7401-8130

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 73-2297

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

HAFFENDEN-RIMAR INTERNATIONAL, INC.,
RIMAR SCOTCH WHISKY TRADING CO.,
RIMAR CORPORATION, CARLOS J. RICKETSON,
RICHARD W. PARROTT, STANLEY G. PRICE,
FRANK T. HENSHAW,

Defendants-Appellants.

On Appeal from the United States District Court for the
Eastern District of Virginia, Alexandria Division

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

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BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

COUNTERSTATEMENT OF THE ISSUE PRESENTED

Did the district court properly enjoin defendants from offering and selling securities in the form of scotch whiskey investments in violation of the registration and antifraud provisions of the federal securities laws where the evidence before the district court showed that:

(1) defendants were advertising and selling an investment package consisting of a property interest in whiskey aging in Scotland together with services which purportedly would permit investors to resell the property interest in approximately four years at a profit equal to a return of 20 to 25% per annum;

(2) purchasers of whiskey interests lacked the physical ability and knowledge of the scotch industry to derive a return on the investment through their own efforts;

(3) investors were led to expect and, in fact, were dependent upon the managerial efforts of the defendants and others in selecting, transferring, insuring, maintaining and reselling the whiskey interests for realization of a return on the investment;

(4) the whiskey interests were the device through which investors financed the inventory of a British whiskey blender's business;

(5) purchasers of whiskey interests furnished capital for a business operation conducted by defendants and a British whiskey broker which provided financing for the aging process in the scotch whiskey industry generally; and

(6) defendants made material misstatements and failed to disclose material facts concerning the nature, profitability and marketability of the investments?

STATUTES INVOLVED

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

> "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing." 1/

PRELIMINARY STATEMENT

This is an appeal from a final judgment entered on September 10, 1973, by the United States District Court for the Eastern District of Virginia (App. 30-32), 2/ permanently enjoining the defendants--Haffenden-Rimar International, Inc. ("Haffenden-Rimar"), Rimar Scotch Whisky Trading Co. ("Trading Co.'), Rimar Corporation ("Rimar"), Carlos J. Ricketson, Richard W. Parrott, Stanley G. Price and Frank T. Henshaw--from further violations of the registration provisions of the Securities Act of 1933 ("Securities Act"), 3/ and of the antifraud provisions of the Securities Act and the Securities

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1/ Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), which defines the term "security" for purposes of that Act, is substantially identical in all relevant respects to the definition contained in Section 2(1) of the Securities Act. See Tcherepnin v. Knight, 389 U.S. 332, 335-336 (1967).

2/ "App. __" refers to pages of the "Joint Appendix" filed by defendants-appellants. "App. X __" refers to pages of the Exhibit volume to the appendix. References to the thirteen-volume record on appeal are cited as "Vol. __, p. __." References to defendants' opening brief are cited as "Br. __."

3/ Sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. 77e(a) and (c).

Exchange Act of 1934 ("Securities Exchange Act"). 4/ The action was brought by the Securities and Exchange Commission pursuant to Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(e) of the Securities Exchange Act, 15 U.S.C. 78u(e). In its complaint, the Commission had alleged that the defendants were violating the registration provisions by offering and selling unregistered securities to the public through the offer and sale of investment contracts, and interests or instruments commonly known as securities, in the form of investments in scotch whiskey aging in bonded warehouses in Scotland (App. 4-5). 5/ The complaint also charged that in connection with the offer and sale of these securities the defendants were making "untrue statements of material facts and . . . [omitting] to

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4/ Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5.

5/ The complaint referred to these investment interests as "whiskey warehouse receipts" in that the sale of the investment was evidenced by a receipt issued to the purchaser by the whiskey warehouseman representing that an order to transfer title to specified casks of whiskey had been received and that title to the whiskey had been registered in the name of the purchaser on the warehouseman's records (App. 42-43). Defendants strongly contended in the court below (App. 18), as they do before this Court (Br. 5-10), that the instrument issued by the warehouseman is merely a "letter of acknowledgement" since it is neither negotiable nor a document of title with intrinsic value as are instruments which are considered warehouse receipts in the United States. The district court properly recognized, however, that it was "immaterial" "[w]hether the evidence of sale is labeled a warehouse receipt or letter of acknowledgement" since "[t]he Securities Act clearly reaches any novel, uncommon or irregular device . . . if it be proven as a matter of fact that it was widely offered or dealt in under terms or courses of dealing which established its character in commerce as an investment contract or as any interest or instrument commonly known as a security" (App. 25-26). Indeed, as discussed at page 13, <u>infra</u>, the existence of a security is not dependent upon whether or not an investment interest or scheme is represented by any document.

To avoid further semantic confusion, which serves only to obfuscate the basic issues presented in this appeal, we shall hereafter refer to what defendants are selling in terms of investments in scotch whiskey interests or scotch whiskey investments.

state material facts . . . " and were "engaging in . . . courses of business which operated . . . as a fraud and deceit upon purchasers and prospective purchasers" of those securities, in violation of the antifraud provisions of the federal securities laws (App. 5-9).

Although the defendants have strenuously argued (App. 18; Br. 3, 13, 15, 20) that they sell no more than identifiable casks of scotch whiskey, with respect to which purchasers have the sole power to hold, import for consumption, sell or otherwise deal as they see fit, the court below--after consideration of detailed stipulations, expert deposition testimony and extensive testimonial and documentary evidence adduced at the trial on the merits--found, in an opinion rendered on August 8, 1973, [6/] that the offer and sale of scotch whiskey by the defendants was made under circumstances where the investors' role "was limited to providing capital with the hope of favorable return" and where investors "relied solely on the advice of the defendants in selecting, buying, storing, trading and selling . . . Scotch . . ." (App. 28). Accordingly, the court concluded that defendants' offers and sales involved a "security" as defined in the Securities Act, and held that they were violating the registration provisions of the Securities Act (App. 25, 29).

The court below also found (App. 28-29) that the defendants "willfully and knowingly violated" the antifraud provisions of the federal securities laws, noting that various materially false and misleading statements had been made to investors concerning the safety of the investment and the expected

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6 / The district court's opinion is reported at 362 F. Supp. 323.

rate of annual return on the investment, and that the defendants had failed to disclose the market risks in scotch whiskey, the amount of commissions or mark-ups included in the purchase price, and the source or basis for market-price quotations employed in making projections of profits.[7]

7/ On September 21, 1973, at the defendants' request, the district court agreed to stay its injunctive order, upon the condition that defendants post a surety bond of sufficient size to guarantee the refund of all amounts invested during the pendency of the appeal, and upon condition that investors be advised in defendants' sales literature of the district court's decision and the pending appeal. Vol. VII, pp. 7, 12, 25. Thereafter, the defendants failed to comply with the requisite conditions and moved this Court for a stay pending appeal, which was denied on December 13, 1973.

COUNTERSTATEMENT OF THE CASE

Introduction

Through the individual defendants' managerial and marketing efforts, the defendant companies--Rimar and its successors, Trading Co. and Haffenden-Rimar--have been engaged since mid-1969 in the widespread promotion and sale of scotch whiskey investments to members of the public in this country. 8/ Employing an extensive advertising campaign in the press, direct mailings and carefully structured group and individual sales presentations, the defendants have induced investors to purchase out of the inventory of Haffenden (Whiskey Brokers) Limited ("Haffenden, Ltd.")--a British scotch whiskey blender and broker--a minimum quantity, for each investor, of 160 gallons of unmatured whiskey contained in casks lying in bonded warehouses in Scotland (App. 10, 22-24, 40-59 (¶¶ 18, 19, 37, 57, 58, 64, 65, 97, 99); App. X 24, 63-75). In their sales promotion, the defendants tout the investment interest in scotch whiskey as an opportunity for investors to reap a 100% return in four years with minimal risk (App. 22, 28-29, 50-51 (¶¶ 59-65); App. X 66, 70, 272, 289). By means of these and other exaggerated claims, the defendants' operations have steadily expanded into at least seven states

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8/ Rimar, a District of Columbia corporation, was formed by defendant Ricketson in May 1969, and has served as a corporate vehicle for various Ricketson business ventures, including the sale of scotch whiskey investments. Ricketson is Rimar's president and principal stockholder. In November 1971, defendant Parrott joined Rimar as Vice President, Marketing; at the same time, Trading Co., a partnership between Parrott and Ricketson, was organized as a division of Rimar and succeeded to Rimar's sales operations for scotch whiskey investments. In late 1972, Trading Co. was dissolved and succeeded by Haffenden-Rimar, a Delaware corporation, wholly-owned by Ricketson, Parrott and Ricketson's wife. Defendant Price has been a salesman for all three companies and holds the position of Washington Metropolitan Regional Sales Director for Haffenden-Rimar. Defendant Henshaw is Regional Sales Director for the Hampton-Norfolk area, having been a salesman for Trading Co. and Haffenden-Rimar since January 1972 (App. 37-47 (¶¶ 1, 3, 4, 5, 6, 7, 9, 12, 13, 16, 17, 48).

and the District of Columbia, with an increased force of over 200 salesmen of which 50 are "active" (App. 54 (¶74) App. X 99-104). As of January 1973, more than $1.5 million had been obtained in at least 745 sales of scotch whiskey interests (App. 54 (¶76)).

As the evidence adduced in the district court established, the purchase of scotch whiskey interests does not constitute merely the purchase of personal property from which profits would be derived through appreciation caused by time and market demand. Rather, the record clearly demonstrates that these investments in fact serve to finance certain British whiskey blenders and brokers, primarily Haffenden, Ltd., during the lengthy aging process required for the production of marketable scotch whiskey, under circumstances where an investor expects to derive a return on his investment through no efforts of his own. Indeed, the evidence shows that it is the defendants, together with Haffenden, Ltd. and others, that perform vital services upon which the success of the investment depends.

The Production of Scotch Whiskey

Scotch whiskey, under British law, is whiskey distilled in Scotland which has undergone an aging process in oak casks lying in bonded warehouses in Scotland for a minimum of three years (App. 41-43 (¶¶ 24, 32)). After completion of the aging process, the unblended whiskey may be immediately bottled and marketed by dealers for consumption or may first be blended with other scotch whiskeys before sale (App. 43 (¶ 31)). Importation of scotch whiskey into the United States is restricted by federal law to whiskey which has aged in casks for at least four years (App. 41-43 (¶¶ 24, 32)).

The initial distillation process involves the production of malt whiskey, which is distilled from a malted barley mash, or grain whiskey, which is distilled from a grain mash (App. 41 (¶¶ 25, 26)). Approximately 120 distillers located throughout Scotland produce malt whiskey which, according to expert testimony, is classified in the scotch whiskey trade on the basis of the character of its flavor as "top class," "first class," "second class" and "third class." A "top class" malt is generally regarded as having the best flavor, while a "third class" malt has relatively lesser character and is used as a "bulking" or "filler" malt in some blends of scotch whiskey. Although any number of distilleries may produce the same class of malt, each distillery is reputed to produce a malt of highly individualized characteristics, which may or may not be desirable for use by any particular company engaged in the blending process. For it is the blender's particular mixture of whiskeys having distinctive characteristics to form a blended scotch whiskey that determines its ultimate acceptability to customers and its successful sale (App. 41 (¶ 25); App. 119; App. X 153, 175, 201-202).

Unlike malt whiskey, which after the aging process may either be bottled straight from the casks for sale or blended with a combination of malts or of malts and grains, grain whiskey is used only for blending since it has little distinctive flavor, being almost a neutral spirit. Grain whiskey is produced by about fourteen Scottish distilleries and is used to make a "lighter" blend of scotch whiskey (App. 41 (¶ 26); App. 119).

Once the distillation process is completed, the "new fillings" (i.e., unaged whiskeys) produced by a distiller are placed in oak casks and immediately placed in a bonded warehouse for the aging process.[9/] The warehouse is usually owned by and located at the distillery (App. 42 (¶ 28)). But because of the substantial amount of capital required to finance the aging process and the risk that market demand for a whiskey produced by a particular distillery may substantially diminish during that process, which may last for 8, 12 or more years as dictated by consumer taste, distillers ordinarily produce to the order of blenders and do not undertake to hold the whiskey during the aging process. As soon as the new fillings are placed in casks and put in bond, blenders select and purchase from the distillers the casked whiskey they believe necessary for their future requirements, and generally finance these maturing stocks themselves (App. 43 (¶ 32); App. 119). Thus, only a very small fraction of all whiskey produced by distillers reaches individual investors, and blenders rarely purchase out of this privately-held "float" (App. 119; App. X 156-157, 242-244). If a blender finds that he does not have a particular whiskey in his matured stock that is needed for the production of a blended scotch whiskey, he utilizes the services of a whiskey broker to purchase it, principally from other blenders (App. 119; App. X 242-244).

During the aging process, charges are incurred for physical storage of the casked whiskey in the warehouse, for repair of damaged casks, and

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9/ The only effective aging of scotch whiskey takes place in casks since, unlike wine, whiskey does not change character in the bottle (App. 41 (¶ 27)).

for certain vital services which may be performed by the warehouseman (App. X 155). A warehouseman not only maintains records on which title to each cask is registered and transferred, but also is expected to check his stock regularly in order to find excessive leakage from damaged casks, which could entirely dissipate the whiskey if undetected (App. 155; App. 119).

Thus, in the selection of scotch whiskey in bond, it is necessary to be conversant both with the class and individual characteristics of whiskeys produced by scores of distillers and with the respective reputations of numerous whiskey warehousemen for integrity and conscientiousness. Moreover, expert knowledge is required concerning the quality of the wood comprising the casks since the use of inferior casking wood can render the whiskey contained therein valueless (App. 24; App. X 154-155).

The Investment Pitch

In their sales promotion, the defendants stress the investment aspects of and profit-making potential in the purchase of scotch whiskey interests. Advertisements placed by the defendants are geared to attracting persons who have invested in stocks by favorably comparing--particularly as to capital appreciation--an investment in scotch whiskey with investing in the stock market. A typical newspaper advertisement states (App. X 58), "Disgusted with the stock market? Invest in Scotch Whiskey," while another emphasizes (App. X 60-62) that "Capital gains have averaged 20% per annum for the past 20 years." Similar parallels with the stock market in terms of safety, liquidity and growth are made in group sales presentations. Thus, prospective purchasers are told that scotch whiskey interests are less volatile in price than stocks, providing even greater safety than the holding of blue chip securities; that an investment in scotch whiskey can be liquidated within five to seven days; and that the investment can be expected to appreciate in value at a rate of 20% to 25% per year (App. X 288-296). Sales literature and prepared sales scripts used by defendants' salesmen extoll the nature of the investment as one which finances the scotch whiskey industry during the aging period (App. 23, 42, 46 (¶ 43); App. X 68, 313).

The Investment Package Offered

When a prospective investor responds to an advertisement or other promotional device, a member of the defendants' sales force visits him. Using the prepared sales script, supplemented by various forms which are designed to project a profit of at least 20% per year for a single sample purchase of whiskey when held for four or more years and then sold (App. 23, 45 (¶ 40), 53-58 (¶¶ 72, 73, 92); App. X 11, 63-73, 75-78, 342), the investor is offered, at set prices that include an undisclosed commission of 30 to 65 percent, several combinations of casks of grain and malt whiskey. These combinations, involving a fixed ratio between grain and malt fillings, differ only with respect to the quantity of whiskey to be provided (App. 49 (¶58); App. X 24, 79, 81, 87, 90, 123, 278). Contrary to defendants' assertion that the whiskey sold is "identifiable" (Br. 5, 13, 15, 21), there is no specification as to the "class" of whiskey or the distillery name (App. X 24, 79, 81, 87, 90, 123, 273, 278). Rather, the prospective investor is simply told that the whiskey combinations being offered come from the "expertly selected" inventory of Haffenden, Ltd. and that the ratios between grain and malt have been fixed by Haffenden, Ltd. on the basis that they are considered the most marketable ratios for purpose of resale to whiskey dealers and blenders, including Haffenden, Ltd., which produces its own blends (App. 23, 49 (¶ 58); App. X 64). Indeed, it is expressly represented to investors that should they make a purchase of one of the whiskey combinations, Haffenden, Ltd. will select the "best available" qualities of grain and malt whiskies out of its "balanced inventory" (App. 49(¶58),56(¶84); App. X 64).

Prospective purchasers are also informed that all the complex matters involved in transferring the scotch whiskey interest to the investor will be arranged by the defendant companies, including the arranging of insurance that the defendants recommend to cover all risks of physical loss and excess ullage (leakage) to the casks and their contents. Lacking the knowledge and practical ability to seek out a British insurance broker, an investor almost always accepts the insurance provided by the defendants as part of the investment package, at an additional undisclosed commission of 1/4 percent (App. 52(¶71, 73), 55(¶83), 58(¶92);).

If an investor decides to purchase, he tenders at least 10 percent of the price as a deposit and executes a purchase order on which the salesman records the desired number of casks of grain and malt whiskey of a minimum age or older (App. 56(¶84)).[10/] The purchase order and deposit are

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10/ Depending on whether the casks contain grain or malt whiskey and upon the various grades of each, a cask may contain from 40 to 120 imperial gallons of whiskey (App. 119; App. X 7). The most prevalent whiskey combination sold costs $921 and consists of 320 gallons of whiskey in five casks (App. X 24, 91).

transmitted by the salesman to one of the defendant companies, which in turn places a covering order for the whiskey with Haffenden, Ltd. in London (App. 56(¶¶85-86)). The covering order, like the investor's purchase order, usually specifies only the number of casks of grain and malt whiskey of a given age or older (App. 56(¶87)).

Upon receipt of the order, Haffenden, Ltd. then determines which casks of whiskey in its inventory it will provide to fill the order, and arranges for insurance for the investor if requested. Although defendants represent to prospective investors that "top choice" malts are being offered, the casks actually selected by Haffenden Ltd. principally contain second and third class malts (App. X64,157-161). After this selection is made out of Haffenden, Ltd.'s inventory, "delivery orders" are executed by Haffenden, Ltd. The delivery orders, in substance, require the warehouseman to transfer title to specific numbered casks, containing whiskey of a named distiller of a certain age, from Haffenden, Ltd. to the investor (App. X 30, 32, 323, 325, 352). Acting as its own broker, Haffenden, Ltd. also prepares an invoice reflecting the gross price of the casked whiskey in pounds sterling (which includes an undisclosed brokerage commission charged by Haffenden, Ltd.), an invoice stating the gross price of insurance, and a statement of the total commission the defendant companies may retain out of the purchase price. These documents and the insurance certificate are mailed by Haffenden, Ltd. to the defendant companies.

The commission statement, received by the defendants from Haffenden, Ltd., reflecting the mark-up charged on the purchase, is not transmitted to the investor. Rather, the defendants prepare their own invoice showing only the gross price in dollars. This invoice along with the insurance certificate, delivery orders, and letters of instruction to the respective warehousemen (which are prepared by the defendants to accompany the delivery orders) are supplied to the salesman and presented by him to the investor.[11/] When the investor pays the balance of the invoiced purchase price, the salesman assists the investor in endorsing the delivery orders and in signing the letters of instruction which are transmitted directly to the warehouses involved (App. 56-58(¶¶88-93). Upon receiving a delivery order and covering letter of instruction the warehouseman transfers title to the casked whiskey on his records, issuing and mailing to the investor a receipt acknowledging that title to the casks has been transferred into the investor's name (App. 58 (¶94); App. X 33-35, 326-329).

11/ It is at this point that the investor first becomes apprised of the specific brand and age whiskey he has purchased.

In addition to the performance of services involving the selection, transfer and insuring of the scotch whiskey interests purchased by investors, the defendants and Haffenden, Ltd. provide other vital services with respect to the investment. Thus, the record reflects (App. 52 (¶69), App. 58 (¶95)), that the defendants furnish advice and information to investors through so-called "confidential market reports," the principal festures of which are market-price quotations for grain and malt whiskeys of various years' of distillation. The purpose of these monthly market reports and the price quotations which are supplied by Haffenden, Ltd. are to assist investors in deciding when to sell. Both the defendants and Haffenden, Ltd., as the district court found (App. 23, 24, 28), represent that they will undertake to assist investors in reselling their interests in scotch whiskey to a British whiskey broker or blender, or will repurchase the interests themselves (App. 23; App. X 287; Vol. IX, p. 221, XI pp. 39-40, 85). In this regard, the evidence establishes that the defendants will perform this service without charge, having stated to investors that the commission for resale has been included in the purchase price of the investment (App. 50 (¶70); App. X 270). Investors are told that Haffenden, Ltd. is the principal resale market for the scotch whiskey interests held by investors (App. 24; App. X 9).

That these services are essential for an investor to realize a return on his investment in scotch whiskey during the aging process is amply demonstrated. Separated from the casked whiskey by several thousand miles of ocean and possessing little or no knowledge of the scotch whiskey trade, the investor lacks both the physical ability and expertise required to undertake the managerial efforts involved in selecting, maintaining and reselling the bonded whiskey. There exists neither a publicly available source of information for current market prices of scotch whiskey nor a public trading market for scotch (App. X 9, 153-154, 156). Indeed, expert testimony reveals that even were an investor to travel to Great Britain and actually contact whiskey brokers to sell his holdings, the fact that brokers principally fill a blender's shortage by dealing with other blenders, makes it unlikely that the investor will succeed, particularly in view of the small quantity and inferior classes of whiskey he wishes to sell (App. 153-160). Thus, notwithstanding the defendants' assertion (Br. 20) that the success of the investment is dependent only upon the passage of "Father Time," the evidence adduced in the court below makes clear that profits cannot be realized by the investor without the efforts of the defendants and Haffenden, Ltd. in providing market-price information necessary to determine whether and when to sell and in providing the resale market itself. Moreover, the success of the investment is necessarily dependent as well upon the services performed by the warehouseman in assuring that the investment will not be lost through dissipation of the whiskey caused by excessive leakage of the casks under his care (App. X 154-157).

It is evident in fact that the financial obligation assumed by investors in purchasing scotch whiskey interests and in paying the annual warehousing charges serves as a means of financing the inventory of Haffenden, Ltd.'s whiskey blending business. The record shows that all whiskey sold to investors by the defendants is selected from Haffenden, Ltd.'s inventory (App. 49-50 (¶ 58), App. X 64) and that the defendants and Haffenden, Ltd. will not only assist investors in resale but will also undertake to repurchase the whiskey interests from investors (App. 23; App. X 287, Vol. IX, p. 221, XI, pp. 39-40, 85). That the repurchase of the whiskey by Haffenden, Ltd. is the actual objective is manifest by the fact thatHaffenden, Ltd. is represented to be the principal user of the scotch whiskey held by investors (App. 24; App. X 9). Indeed, Haffenden, Ltd. expressly states that its more than 2,000 investor-clients, which own 80 percent of the bonded scotch whiskey held by persons outside of Scotland, form an assured source for its blending needs that is under its control (App. X 106-107).

The Fraudulent Practices

In connection with the offer and sale of the investment interest in scotch whiskey here involved, the defendants have been perpetrating a fraud on public investors by issuing and disseminating materially false and misleading statements and by failing to disclose material facts concerning the investment, including its profitability, safety and marketability (App. 29). The defendants do not challenge the lower court's basic finding of fraud, and there exists substantial evidence in the record to support it.

At the heart of the fraud are the defendants' projections that an investment in scotch whiskey will secure a return of 20 to 25 percent per year. This representation is repeatedly emphasized by the defendants in projection forms, advertisements and other sales promotion materials, and is based on the defendants' claim that the annual rate of return in scotch whiskey has historically, over the past 20 years, averaged between 20 and 25 percent (App. 22-23, 45(¶42), 46(¶43), 50(¶60), 51(¶65); App. X 5, 8, 11, 45, 60-62, 70, 73, 75-76, 272, 277). The defendants' projections are totally false in that the claimed historical growth rate and thus the projections have no basis in fact (App. X 182-183). Moreover, the profits projected by the defendants are grossly overstated in that they do not take into account the substantial undisclosed sales commissions charged by the defendants, either as a deduction from principal or even as an expense (App. 42(¶68), 58(¶92). Rather, the sales commission remains in the purchase price which is used as the initial value of the investment upon which the projection is based. In fact, if the sales commissions are properly treated in connection with these projections, the resultant projected return would reveal that investors in scotch whiskey during recent years would at best break even on their investment (App. X 11, 342).

The defendants have also falsely stated that they are offering investors "top choice" malts. As previously indicated at page 14, supra, the whiskeys which are actually selected out of Haffenden, Ltd.'s inventory and sold to investors, are in almost every instance second and third class malt whiskeys. The failure of the defendants to disclose the true quality of whiskeys offered is compounded by the misleading market-price quotations provided by the defendants in confidential market reports (App. X 79-93, 105-109). The market prices quoted generally exceed the prices for "top choice" malts and best quality grain whiskey and bear no relationship to the actual market prices which prevail in the trade for the classes of whiskey sold by the defendants to investors (App. X 185-203, 208-210). These quotations are clearly designed to mislead investors into believing that the whiskey which they have purchased is of the highest quality and will command a high price on resale. No disclosure is made to investors concerning the source of these market quotations.

The defendants represented to investors that the existence of a short supply of and increased world-wide demand for scotch whiskey provided a "seller's" market" for the investment (App. X 70-73, 81-82, 88-89, 92, 93, 105). It was further stated that the whiskey combinations offered by the defendants comprise the best marketable ratios for resale to British blenders. These statements are highly misleading. There is a failure to disclose that market demand for whiskey varies widely depending upon the particular whiskey involved and accordingly, the investment may be speculative. Moreover, it is not the practice of blenders to purchase the whiskey requirements in small parcels containing a ratio of second or third class malt and grain whiskey from investors or anyone else. The defendants, in fact, failed to disclose that it is exceedingly difficult, if not impossible, for an investor in the United States to dispose of his small holdings (by industry standards) of marginal quality grain and malt whiskey to British blenders or brokers at realistic market prices in the trade, much less the market prices quoted by the defendants and by Haffenden, Ltd. (App. X 156-157, 243).

ARGUMENT

THE DISTRICT COURT PROPERLY CONCLUDED THAT DEFENDANTS OFFERED AND SOLD SECURITIES IN VIOLATION OF THE REGISTRATION AND ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

The federal securities laws "enacted for the purpose of avoiding frauds" must be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (Investment Advisers Act); accord, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (Securities Exchange Act); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (Securities Exchange Act).

In interpreting the definition of "security" in Section 2(1) of the Securities Act, the Supreme Court stated in Securities and Exchange Commission v. C.M. Joiner, 320 U.S. 344, 350-351 (1943):

> "[C]ourts will construe the details of an act in conformity with its dominating general purpose, will read text in light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy."

The legislative purpose stated in the preamble to the Securities Act--"to provide full and fair disclosure of the character of securities sold in interstate commerce and through the mails, and to prevent fraud in the sale thereof. . . ."[12/] --was made effective by defining "security" in Section 2 of the Act

> "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world

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12/ 48 Stat. 74 (1933).

fall within the ordinary concept of a security."

H.R. Rep. No. 85, 73rd Cong., 1st Sess., 11 (1933).13/

Recognizing the broad scope of the statutory coverage, two other district courts, like the lower court in the present case, have recently held that scotch whiskey investments similar to those which were sold here are securities within the meaning of the federal securities laws. Both of those courts specifically rejected the contention, as did the court below, that the promoters were merely selling casks of whiskey. Securities and Exchange Commission v. M. A. Lundy Associates, 362 F. Supp. 226, 238 (D.R.I. 1973); Securities and Exchange Commission v. Glen-Arden Commodities, Inc., et al, No. 73-C-1264 (E.D.N.Y., January 17, 1974), slip opinion pp. 12-13, appeal pending, C.A. 2, No. 74-1069.

The court below properly concluded (App. 25-26) that, regardless of the terminology used by the promoter, if the commercial reality of the scheme is such as to establish the device as an "investment contract" or an interest "commonly known as a 'security'"--two of the terms included in the definition of a security in the Securities Act--then it is within the

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13/ The "ordinary concept" intended by Congress in the federal securities laws might surprise many laymen, even today. For example, the 1934 amendment to the definition section of the Securities Act, which changed the phrase "or in general any instrument commonly known as a 'security'" to "or, in general, any interest or instrument commonly known as a 'security'" (emphasis added), suggests the comprehensive scope of the intended coverage. The House managers of the amending legislation stated that the purpose of the amendment was "to apply the act to interests commonly known as 'securities' whether or not such interests are represented by any document or not." H.R. Rep. No. 1838, 73rd Cong., 2d Sess. 39 (1934). Compare Pub. L. No. 22, §2(1), 48 Stat. 74, with Pub. L. No. 291, §201(a), 48 Stat. 905. See also Roe v. United States, 287 F. 2d 435 (C.A. 5, 1961), and Securities and Exchange Commission v. Addison, 194 F. Supp. 709, 722 (N.D. Tex., 1961).

reach of that Act. The whiskey interests involved here were investments through which the public was induced (1) to provide financing for the inventory of Haffenden, Ltd.'s whiskey blending business and (2) to invest in a business operation which provided financing for the aging process in the scotch whiskey industry generally. We submit that these whiskey investments are interests "commonly known as a 'security'" as well as "investment contracts."

A. Defendants Have Offered and Sold Interests "commonly known as a 'security.'"

1. Purchasers of Defendants' Whiskey Interests Provided Financing for the Inventory of Haffenden, Ltd.'s Whiskey Blending Business.

The Supreme Court has repeatedly admonished that "form should be disregarded for substance and the emphasis should be on economic reality." Tcherepnin v. Knight, supra, 389 U.S. at 336; Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293, 298 (1946). In referring to the test for determining the existence of a security, the Court, in Securities and Exchange Commission v. Joiner Corp., supra, 320 U.S., at 352-353, stressed the economics of the investment scheme, stating:

> "The test rather 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."

The Court also stated in Joiner that "[i]n the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be." 320 U.S. at 353.

Of significance here, in light of the principles enunciated in Joiner, is defendants' consistent representation to the public that they are offering an "investment." Although defendants contend that they are selling no more than identifiable casks of whiskey (Br. 13, 15, 21), the economic reality of the situation is that such is the least of what they are selling. The nature of the investment offered and sold by the defendants substantially negates any serious claim that members of the public were merely buying a piece of tangible personal property "for investment" the way one ordinarily buys paintings or rare stamps. Defendants offer investors casks of whiskey in combinations of grain and malt not differentiated except as to quantity and minimum age. Prospective purchasers are told they will have the "best available" malts and grain selected for them by defendants' supplier, Haffenden, Ltd., out of its "balanced inventory" (see pp. 13-14, supra). Investors buy essentially blindly out of Haffenden, Ltd.'s stock. The owner of Haffenden, Ltd., they are assured, will not select a brand for them that he would not use himself (App. X 64). Reliance by the investor on Haffenden, Ltd.'s skill in selecting a marketable ratio of grain and malt in each combination sold, and in selection of the distillery brands to fill the order, is required because of the investor's lack of knowledge about the scotch whiskey trade. Unknown to the investor, his investment is additionally at the hazard of Haffenden, Ltd.'s expert knowledge of the reputation of the warehouses in which the casks are stored and the quality of the wood used in each individual cask (see p. 11, supra). Finally, the defendants offer to obtain insurance for the investor on the purchased whiskey (see p. 13, supra).

Having acquired his whiskey investment, the investor is constrained by British law, by the vast quantities of liquid involved, and by the very nature of the investment, not to reduce his individual casks of whiskey to his personal possession. Until well into the Commission's investigation, the defendants realistically advised investors that importation into the United States for consumption was impractical (App. 23, 27-28). It is clear, the protestations of the defendants notwithstanding, that the purchaser of 40- to 120-gallon casks of scotch whiskey lying in bond in Scotland has neither the intent nor the desire to reduce them to his personal possession and use. Importation into this country, even if financially possible, as the defendants claim, is simply not what these transactions are all about; one does not realize a 100 percent return on his investment in four years by drinking it.

Rather, this investment scheme contemplates that the holdings will be resold for blending in Britain. In fact, as the defendants state in their own sales literature, the commercial function of the public investor is to finance the scotch whiskey trade. The sales literature explains, "SCOTCH WHISKEY has become available to investors outside the United Kingdom" because of "the enormous financing required to hold stocks of maturing WHISKEY over periods extending for years and because of credit restrictions imposed in the United Kingdom" (App. X 41).

As an additional service, the defendants supply investors with so-called "Confidential Market Reports" intended to aid the investors in decidng when to sell their holdings (see p. 16, supra). There is no publicly available source of independent market information and investors must rely upon the defendants in this regard (see p. 17, supra). Furthermore the "market" available to investors would seem to be completely within the control of the defendants and Haffenden, Ltd. The investor cannot, because of the unmarketably-small size of his holdings and the marginal quality of the whiskeys he has been sold, realistically expect to be able to induce other brokers to assist him when he decides to resell. Thus, if he is to obtain his promised profits he must deal with the defendants and Haffenden, Ltd. And, although the investor is given assurances that the defendants and Haffenden, Ltd. will either arrange for resale of his whiskey to other persons or repurchase it themselves, it can be expected that Haffenden, Ltd. will repurchase most, if not all, of the investors' whiskey for use in Haffenden, Ltd.'s own blending operations. As is made clear in the sales literature (p. 18, supra), Haffenden, Ltd.'s own inventory, comprising a claimed 80 percent of the scotch whiskey owned by persons outside of Scotland, is being made available to investor-"clients," so that Haffenden, Ltd.'s supplies for its blending business will be assured. Thus, the design and function of the defendants' investment program is to provide a source of financing for the inventory needed in Haffenden, Ltd.'s scotch whiskey blending operations.

Although the whiskey investments offered by the defendants take the form of interests in personal property, it is clear from a long line of federal and state court decisions that this feature in no way precludes a finding that the overall investment relationship constitutes a security. The existence of a property interest, even a recognized interest in real property, has not precluded the finding of a security by the Supreme Court in the case of leases to oil land (Joiner, supra, 320 U.S. at 352) or fee simple estates in strips of an orange grove (Howey, supra). Similarly, beavers (Continental Marketing Corp. v. Securities and Exchange Commission, 387 F. 2d 466 (C.A. 10, 1967), certiorari denied, 391 U.S. 905 (1968)), or chinchillas (Hollywood State Bank v. Wilde, 160 P. 2d 846 (Cal. App. 1945)) and silver foxes (Securities and Exchange Commission v. Payne, 35 F. Supp. 873 (S.D. N.Y., 1940))--even barrels of crude oil (Securities and Exchange Commission v. Crude Oil Corp., 93 F. 2d 844 (C.A. 7, 1937)) and casks of bourbon whiskey (State v. Unger, 296 N.W. 629 (Wisc., 1941))--have been found by other courts to be the device used to offer and sell investments properly regulated as securities.

Several factors which were viewed by the courts, in the cases where investments took the form of property interests, as elements tending toward the existence of a security are also present in the instant case. Thus, the property cases involved the investor's unfamiliarity with the business in which he invested. See Howey, supra; Blackwell v. Bentsen, 203 F. 2d 690 (C.A. 5, 1953) (another orange grove scheme); Joiner, supra; Continental Marketing Corp. v. Securities and Exchange Commission, supra; Securities and Exchange Commission v. Payne, supra. Unfamiliarity by the investor in the present case with the scotch whiskey market and with the types of scotch is a major element here. Another thread in the cases is the inability of an investor, by virture of the distances involved, to exercise genuine dominion over the property purchased. Joiner, supra; Blackwell v. Bentsen, supra; Holloway v. Thompson, 42 N.E. 2d 421 (Ind. App., 1942) (interests in cemetery lots). The distances in the instant case are even more burdensome. Finally, gross over-pricing of the property sold may indicate, as in Joiner, ". . . that an economic interest in [the] . . . undertaking was what . . . gave to the instruments most of their value." 320 U.S. at 349. It has been suggested that premiums, paid by investors over the actual market price for the property interest, represent the discounted value of the ultimate success of the enterprise involved. Coffey, "The Economic Realities of a 'Security': Is There a More Meaningful Formula?," 18 W. Res. L. Rev. 367, 391 (1967). The phenomenon of premiums representing future investment value is often encountered in the cases. Joiner, supra; Los Angeles Trust Deed and Mortgage Exchange v. Securities and Exchange Commission, 285 F. 2d 162 (C.A 9, 1960), certiorari denied, 336 U.S. 919 (1961); Securities and Exchange Commission v. Crude Oil Corp., supra; see also the pyramid sales cases, State v. Hawaii Marketing Center, 485 P. 2d 105 (Haw., 1971); Securities and Exchange Commission v. Glenn W. Turner Enterprises, 474 F. 2d 476 (C A. 9, 1973), affirming, 348 F. Supp. 766 (D. Ore., 1972), certiorari denied, ___ U.S. ___, 94 S. Ct. 117 (October 9, 1973), where the "price" paid for the goods sold, also purchased for the investor the right to participate in the profits derived from bringing other investors into the scheme. In the present case the exorbitant commissions of 30 to 65 percent reflect the fact that investors were paying not merely for the scotch whiskey but also for services offered by the defendants.

Thus in no realistic sense can it be said that members of the public in this country were simply deciding to go out and buy identifiable pieces of property which they would shrewdly transform into a substantial profit. Investors were instead paying their money to the defendants to obtain an investment in the operation of an unfamiliar business in a distant country, which they could not themselves monitor; and the price which they paid for this investment clearly indicates that they were buying something more than mere barrels of alcoholic beverage.

As already noted, the investors in defendants' scotch whiskey interests were providing inventory financing for Haffenden, Ltd.'s whiskey blending business. The Commission submits that an investment, such as that involved here, to finance inventory by the sale of units of that inventory to investors, under circumstances where it is contemplated that the investors will later sell it back to the promoters at a profit, involves an interest "commonly known as a 'security'" within the meaning of the Securities Act.

Many instruments traditionally used to finance inventory or equipment are specifically covered by the Securities Act. Thus, secured debt obligations of a business are within the terms of the definition of security in Section 2(1); "bond," "debenture" and "note" are expressly mentioned. Section 2(4) of the Act also includes equipment trust certificates within the coverage of the Act by specifying who shall be deemed the "issuer" of such certificates.

Several court decisions finding nominal sales of property to constitute securities have involved devices to finance the inventory of an enterprise. In view of the so-called "whiskey warehouse receipt" cases, this technique appears to have been prevalent in the American bourbon industry after the repeal of prohibition.[14] Thus, in Penfield Co. v. Securities and Exchange Commission, 143 F. 2d 746 (C.A. 9), certiorari denied, 323 U.S. 768 (1944), the court found an investment contract to exist where a company sold warehouse receipts for casks of bourbon whiskey and induced purchasers to exchange the warehouse receipts for contracts to bottle and market the whiskey after it was aged. See also, Securities and Exchange Commission v. Bourbon Sales Corp., 47 F Supp. 70 (W.D. Ky., 1942), involving a company related to Penfield. Similarly, in State v. Unger, supra, sales of warehouse receipts for bourbon whiskey coupled with a guarantee by the seller to trade, at the buyer's option, an equal amount of "green" whiskey plus cash for the original holding, were held to be sales of "beneficial interests," "investment contracts" and "interests in a profit venture" within the meaning of the Wisconsin securities statute.[15]

14/ See 1 Loss, Securities Regulation 502 (1961) for a description of the sudden blossoming of investment schemes involving bourbon after the passage of the 21st Amendment to the Constitution.

15/ Representations made by the defendant Unger to investors bear a remarkable similarity to some made in this case; thus, profits were represented as arising "from steady demand plus scarcity of aged whiskey." 296 N.W. at 630.

In view of the defendants' concern (Br. 5-10) that this Court not misapprehend their claimed distinction between the instant case and the "whiskey warehouse receipt" cases, we note that two of the courts which found that the warehouse receipts were securities, when evidently used for inventory financing, concluded, in other cases not involving such financing, that "naked" whiskey warehouse receipts were not securities: Unger v. State, 284 N.W. 18 (Wisc., 1939), decided two years prior to State v. Unger, 296 N.W.629 (Wisc., 1941), supra, quashed an information alleging no more than the sale of whisky warehouse receipts; Brown v. Cummins Distilleries, 53 F. Supp. 659 (W.D. Ky., 1944), decided by Judge Miller who had two years previously found a security to exist in the sale of bourbon warehouse receipts and bottling contracts in Securities and Exchange Commission v. Bourbon Sales Corp., supra, held that a distribution in kind of a dissolving corporation's assets in the form of warehouse receipts for bourbon did not involve the sale of a security.

It should also be noted that the blue sky laws of many states specifically include "whiskey warehouse receipts" in their definition of securities. See, Florida, Statutes §517.02 (1971); North Carolina, General Statutes § 78-2(9) (1971); Ohio, Rev. Code §1707.01(B) (1972) ("warehouse receipts for intoxicating liquor.") Whiskey warehouse receipts would also be included within the definition of "securities" in Louisiana and New Hampshire which cover all warehouse receipts: La. Rev. Stat. §51.701(1) (1969); N. H. Rev. Stat. §421-2 (1971). These provisions are an apparent recognition of the practice within parts of the industry, evident from cases cited above, of selling the warehouse receipts as an investment to the public in order to finance inventory.

A financing arrangement remarkably similar to the instant case was present in two cases involving cemetery lots. Holloway v. Thompson, 42 N.E. 2d 421 (Ind. App., 1942), is particularly apt. In that case the sale of cemetery lots to finance the development of a cemetery was held to involve the sale of an "interest or instrument commonly known as a security" under the Indiana securities laws. The plaintiffs, husband and wife, had purchased a deed to 4-1/2 burial lots [16/] with the promise that the company would repurchase the lots at 6 percent interest within one year. The court stated that the concept of an "interest or instrument commonly known as a security" was broad enough "to include any form of instrument used for the purpose of financing and promoting enterprises and which is designed for investment," and found further that from the company's point of view, the

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16/ The 4-1/2 lots were adequate for about 31 graves.

scheme involved sales of "units," for financing and promotion, which were designed to afford an opportunity for speculation and investment. 42 N.E. 2d at 425. Almost identical statements also appear in the other cemetery lot case, In Re Waldstein, 291 N.Y.S. 697, 700-701 (1936), which involved the sale of "burial lots, to be held by investors until they are absorbed in the normal course of events." 291 N.Y.S. at 700. Significantly, both Holloway and Waldstein were cited with approval by the Supreme Court in Joiner, where the Court stated, with reference to these cases, that when cemetery lots "become the subjects of speculation in connection with the cemetery enterprise, courts have held conveyances of these lots to be securities." 320 U.S. at 352, n. 10.

It is evident that the defendants in the present case are, in the classic manner of the bourbon whiskey and the cemetery lot promoters, selling interests "for the purpose of financing and promoting enterprises, and which [are] designed for investment." In Re Waldstein, supra, 291 N.Y.S. at 701.

Ordinarily an inventory financing arrangement in the form of a loan secured by real or personal property includes the promise of a specific rate of return in the form of interest, and certain of the cases in which a security involved the sale of property have included promises of a guaranteed return. Thus, the cemetery lots in Holloway v. Thompson were to be repurchased by the promoters at 6 percent interest. State v. Unger (bourbon whiskey) involved the option of the purchaser to "turn over" his investment by accepting "green" whiskey plus a fixed amount of cash in exchange for his present holdings every six months. The defendants (Br. 22) presumably would seek to distinguish these cases by contending that in the present case there is no guarantee by the defendants or by Haffenden, Ltd. to repurchase the investor's scotch whiskey holdings. But, as pointed out earlier (see pp. 16-17, supra), the circumstances are such that, as a practical matter, the investor is dependent upon the defendants and Haffenden, Ltd. to be able to dispose of his investment profitably. The supposed "irrevocable" nature of the scotch whiskey interest sold to the investor (Br. 22) is particularly irrelevant when one considers the fact that a holding of about 320 gallons of liquid (see p. 13, supra) is too much to consume by oneself and ordinarily too little to interest a blender who deals in thousands of gallons. The investor's "irrevocable" interest is worthless, in the absence of a public trading market (see p. 17, supra), without the market provided by the defendants and Haffenden, Ltd. (see pp. 17-18, supra). Furthermore, the investor is given assurances that the defendants and Haffenden, Ltd., if unable to find a purchaser for the investor's whiskey, will repurchase it themselves; indeed, the very purpose of the investment scheme involved in this case is to provide financing for the whiskey inventory needed in Haffenden, Ltd.'s blending business (see p. 18, supra). Thus, the whiskey interests sold by the defendants are financing arrangements in which it is contemplated that the whiskey will ultimately be resold by the investor to Haffenden, Ltd. at a profit. The profitability and success of these investments are therefore dependent on the profitability and success of the whiskey blending business conducted by Haffenden, Ltd. In terms of economic reality, the investors who purchase these whiskey investments have much the same relationship to Haffenden, Ltd. as would persons who provided inventory financing to Haffenden, Ltd. in return for debt securities containing Haffenden, Ltd.'s promise to pay principal and interest and accordingly both types of investors are in need of the protections accorded by the federal securities laws. The whiskey investments here involved--in serving as devices to provide inventory financing--are interests "commonly known as a 'security,'" for, even if these devices are viewed as being somewhat novel in form, the Supreme Court emphasized in Joiner, 320 U.S. at 351:

> "[T]he reach of the [Securities] Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'" 17/

17/ The defendants (Br. 22) cite the district court opinion in Securities and Exchange Commission v. Koscot Interplanetary, Inc., 365 F. Supp. 588, 593 (N.D. Ga. 1973), appeal pending, (C.A. 5, No. 73-2339, for the proposition that an investment must have a national reputation as a security to be "commonly known as a 'security'" within the meaning of the Securities Act. We submit that, as devices to provide inventory financing, defendants' whiskey interests satisfy the Koscot test.

2. <u>Purchasers of Defendants' Whiskey Interests Invested in a Business Operation Which Provided Financing for the Aging Process in the Scotch Whiskey Industry Generally</u>

As we have shown in the preceding subsection, the whiskey interests here involved constitute an interest "commonly known as a security" for the reason that they are the device through which an investor finances the inventory of Haffenden, Ltd.'s whiskey blending business. But even apart from that fact, and even to the extent that some of the investors' whiskey may be sold to other blenders, the purchase of whiskey interests under the circumstances presented in this case gives rise to a relationship between the purchasers and the defendants and Haffenden, Ltd. which necessarily involves the existence of an interest commonly known as a security.

The common thread running through the decisions of the Supreme Court and of the lower courts which have dealt with the definition of term "security," is the recognition that the essential relationship underlying the presence of a security is one where the investor provides capital to an enterprise managed or controlled by others with the expectation of a favorable return through no managerial efforts of his own. Thus, the Court in <u>Joiner</u> specifically stated that the "defendants' efforts . . . were within the term 'any interest or instrument commonly known as a security,'" 320 U.S. at 351, where the cost of drilling a test oil well was financed by sale of leaseholds on adjacent acreage to members of the investing public who had no control over the well-drilling enterprise. 320 U.S. at 346. In <u>Howey</u>, <u>supra</u>, 328 U.S. at 300, the Supreme Court similarly noted: "The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise." Securities and Exchange Commission v. Variable Annuity Life Insurance Co., 359 U.S. 65, 71 (1959) involved an annuity that "place[d] all the investment risks on the annuitant, none on the [insurance] company" which managed all of the annuitants' investments and determined investment policy. The "Flexible Fund" program involved in Securities and Exchange Commission v. United Benefit Life Insurance Co., 387 U.S. 202, 211 (1967), was "pitched to the same consumer interest in growth through professionally managed investment" as mutual funds. And in Tcherepnin v. Knight, supra, the petitioners were found to have participated in "a money-lending operation dependent for its success upon the skill and efforts of the management of . . . [a Savings and Loan Association] in making sound loans." The Court explicitly rejected "the Court of Appeals' analysis which led it to conclude that a withdrawable captial share [of a Savings and Loan Association] is not an 'instrument commonly known as a security.'" 389 U.S. at 243.[18/] The understanding that a security contemplates a relationship that limits the investor's role to providing capital with the hope of a favorable return in a business operation managed by others has been similarly perceived by numerous other courts.[19/]

18/ The Court in Tcherepnin also pointed out, contrary to the suggestions made by defendants here (Br. 5-10), that an interest or instrument need not be negotiable in order to be a security. 389 U.S. at 343-345.

19/ See, e.g., cases cited at pages 27, 28, 30-33, supra.

In the case at bar, purchasers of scotch whiskey investments supply the capital for a business operation conducted by Haffenden, Ltd. and the defendants which provides financing for the aging process involved in the production of scotch whiskey. In substance, the business operation undertakes to act in a real sense as a middleman between the distillation process and the blending process by taking up distillers' production and performing the necessary intermediate function of providing funds to maintain and store maturing stocks during the aging process that is required before blenders and bottlers may produce and market scotch whiskey. Possessing neither the physical ability nor knowledge to exercise control over the business operation, investor-purchasers expect to derive a favorable return from their outlay of capital to the business through the managerial efforts of Haffenden, Ltd. in selecting whiskeys from distillers, which by reason of their quality and quantity are suitable for financing for ultimate resale to a blender or bottler, and throughthe efforts of the defendants and Haffenden, Ltd. in ultimately reselling the financed stock to bottlers and blenders upon completion of the aging process.

B. Defendants Have Offered and Sold "investment contract[s]."

In challenging the district court's conclusion (App. 25) that defendants' scotch whiskey interests were investment contracts, defendants rely (Br. 11) upon the language of the Supreme Court in Howey that

> "an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." 328 U.S. at 298-299.

Defendants claim that the whiskey interests did not involve a "common enterprise" and that profits were not to come "solely from the efforts" of others. Both of these contentions are without merit.

1. With respect to their common enterprise argument, defendants assert (Br. 12-15, 18-19) that there was no "pooling" of the investors' interests or funds. But no such pooling is required. Thus, in Blackwell v. Bentsen, supra, which involved an orange grove scheme, investors had the right to give directions as to the management of their plots, and the expected profits of each investor were dependent on the yield of each individual plot; the investors' interests were not pooled. Defendants seem to contend that, even if the common enterprise provision does not require that the investors' interests be pooled, there must at least be some form of sharing or joint operation among the investors. Assuming, arguendo, that this is required, the common enterprise among investors here is their financing of Haffenden, Ltd.'s inventory. In any event, contrary to defendants' position, there need be no sharing or joint operation among the investors. Thus, the common enterprise found to exist in Los Angeles Trust Deed and Mortgage Exchange v. Securities and Exchange Commission, supra, 285 F. 2d 162, was that between each investor and the promoter, where the Mortgage Exchange sold second trust deed mortgages to investors, promising to select, evaluate, service and supervise the investment for the purchaser.

Alluding to the common enterprise requirement, the court said, "In all this there was reliance on the appellants; an anticipated common effort," 285 F. 2d at 168. The court found "that the economic welfare of the purchasers [was] inextricably woven with the ability of LATD to locate by exercise of its independent judgment a sufficient number of discounted trust deeds, and the ability of LATD to subsequently meet its commitment to check, evaluate, supervise and supersede." 285 F. 2d at 172. More recently, the same court similarly stated in Securities and Exchange Commission v. Glenn W. Turner Enterprises, supra, 474 F. 2d at 482 n. 7:

> "A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties."

Defendants seem to contend (Br. 11-12) that there was no common enterprise because they assertedly were performing mere brokerage services. But even apart from the services performed by defendants, the investors were also dependent on the efforts and services of Haffenden, Ltd. Furthermore, we fail to see how the defendants can seriously compare these scotch whiskey investments--involving a relationship in which the investor was completely dependent on the defendants and Haffenden, Ltd. in order to realize his profit--with a brokerage account maintained for trading in the organized public trading markets. 20/

20/ In view of this distinction between the whiskey investments and conventional brokerage accounts, defendants' reliance (Br. 13-15) on Milnarik v. M-S Commodities, Inc., 457 F. 2d 274 (C.A. 7), certiorari denied, 409 U.S. 887 (1973), is misplaced. In addition, it appears that some courts may disagree with Milnarik. See Commercial Iron & Metal Co. v. Bache & Co., Inc., 478 F. 2d 39 (C.A. 10, 1973); Maheu v. Reynolds and Co., 282 F. Supp. 423 (S.D. N.Y., 1968); Berman v. Orimex Trading, Inc., 291 F. Supp. 701 (S.D. N.Y., 1968).

2. With respect to the defendant's argument regarding reliance by investors upon the efforts of others, we submit that the court below has correctly identified the passive nature of the investor's role in this scheme: "Their participation in the enterprise was limited to providing capital with the hope of a favorable return" and further, "[m]ost, if not all, of the investors relied solely on the advice of the defendants in selecting, buying, storing, trading and selling the scotch. . ." (App. 28).

As we have set forth above, the reliance of the investor on the defendants at each stage of the investment, from selection through to the undertaking by the defendants and Haffenden, Ltd. to repurchase the investor's holdings themselves, is complete. The facts in this case compel the conclusion that the investor's expectation of profit, as much as 100 percent in four years, depends on the quality of the services provided by the defendants and others and in fact, judging from the record the investor's only hope of realizing his profit depends on whether the defendants and Haffenden, Ltd. can actually pay the prices promised for the investor's holdings on resale; for as we have seen p. 19, *supra*, the scotch being peddled by the defendants could never command the prices quoted to investors by the defendants in the "real" market for scotch whiskey.

The defendants, of course, deny (Br. 19) that they provide any services that would produce a profit for the investor, stating that the investor has only "Father Time" (Br. 20) and the "market" (Br. 21) to look to. If this were true, the record indicates clearly that the investors will be rudely shocked when they discover that no blender is interested in their small holdings and even that if he were the blender will not pay the prices the investor has been led to expect. If these holdings are to be sold at all, it is apparent that they will be sold through the defendants to Haffenden, Ltd., returning them to Haffenden, Ltd.'s "balanced inventory."

The defendants also cite several other elements familiar in the litany of the long line of investment contract cases, to raise doubts as to the fact of the investors' complete dependance on the defendants and the successful operation of their scheme. Actually none of these elements interferes with the finding of an investment contract: the "sole dominion" of the investor over his property has often been asserted and as often been ignored;[21/] nor does the payment of storage, service or similar charges negate the existence of an investment contract.[22/]

The fact that the investor would make the decision to sell his investment and realize the profit created by others is perhaps the most irrelevant consideration.[23/]

Finally, the fact that the forces of nature (in the instant case, time and the chemistry of the aging process) or the performance of a market

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21/ W.J. Howey Co., supra; Securities and Exchange Commission v. Payne, supra; Continental Marketing, supra.

22/ State v. Unger, 296 NW 629, supra, Securities and Exchange Commission v. C.M. Joiner, supra; Roe v. United States, supra.

23/ Securities and Exchange Commission v. W.J. Howey, supra; Continental Marketing Corp. v. Securities and Exchange Commission, supra; Los Angeles Trust Deed Mortgage Exchange v. Securities and Exchange Commission, supra.

contribute to the profit potential is equally non-determinative.24/

In fact in the case at bar this Court is not confronted with any efforts nominal or significant of investors which contribute to the promised return on the investment within the teaching of the cases. Therefore, we fail to see the relevance of the defendants reliance on Securities and Exchange Commission v. Koscot Interplanetary, Inc., 365 F. Supp. 588 (N.D. Ga., 1973), appeal pending, C.A. 5, No. 73-2339.25/

Finally, the defendants (Br. 16) would evidently take comfort from the holding in Sinva v. Merrill Lynch, Pierce, Fenner & Smith, 253 F. Supp. 359 (S.D.N.Y., 1966) that no investment contract is involved where a speculator in the commodities futures market relies solely upon his own efforts to generate his profits, and not upon efforts of another. In the Commission's view, however, the defendants' reliance on this case is misplaced. The rule in Sinva, which is no more than a restatement of the rule in Howey would, on the facts of the case at bar which show substantial reliance by investors on the defendants, clearly require the finding of an investment contract.

24/ Continental Marketing, supra (the mating instinct of beavers); State v. Unger, supra (the aging of bourbon whiskey); In Re Waldstein, supra (the natural process of dying); Hollywood State Bank v. Wilde, 160 F. 2d 846 (Cal. App., 1945) (the mating instinct of chinchillas); Securities and Exchange Commission v. United Benefit Life, supra (stock market).

25/ Even if Koscot were relevant, it is being appealed by the Commission, and on the strength of the decision of the Court of Appeals for the Ninth Circuit involving the same scheme. Securities and Exchange Commission v. Glenn Turner, 474 F. 2d 476 (C.A. 9, 1973), affirming, 348 F. Supp. 766 (D. Ore. 1972), certiorari denied, ___ U.S. ___ 94 S. Ct. 117 (1973), the Commission submits that the District Court for the Northern District of Georgia is in error. See also Lino v. City Investing, ___ CCH Fed. Sec. L. Rep. ¶94,124 (C.A. 3, 1973) where the Court of Appeals for the Third Circuit expressly found the reasoning of the Court of Appeals for the Ninth Circuit "persuasive" on the proper application of the "solely" requirement in Howey.

CONCLUSION

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

Respectfully submitted,

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