A TARGET FOR INVESTMENT FRAUD THE MEDICAL DOCTOR

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Medical doctors are targets for private investment fraud. Due to their high incomes and perceived limited legal and financial sophistication, these individuals are sought after for the sale of passive investment opportunities. Generally referred to as "private placements" or sold through documents known as "PPM's," these investment opportunities are not offered or sold with the comprehensive information disclosure of a registered investment security, such as that found on a national securities exchange or the over-the-counter markets. Instead, the investments are sold with limited disclosure and generally through people who are not licensed for their sale. The result is the sale of illegal investment products which carry disproportionate risk for any reasonably expected return or which are simply outright frauds.

This is an informational overview on the selection of private investment opportunities and, if an investment has been made, the methods in which funds can be recovered. We begin with a background on the law regarding required information disclosure in securities offerings and an explanation why most private investment opportunities do not comply. The article continues with strategies for recovery of investment losses. We then conclude with guidance on how to select and negotiate private investments.

The Recovery of Investment Losses.

The law mandates comprehensive disclosure almost any time a private investment opportunity is offered or sold. Few private companies have or devote the resources necessary to make that information disclosure to investors. The reality is that the scope of the disclosure requirements is so broad that even the largest issuers have difficulty to comply. A single omission or misstatement may then serve as grounds to raise common law, state, and/or federal securities fraud claims. The company, management, and any sales or promotional agents may be jointly liable and an investor entitled to the return of his or her investment.

The disclosure requirements are broad and generally prohibit the making of a false statement or omitting to state a material fact. Materiality is governed by a "reasonable" investor standard and is dependent upon whether the false statement or omitted fact would alter the total mix of information available and affect the decision to invest. Regulation S-K, 17 C.F.R. §229.1, *et. seq*., can be consulted for what can constitutes "material" information. The regulation provides instructions on the required disclosures when a company files to register a public offering or sale of securities. These necessary disclosures include: (i) detailed descriptions of the business and the

company's properties, (ii) legal proceedings, (iii) descriptions of the securities offered as well as all other classes of the company's securities, (iv) work experience and qualifications of officers, directors, and other control persons, (v) executive compensation, (vi) ownership, (vii) transactions among affiliated persons and the company, (viii) risks in investing in the company and its securities, as well as (ix) the use of proceeds of the offering. The omission prong is particular useful because although there are no particular required disclosures necessary to accredited investors, the anti-fraud prohibitions remain and offer grounds for civil litigation under claims of fraud or rescission for a failure to disclose. If non-accredited investors are involved in the investment offering, the required disclosures for the entire group may be heightened to the equivalent as would otherwise be required in the company's filing a registration statement.

Most securities fraud lawsuits are brought under federal statute 15 U.S.C. §78j, also known as Section 10(b) of the Securities Exchange Act of 1934, and promulgated rule 10b-5 thereunder, 17 C.F.R. §240.10b-5. This provision is referred at as the "judicial oak" because it was enacted by statute in a broad form to prevent fraud on the markets, but court decisions have developed such an extensive body of legal precedent that the figurative oak tree has grown. Florida Statue §517.301 is the state law equivalent. For Georgia, turn to O.C.G.A. §10-5-54.

Another option to recover investor funds may be to unwind the investment and request rescission. Section 29(b) of the Exchange Act, 15 U.S.C. §78cc, provides the statutory mechanism to rescind contracts entered into on fraud. Rescission is a powerful tool for the investor when timely asserted. For example, where a required disclosure was not made, the unregistered investment was publicly offered without compliance with a particular exemption, or an unlicensed salesman was used in the process, the investor may be able to then demand repayment of all funds invested. Florida and Georgia also have state law equivalents and those are Fla. Stat. §517.211 and O.C.G.A. §10-5-58.

Timing is important and action should generally be quickly taken. First, statutes of limitation apply. For rescission under §29(b), investors may find that a limited, one year period applies from date of discovery or three years from the date of sale. Under §10(b) of the Exchange Act and Rule 10b-5 thereunder, suits seeking damages for fraud are governed by a two year limitations period from discovery or five years from date of sale. Florida law provides a two year limitations period from the time which the facts were or should have been discovered or five years from the date of sale. Fla. Stat. §95.11. Georgia has a similar provision under O.C.G.A. §10-5-58. Second, a fight may ensue with other creditors, defrauded investors, or even a state or federal agency. Larger issuers may survive a securities lawsuit, but many smaller companies will not. A fight for remaining assets ensues and it is common to see parallel litigation of civil, regulatory, and at times criminal proceedings.

Issuers and management face a difficult decision in defending securities fraud lawsuits. Even when the merits of a lawsuit may be perceived as weak, there is a tremendous cost in the legal defense and, if the lawsuit is successful, the damage on the company and management can be severe. At the time of filing, mere accusations of fraud may interfere with the ability of the issuer to raise additional capital because that fraud litigation would likely have to be disclosed to investors. There are also important licensing and career decisions to be made by management because if a judgment is entered, a finding of fraud may result in the end of management's career. For example, management and licensed salespeople may be prohibited from work within the securities industry for years, including serving as an officer or director of a public company. For those individuals who hold professional licenses, a §10(b) fraud claim will likely lead to revocation.

A Professional's View – Negotiating the Better Investment Deal.

Attorneys are generally approached many years after an investment is made and when a fraud becomes apparent. However, the most critical phase in the

investment process is at the beginning. This is the time when due diligence can be conducted, the terms of the investment are negotiated, and the legal protections to guard a subsequent recovery are set. The following are a few tips in negotiating a better investment deal.

1. **Control and Verify the Use of Proceeds**. Proper control mechanisms should be in place to ensure that the invested funds will actually be used for the intended purpose. This begins with an escrow agent. If there are any contingencies of funding or if the funds are to be deployed for a specific purpose, use a reputable escrow agent. For example, if the purpose of the investment is to acquire a hotel, a funding contingency should be set so that your funds are only dispersed when the issuer receives sufficient investment to acquire the property and the working capital to initially operate it. If the contingency is not met, the escrow agent serves as a fiduciary to return those funds. If, on the other hand, the contingency is met, the funds can be held for the closing attorney pending purchase. However, the release of funds does not then conclude the investor's work. A system of continual oversight and review should be utilized to verify that additional investments and cash flow are used in the specified manner or, at least, a reasonable manner.

2. **Demand Full-Time Participation by Management**. Your investment should be management's primary focus at the time of sale and until your desired return is met. Unfortunately, most private investments are sold without any requirement for management to even continue working with the company or to devote a set amount of hours toward the goal. This is a negotiating point and one that can be controlled by contract. If the investor would like management to continue to a certain point in time, arrange for an attorney to insert language to mandate the managers' participation, absent which they forfeit their own compensation or even interests in the venture. Another option is to offer a subsistence salary while operations commence. Thereafter gradually increase the managers' salary and ownership interests upon reaching certain milestones for the project.

3. **Identify an Exit Strategy and Demand a Contractual Provision for Liquidity**. The starting point of investment analysis is the identification of the exit. The investment selection process involves estimation of the timing and amount of future cash flows. The problem is that many of the private investment opportunities do not have a recognized market for trading the company's securities and the company's management will likely have control on when and whether to authorize a liquidity event. Conflicts of interest arise because management likely has perpetual salaries or management fees and those will take priority over investment distributions. Hence, for example, in a real estate investment, it would be prudent for the investor to contractually mandate that the company repurchase the securities after a specified period of time or, if the company is unable to do so, proceed and liquidate the assets of the company and return what remains of the principal. If an extension might be necessary or warranted, that decision should ultimately rest with the investor (or by vote of the investors) and not management.

4. **Prevent Dilution of Ownership Interest**. This is an important provision and a protection against the sale of your proportionate interest and control. An investor purchases a "slice of the pie" and when the company has authority to sell additional shares or issue them to management, the proportionate percentages of both interest and control are lost. While circumstances can arise where additional capital raises will build a bigger pie for all and promote the growth the company, this should be done with the investor's approval.

5. **Take a Seat on the Board of Directors**. Professional investors will demand a seat on the company's board of directors and seek active oversight over their investments. If the investment is sufficiently large to warrant the time, it is recommended that the investor be present at the meetings and participate in the control of the company.

6. **Retain Voting Control**. Voting structures and percentages are the safeguard for the investor in the

event that conflicts of interest develop with management or confidence is lost in their ability to manage the enterprise. If necessary, a meeting of the interested stakeholders can be called and, with voting rights, control can be exercised over both the company's management and its board. Expect resistance on this particular point because most managers seek passive investors and are unwilling to part with control of the enterprise.

7. **Request Personal Guaranties, Liens, and Security Interests**. Institutional lenders require heightened protection when making their loans. For example, when banks extend loans for home financing, they generally require first positions liens on the property and then for the borrower to personally guaranty payment of the debt. An investor can demand the same. Take a first position lien on all real property. Security interests can be filed under the Uniform Commercial Code for personal property of the company. You can then exercise leverage over management when they have personally guaranteed the return. Some institutions even take a step further and require cross-collateralization; thereby taking liens and security interests on property held by third parties or affiliated companies to serve as yet additional protection in the event of the company's default.

8. **Get a Professional Valuation or Opinion**. An important consideration for investment is that of valuation. For registered companies, a public market for the sale of securities exists and therefore, a current and historic comparison can be made for pricing and irrespective of whether the particular issuance of securities is registered. The market pricing for these securities arguably already reflects the valuation made by the public. For private placements, pricing information may not be available and, moreover, the lack of any trading market may serve as a complete bar to the subsequent sale. The result is that the investor is charged with making his or her own independent review and valuation of the securities to be issued.

About our Firm and the Author.

Convergent Litigation Associates is a law firm focused on the representation of clients through complex commercial litigation. Recognizing the need for experienced representation through the terrain of the securities industry as well as commercial disputes, and the economic value in small firm representation, the law firm has represented individuals and investment groups, private and publicly-traded companies, and registered market participants through civil litigation and regulatory defense matters. The firm provides exclusive representation in a number of U.S. jurisdictions and can also assist through such matters, in conjunction with locally admitted attorneys, on a national basis.

Mr. Stegawski serves our group as a Managing Director. Prior litigation experience has included civil and regulatory securities fraud defense, shareholder common fund and derivative litigation, cross-border securities fraud, and a variety of complex commercial litigation. Michael is admitted to practice law in the states of Florida and Georgia and is admitted to appear before the United States District Courts for the Southern, Middle, and Northern Districts of Florida, Middle and Northern Districts of Georgia, District of Colorado, as well as the United States Courts of Appeal for the Eighth and Eleventh Federal Judicial Circuits. Stegawski has also made special appearances in the United States District Courts for the District of Utah, District of South Dakota, and the Central District of California. Internationally, Mr. Stegawski is admitted to practice law as a solicitor in England and Wales (currently non-practising). Michael received his bachelor's degree in finance from Wake Forest University and juris doctorate from the Georgia State University College of Law.

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