MASSACHUSETTS LAWYERS WEEKLY

Investor can recover damages for misrepresentation over patents

Reliance test rejected for 'blue sky' liability

By: Pat Murphy January 21, 2015

An investor seeking damages under Massachusetts' "blue sky" law was not required to prove that he was actually induced to invest in a medical device company by false assurances about patent protection, the 1st U.S. Circuit Court of Appeals has decided.

The defendant founder of the company argued that there must be some proof of loss causation for an investment to occur "by means of" a material misrepresentation under §410(a)(2) of the Massachusetts Uniform Securities Act.

But the court rejected the notion that there is a loss-causation or reliance requirement for a claim under the securities statute and affirmed an award of $1.5 million to the plaintiff investor in the company's bankruptcy case.

"Given that a central purpose of the statute is to provide a 'heightened deterrent' against the use of misrepresentations in selling securities, we find that the requisite connection is established when the communication containing the material misrepresentation was *used* to effect the sale — and not whether it was actually successful in securing the sale that, in any event, transpired," Chief Judge Sandra L. Lynch wrote for the unanimous panel.

The 15-page decision is *In Re: Access Cardiosystems, Inc.*, Lawyers Weekly No. 01-005-15. The full text of the ruling can be found by clicking here.

Investor protections upheld

Barry C. Klickstein of Day Pitney in Boston represented the plaintiff investor in the appeal before the 1st Circuit. Klickstein also represented other investors, as well as the company, Access Cardiosystems, in related actions against its founder, Randall Fincke, in the company's bankruptcy case.

Klickstein said the 1st Circuit's decision is important because it addresses an aspect of the Massachusetts blue sky law that courts have not had a chance to examine. The court's interpretation of §410(a)(2) is consistent with the blue sky law's underlying purpose as a consumer protection statute, he said.

"The intent of the statute is to place the burden on the promoter who is seeking investments to be punctilious in their representations," he said. "You can't be fast and loose."

Pointing out that the core of the Access Cardiosystems business was its intellectual property, Klickstein said the very heart of the statute's protections would have been undermined by allowing Fincke to be "cute" in representing the patent protections enjoyed by the company's products.

Imposing a reliance or loss-causation requirement would "eviscerate" the statute, he added.

"If you had to prove causation, then someone who made a misstatement would be able to throw an added roadblock in any investor's attempt to recover," Klickstein said.

Boston attorney John J.E. Markham II defended Fincke. Markham did not respond to a request for comment prior to deadline.

But Boston attorney Philip Y. Brown said that the 1st Circuit's decision should help remove any lingering doubt that there is a reliance requirement under the statute.

"Even though reliance shouldn't be an issue in determining liability under the statute, in a lot of these cases defendants want to point to whether or not the person actually relied on the misleading statement," Brown said.

"The 1st Circuit probably got it correct in saying that it's not a reliance standard and that the focus needs to be on what the seller used to sell his securities."

The Rackemann, Sawyer & Brewster litigator represented the plaintiff in the leading Massachusetts case on §410(a)(2), the Supreme Judicial Court's 2004 decision in *Marram v. Kobrick Offshore Fund.*

Business litigator William J. Lovett of Collora in Boston agreed that the 1st Circuit got it right in *Access.*

"The statute's not meant to burden the plaintiff with a heightened reliance standard," Lovett said. "If you made the misrepresentation, and the sale was made by means of the misrepresentation, you're liable."

Lovett also applauded the 1st Circuit for finding that disclaimers in the business plan that Fincke distributed to prospective investors could not insulate him from liability under §410(a)(2).

"The court rightly found that somebody who is soliciting investments and selling securities in Massachusetts can't get out from under an otherwise false statement by pointing to those disclaimers," he said.

Failed startup

Access Cardiosystems was a small startup that sold portable external heart defibrillators. Fincke, the defendant, was the company's founder, director and officer.

From 2001 to 2005, the defendant was able to secure more than $20 million in investments from four investors, including the plaintiff, Joseph R. Zimmel. The plaintiff was the last to invest in Access, after receiving a business plan prepared by the defendant in 2002 to secure new investors.

The 2002 business plan contained the statement: "Access has been advised by its patent counsel that its product does not infringe any patents known to him."

After Access filed for Chapter 11 bankruptcy in 2005, the plaintiff and the three other investors sued the defendant under §410(a)(2). The blue sky law provides for liability for sales of securities accomplished "by means of" fraud or misrepresentation.

The Bankruptcy Court conducted a trial on the §410(a)(2) claims and found that the defendant had made a misrepresentation in the 2002 business plan in that patent counsel never offered an opinion on whether Access's defibrillator product infringed other patents. Moreover, the Bankruptcy Court found that the defendant knew or should have known of the falsity of the statement concerning patents.

Of Access's four investors, only the plaintiff received the 2002 business plan prior to making his investment. Accordingly, the Bankruptcy Court found that only the plaintiff had established that he was entitled to damages under §410(a)(2) for the defendant's soliciting an investment "by means of" a material misstatement.

The defendant appealed from the $1.5 million judgment entered by the lower court.

Objective standard

On appeal, the defendant argued that his 2002 business plan did not contain a false statement because he did, in fact, discuss potential patent claims with counsel and never claimed he had received a formal legal opinion on those issues.

But Judge Lynch concluded that the Bankruptcy Court's finding that patent counsel never offered any opinion, formal or informal, was "fully supported" by the record.

"At most, Fincke had 'discussed' [potential infringement claims] with patent counsel, and 'related [Fincke's] personal conclusion that the [Access device] did not infringe,'" Lynch wrote. "We agree with the bankruptcy court's conclusion that this is a 'far cry from receiving "advice."'"

Lynch also flatly rejected the defendant's contention that any misrepresentation in the 2002 business plan was cured by the disclaimer, "there can be no assurance that [the] opinion is correct in all respects."

Massachusetts law "does not permit a seller to defeat his statutory obligation of truthfulness by suggesting that a nonexistent opinion should not be relied upon, or by hedging his misrepresentation," she said.

The defendant's primary argument on appeal was that the plaintiff's claim could not satisfy §410(a)(2)'s "by means of" requirement because it was based solely on his receipt of the misrepresentation prior to his decision to invest, and not on the role the misstatement actually played in that decision.

Noting the absence of authority on that precise issue under Massachusetts' blue sky law, Lynch looked for guidance to the federal courts' interpretation of a similar provision under the federal Securities Act of 1933.

While acknowledging that some federal courts have held that the "by means of" language in the federal statute requires a causal connection between the misleading representation and the investor's purchase, Lynch found an objective test more appropriate.

Under the objective test recognized by the 1st Circuit here, the "by means of" requirement of §410(a)(2) is established when the communication containing the material misrepresentation is simply "used" to effect the investment.

While reliance may be an easy or obvious way to demonstrate that a sale was "by means of'" a material misrepresentation, it is not necessary, Lynch said.

"In context, the seller's actions alone may also show that a subsequent sale was 'by means of' the misrepresentation," she wrote.

Accordingly, Lynch said, the Bankruptcy Court properly found that the plaintiff was not required to show actual reliance and focused its inquiry on the objective evidence of whether the defendant had used the 2002 business plan to solicit investments.

In affirming the lower court's judgment, Lynch pointed to evidence that the defendant provided the plaintiff with the 2002 business plan when they met in October 2002 to discuss the plaintiff becoming a new investor in Access. The plaintiff purchased $1 million in Access shares later that month and another $500,000 in shares in November.

"These facts, the [Bankruptcy Court] correctly concluded, were sufficient to show that [the defendant] had solicited [the plaintiff's] October and November investments 'by means of' the October 2002 Business Plan," Lynch said.

CASE: *In Re: Access Cardiosystems, Inc.*,Lawyers Weekly No. 01-005-15

COURT: 1st U.S. Circuit Court of Appeals

ISSUE: Was an investor seeking damages under Massachusetts' "blue sky" law required to prove that he was actually induced to invest in a medical device company by false assurances about the patent protection enjoyed by its products?

DECISION: No

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