. 1978) (limited partnership interests in real estate venture with tax benefits and profits from future sale of property to be managed by promoters; court observed that ignoring the tax consequences of a real estate transaction when considering securities claim would be "trying this case blindfolded").

Of the opinions which hold to the contrary, Sunshine Kitchens v. Alanthus Corp., 403 F. Supp. 719 (S.D. Fla. 1975), was subsequently termed "incorrect" by its author in Stowell v. Ted S. Finkel Investment Services, supra, 489 F. Supp. at 1221. In Braniff Air Inc. v. LTV Corporation, 479 F. Supp. 1279 (N.D. Tex. 1979), the court found that participation in a tax pooling arrangement was not a security since tax benefits were the sole basis for the transaction. By contrast, investors here expected income in addition to the tax benefits.

c. The authorities relied on by appellants are inapposite.

Appellants rely on several decisions involving the sale of a franchise, apartment complexes or interests in real estate joint ventures. They contend that, under those decisions, a transaction is removed from the reach of the federal securities laws if the investor has the bare legal or contractual right to control some aspect of the enterprise. Contrary to appellants' contention, those cases do not view such formalities as dispositive but rather recognize that the economic reality of the transaction must control.

Appellants rely primarily on the Fifth Circuit's opinion in Williamson v. Tucker, supra. That case addressed whether the offer of interests in joint ventures owning undivided interests in real estate constituted the offer of an investment contract. Formal control over the venture was held by the joint venturers under the terms of the joint venture agreement, but the managerial functions had been delegated to the promoter. The court recognized that it was the economic reality of the venture which was to govern, 645 F.2d at 418, and proposed a test for the district court to apply on remand in determining whether the powers held under a general partnership or joint venture agreement were significant. The court stated (id. at 422-423, emphasis added):

> "[T]he mere fact that an investment takes the form of a general partnership or joint venture does not inevitably insulate it from the reach of the federal securities laws. All of these cases [referring to several opinions, including ones upon which appellants here rely] presume that the investor-partner is not in fact dependent on the promoter or manager for the effective exercise of his partnership powers. If, for example, the partner has irrevocably delegated his powers, or is incapable of exercising them, or is so dependent on the particular expertise of the promoter or manager that he has no reasonable alternative to reliance on that person, then his partnership powers may be inadequate to protect him from the dependence on others which is implicit in an investment contract."

Even assuming that the powers retained by the Aqua-Sonic licensees were analogous to the joint venturers' powers in Williamson, the court there expressly recognized three situations where the control rights would not be dispositive. Each of those situations is, in fact, present here. Every one of the Aqua-Sonic licensees "irrevocably delegated" his marketing powers by retaining Ultrasonic as sales agent, subject to a cancellation right which we have shown was illusory. Further, the district court expressly found investors "incapable" of even latent control of the enterprise as a whole. (See note 31, supra). And, with respect to the development and manufacturing phases of the enterprise, the investors were clearly "dependent on the particular expertise of the promoter or manager." Moreover, the Williamson opinion makes clear that the three situations it described were only "example[s]," and that the ultimate test is whether investors are "in fact dependent" on the promoter or manager -- a test which the district court expressly found to be satisfied here.

In Shultz v. Dain Corporation, 568 F.2d 612 (1978), and Fargo Partners v. Dain Corporation, 540 F.2d 912 (1976), the Eighth Circuit found that purchasers of apartment complexes, coupled with a management contract which had been required as a condition of financing, had not bought investment contracts. Those cases, unlike the present case, involved individual real estate transactions, negotiated at arms' length, where the purchaser had sufficient bargaining power to establish his own purchase terms.

Finally, in Mr. Steak, Inc. v. River City Steak, Inc., 460 F.2d 666 (1972), the Tenth Circuit affirmed a district court's determination that a restaurant franchise coupled with the option to accept a manager designated by the franchisor was not a security. The court noted the district court's findings that the fortune of the franchisee "stands or falls independently of [the franchisor's] * * * success or failure." Id. at 670. Here, by contrast, the success of

the licensee is dependent on the success of the promoters. Moreover, unlike the present case, in Mr. Steak, there was no economic impediment to the franchisee's election to manage its restaurant on its own.

CONCLUSION

For the foregoing reasons, the judgment of the district court should be affirmed.

Respectfully submitted,

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STATUTORY APPENDIX

Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1)

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

(1) 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.

* * *

Sections 5(a) & (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) & (c)

§ 77e. Prohibitions relating to interstate commerce and the mails

(a) Sale or delivery after sale of unregistered securities

Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

* * *

(c) Necessity of filing registration statement

It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a)

§ 77q. Fraudulent interstate transactions

(a) Use of interstate commerce for purpose of fraud or deceit

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

* * *

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(10)

§ 78c. Definitions and application

(a) Definitions

When used in this chapter, unless the context otherwise requires—

* * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

* * *

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b)

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Commission Rule 10b-5, 17 CFR 240.10b-5

§ 240.10b-5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.