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ORIGINAL

Case No. 72597-1-I

COURT OF APPEALS FOR DIVISION I
STATE OF WASHINGTON

STANLEY SMITH,

Appellant,

v.

TERRY MARTIN and M&M TECHNOLOGIES, INC.,

Appellees.

APPELLANT'S OPENING BRIEF

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INTRODUCTION

When are government demands for the disgorgement of ill-gotten funds from a Ponzi scheme a "claim?" The appellant, Stan Smith, seeks reversal of the trial court's determination that formal demands issued to M & M Technologies, Inc. ("M & M")(pre-formation of the License Agreement and related agreements) by the Securities and Exchange Commission ("SEC") for the disgorgement of ill-gotten funds was not a "claim" against M & M for purposes of Paragraph 12.1(g) of the parties' License Agreement. CP P1. Specifically, paragraph 12.1(g), entitled "WARRANTIES AND REPRESENTATIONS," provides:

> Each Party (the "Warranting Party") warrants and represents to the other Party that:
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> > (g) the Warranting Party is not presently the subject of . . . any claim that would have a material adverse affect on the other Party.

CP P1. M & M's principal, Terry Martin, admitted unequivocally that if the SEC demand had risen to the level of a "claim," the SEC claim would have had a material adverse effect on M & M, and by extension, Mr. Smith. RP 268-274. However, Mr. Martin maintained that the SEC claim was not yet a "claim" under paragraph 12.1(g). RP 273. His testimony was undisputed.

The trial court determined, however, that the "SEC claim against M & M Technologies, as a relief defendant for $550,000, was an inchoate potential claim" only and therefore M & M had not breached Paragraph 12.1(g). CP 125 at ¶¶ 3.21-3.24. The trial court's determination was an error of law. For the SEC's claim to be a "claim" under paragraph 12.1(g), M & M did not need to formally be named as a relief defendant in the on-going Ponzi scheme litigation by the SEC. *Cf. Olympic S.S. Co. v. Centennial Ins. Co.,* 117 Wn.2d 37, 52, 811 P.2d 673 (1991)("A 'claim' is a demand for compensation"); *Safeco Title Ins. Co. Gannon*, 54 Wn. App. 330, 335, 774 P.2d. 30 (1989)("'Claim' ordinarily means a demand . . . for damages . . ."); RCW § 4.92.100 (pre-suit claim against State of Washington must be presented to the Office of Risk Management as precondition of filing suit).

The trial court's ruling should be reversed and judgment should be entered in Mr. Smith's favor in the amount of $600,000, plus pre-judgment and post-judgment interest. As a matter of law, M & M breached paragraph 12.1(g), which rendered the License Agreement null and void, *Miller v. Commercial Union Assurance Co.,* 69 Wash. 529, 125 P.2d 782 (1912); *Clausing v. De Hart,* 83

Wn. 2d 70, 515 P.2d 982 (1973), and entitled Mr. Smith to the return of his investment and applicable interest.

I. ASSIGNMENTS OF ERROR

Mr. Smith assigns error to the trial court's Findings of Fact and Conclusions of Law. CP 125.

Specific assignments of error are:

A. The trial court erred as a matter of law by ruling that the word "claim" in paragraph 12.1(g) of the License Agreement did not encompass the SEC's claim against M & M because suit had not yet been filed against M & M. CP 125 at ¶¶ 3.21-3.24.

B. The trial court erred as a matter of law by ruling that M & M has not breached the License Agreement and was entitled to retain all funds paid by Mr. Smith to M & M. CP 125 at ¶ 3.09, 3.45, 3.47, 4.02 and 5.03, Conclusions of Law 3, 6, 8, and 11.

Issues pertaining to these assignments of error are:

A. The language of Paragraph 12.1(g) is an affirmative representation and warranty that, if untrue, voids the License Agreement. *Cf. Miller v. Commercial Union Assurance Co.,* 69 Wash. 529, 125 P.2d 782 (1912);

Clausing v. De Hart, 83 Wn. 2d 70, 515 P.2d 982 (1973).

> Warranties differ from representations, then, in that falsity of a representation will defeat the contract only where it is material, as representations are merely inducements to the making of the contract, while in case of a warranty the statement is made material by the very language of the contract, so that a misrepresentation of a matter warranted is a breach of the contract itself. Therefore the falsity of a statement which is made a warranty will avoid the contract without regard to whether it can be considered as material in any way to the risk or the loss.
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> * * *
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> "One of the very objects of the warranty is to preclude all controversy about the materiality or immateriality of the statement. The only question is, has the warranty been kept? There is no room for construction; no latitude; no equity. If the warranty be a statement of facts, it must be literally true; if a stipulation that a certain act shall or shall not be done; it must be literally performed." 1 May, Insurance (4th ed.), § 156.

Miller at 534-5 (citations omitted).

B. In the absence of a specific definition of "claim" in the License Agreement, the trial court must construe "claim" in paragraph 12.1(g) according to its plain meaning, which is a demand for money or other assertion of a legal right (or is an ambiguous terms that must be construed against the drafter, M & M). *Olympic S.S. Co. v. Centennial Ins. Co.,* 117 Wn.2d 37, 52, 811 P.2d 673

(1991); *Safeco Title Ins. Co. Gannon*, 54 Wn. App. 330, 335, 774 P.2d. 30 (1989); RCW § 4.92.100; RP 228, 300—302, 423-424.

II. STATEMENT OF FACTS

The appellant, Stan Smith[1], is a former construction worker and rehabilitation counselor turned residential real estate landlord, who entered into a series of inadvisable transactions with M & M Technologies, Inc. ("M & M") in March and April, 2007 that were beyond his experience and expertise. RP 364-365, 370-372.

Between December 4, 2006 and April 11, 2007 (the date the License Agreement was executed), Mr. Martin and M & M learned that they were the subjects of investigation by the SEC into a Ponzi Scheme operated by an entity, IFC, and several individuals, one of whom, Mac Stevenson, was a business colleague of Mr. Martin at GEM Technology. CP P18-21, 26, D27, 33-38, 41; RP 154-158, 251-271. The exchanges between Mr. Martin and the SEC and the financial records of M & M and CD2E, an investment entity wholly-owned by Mr. Martin, show that Mr. Martin, M & M and CD2E collectively received over $2 million from IFC's illicit criminal

[1] Mr. Smith's testimony at trial was made difficult because he suffers from Miniere's Disease and could not concentrate for extended periods.

activities, not including approximately $300,000 paid directly to Mr. Martin as "consulting fees."[2] RP 188-200. Further, as of March 13, 2007, Mr. Martin was notified by the SEC that M & M was likely to be named as a "relief defendant" (along with CD2E and Mr. Martin, individually) and that the SEC intended to disgorge the ill-gotten funds (including $550,000 paid directly by IFC to M & M). The SEC thereafter filed suit against Mr. Martin, M & M and CD2E on April 9, 2009, which ultimately led to an agreed settlement on July 16, 2008 for the repayment of in excess of $630,000. CP P18-21, 26, D27, 33-38, 41; RP 177-178.

At the heart of this appeal is the interpretation of the word "claim" in paragraph 12.1(g) of the License Agreement entered into on April 11, 2007. CP P1. Mr. Smith was unaware of the SEC allegations against M & M, or the likely impacts on M & M's operations, and he was unaware the M & M was "broke."[3] RP 203-207. When Mr. Smith agreed on March 15, 2007 to loan $200,000 to M & M on a short term basis (4-6 months), the purpose of the

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RP 366-370.

[2] Mr. Martin testified that he didn't know the nature of IFC's business, but acknowledged that he provided $300,000 in consulting fees without knowing. RP 188-190.

[3] Mr. Martin was earlier notified by phone on December 4, 2006, such that he was aware of the potential disgorgement issue due to IFC's payment of $550,000 to M & M, which he later confirmed by reviewing M

loan, according to Mr. Martin's representations to Mr. Smith, was that M & M was buying a business and needed to show "cash on hand" for the transaction to close.[4] The agreement was that Mr. Smith's funds were not to be disbursed; they were to remain in M&M's account. RP 392-393. For this reason, M&M simply secured the loan by pledging one share of M&M with handwritten notations and no formal promissory note was ever executed. CP D29; RP 215-218. Unbeknownst to Mr. Smith, however, instead of holding his $200,000 in M & M's account, M & M used the funds immediately to pay M & M's payroll, to repay shareholder loans to M&M (*e.g.*, Mr. Martin's shareholder loan) and to extend loans to key shareholders. The loan proceeds were all but fully disbursed by April 1, 2007.[5] RP 218-219, 222-223.

Shortly after the loan was made by Mr. Smith—even as his funds were being disbursed in breach of their understanding—Mr. Martin approached Mr. Smith with a business proposition to help M&M conduct certain research and development ("R&D") and

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& M's bank statements were indeed received by M & M. RP 192-200.

[4] M & M agreed to repay $200,000 plus an additional $200,000 because the purported business transaction that he was closing was very lucrative.

[5] Mr. Smith is deeply religious, and his judgment was clouded by Mr. Martin, who represented himself as a man of faith and then played on Mr. Smith's faith by appealing to Mr. Smith as fellow Christian. RP 336, 393-394. Instead of "trust and verify," Mr. Smith simply trusted.

ultimately to license any products that proved to be marketable from R&D. Until that point in time, M & M had never sold a single commercial product to the public in over 10 years of existence. RP 246-247. Lack of sales notwithstanding, Mr. Martin's pitch to Mr. Smith was that M & M is prepared to repay the loan, but he wanted Mr. Smith to consider a "once in a lifetime" opportunity that M &M and Martin pitched in M & M's 2006 business plan as generating gross profit of over $200,000,000 in Year 1. CP D32. In essence, Mr. Martin and M & M did not have the funds to repay Mr. Smith, so Mr. Martin dangled a financial carrot in front of Mr. Smith to avoid having to disclose that Mr. Smith's funds were gone.

For personal and religious reasons, Mr. Smith agreed to help M&M develop a marketable product. The initial letter of intent between the parties was executed on March 28, 2007 and the subsequent R&D, License and Option agreements (collectively, "Agreements") were executed on April 11, 2007. Mr. Martin and Mr. Smith met, reviewed and discussed the Agreements, their scope and intended purpose, etc. During these meetings, Mr. Martin confirmed repeatedly that the successful completion of R&D to develop an actual product was a precursor, *i.e.*, a condition precedent, to any license rights that was being granted under the

Agreements. RP 409-422. The payments to be made at the time of signed were characterized as "deposits" for when R&D efforts proved to be successful. RP 98-100. Mr. Smith, whose experience was in real estate, not technology, indicated that he was uncomfortable signing without consulting with an attorney. However, instead of encouraging Mr. Smith to have the Agreements independently reviewed, Mr. Martin recommended a local counsel, Mr. Edwin Hubbard, who thereafter represented all parties in the transaction. RP 70-71. Mr. Smith did not learn until after the fact that Mr. Hubbard had performed legal services for M & M and that Mr. Martin had studied under Mr. Hubbard's tutelage to become a lawyer.[6] RP 299-303.

Between April 11 and May 4, 2007, Mr. Smith transferred $400,000 in additional funds to M&M as a deposit against future license fees if R&D resulted in a marketable product. RP 409-422. By separate oral agreement, the parties subsequently agreed to hold and use the additional $400,000 for R&D purposes once Mr. Smith/NuPower provided specifications/performance criteria for

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[6] Mr. Smith has since filed a malpractice suit against Mr. Hubbard for *inter alia* failing to disclose conflicts of interest, etc., and for not explaining aspects of the Agreements that may appear to be different from the oral understandings between the parties.

their intended market application.[7] Again, however, as with the earlier $200,000, the later funds were disbursed and out of M&M by June 1, 2007. RP 282-290. In the interim, of course, Mr. Martin and M&M were served with the SEC's complaint against them as "relief defendants." In fact, by June 1, 2007, Mr. Martin and M&M had prepared and filed answers to the SEC complaint, but they failed to disclose even these latest developments to Mr. Smith. RP 266-267. Instead, they waited until all of Mr. Smith's funds were paid into M&M and then disbursed. In short, Mr. Martin and M&M raced to disburse the funds before the SEC acted on its threats to disgorge M&M's assets.

ARGUMENT

I. Standard of Review

This Court reviews the trial court's decision *de novo* for error of law in the interpretation of paragraph 12.1(g) and whether M & M breached. *Colorado Structures, Inc. v. Ins. Co. of the West*, 161 Wn.2d 557, 586, 167 P.3d 1125 (2007).

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[7] The R&D process was stopped dead in its tracks when Mr. Smith learned of the SEC filing on May 28, 2007. Mr. Smith could not raise funds, nor could he invest further funds in R&D through M&M while the likelihood of disgorgement was looming.

II. The License Agreement Is Void Because M & M Breached Its Representation and Warranty in Paragraph 12.1(g).

A. The Import of Representations and Warranties.

Representations and warranties in the formation of contracts have special legal significance. In *Miller v. Commercial Union Assurance Co.,* 69 Wash. 529, 125 P.2d 782 (1912), this Court explained the significance in detail as follows:

> When the parties by the terms of their contract expressly stipulate that a representation shall be regarded as material, it ceases to be a representation only and becomes a warranty. Warranties differ from representations, then, in that falsity of a representation will defeat the contract only where it is material, as representations are merely inducements to the making of the contract, while in case of a warranty the statement is made material by the very language of the contract, so that a misrepresentation of a matter warranted is a breach of the contract itself.
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> Black's Law Dictionary defines "representation" as a statement of fact which was made to induce another to enter into a contract. Typically, representations are statements that a party has examined, considered, and believes to the best of his or her knowledge to be true. These statements generally represent the existence of past or present facts.
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> * * *
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> A "warranty", on the other hand, is a promise that a certain fact is or will be true. These warranties will, in most cases, be guaranteed for a period of time. A warranty protects against loss if the promised statements turn out not to be true.
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> * * *

> Ordinarily a misrepresentation of the assured will not affect the validity of a policy unless it is material to the risk or, by the terms of the application and policy, has become an affirmative warranty. When the parties by the terms of their contract expressly stipulate that a representation shall be regarded as material, it ceases to be a representation only, and becomes a warranty.
>
> Warranties differ from representations, then, in that falsity of a representation will defeat the contract only where it is material, as representations are merely inducements to the making of the contract, while in case of a warranty the statement is made material by the very language of the contract, so that a misrepresentation of a matter warranted is a breach of the contract itself. Therefore the falsity of a statement which is made a warranty will avoid the contract without regard to whether it can be considered as material in any way to the risk or the loss.
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> In *Poultry Producers' Union v. Williams*, 58 Wash. 64, 66, 107 Pac. 1040, 137 Am. St. 1041, we said:
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> "A warranty must be strictly true. *Rice v. Fidelity & Deposit Co.*, 103 Fed. 427. A representation need only be substantially true. *Missouri K. & T. Trust Co. v. German Nat. Bank*, 77 Fed. 117. 'The crucial distinction between a representation and a warranty is that the one is not, and the other is, a part of the contract between the parties, and that the truth of the one is not, and the truth of the other is, a condition precedent to a recovery upon the policy or bond to which they relate.' *Rice v. Fidelity & Deposit Co., supra*."

Miller, 69 Wash. at 534-5 (citations omitted); *Clausing v. De Hart,*

83 Wn. 2d 70, 515 P.2d 982 (1973).

B. The Ordinary Meaning Of The Word "Claim."

Paragraph 12.1(g), entitled "WARRANTIES AND REPRESENTATIONS," provides:

> Each Party (the "Warranting Party") warrants and represents to the other Party that:
>
> (g) the Warranting Party is not presently the subject of . . . any ***claim*** that would have a material adverse affect on the other Party.

CP P1 (emphasis added). Because the License Agreement does not define "claim" and it was drafted by M & M, CP P1; RP 228, 300--302, the word "claim" must therefore be given its plain and ordinary meaning, and to the extent that it may be ambiguous, the ambiguity must be construed against the drafter, M & M. *Olympic S.S. Co. v. Centennial Ins. Co.,* 117 Wn.2d 37, 52, 811 P.2d 673 (1991); *Safeco Title Ins. Co. Gannon*, 54 Wn. App. 330, 335, 774 P.2d. 30 (1989). *Berg v. Hudesman,* 115 Wn.2d. 657, 801 P.2d 222 (1990); *Hearst Communications, Inc. v. Seattle Times, 154 Wn.2d 493, 115 P.2d 262 (2005).*

The ordinary meaning of "claim" is a demand for compensation. *Olympic,* 117 Wn.2d at 52; *Safeco,* 54 Wn. App. At 335. Black's Law Dictionary further defines "claim" as:

1. A legal assertion; a legal demand; Taken by a person wanting compensation, payment, or reimbursement for a loss under a contract, or an injury due to negligence.
2. Amount a claimant demands.

Known or unknown, Mr. Martin and M & M warranted that no such "claim" existed at the time of execution of the License Agreement. The only legal determination for the trial court to rule upon, therefore, was whether the undisputed facts, *i.e.*, the SEC investigation, its demand letters to M & M and Mr. Martin, and the filing of an Amended Complaint on April 9, 2007—all of which transpired before the License Agreement was signed by the parties—constituted a "claim" for purposes of paragraph 12.1(g). CP P18-21, 26; CP D27, 33-38, 41.

The trial court determined that "SEC claim against M & M Technologies, as a relief defendant for $550,000, was an inchoate potential claim" only, and therefore M & M had not breached paragraph 12.1(g). CP 125 at ¶¶ 3.21-3.24. This determination was an error of law. Essentially, the trial court adopted a narrow interpretation of "claim" and equated "claim" with "lawsuit." The substantial weight of the undisputed evidence establishes that the SEC had clearly made a claim against M & M, as a relief defendant in the Ponzi scheme litigation, for $550,000 (and M & M indeed

settled by paying the demanded amount). CP P18-21, 26, D27, 33-38, 41; RP 177-178. The mere fact that M & M was not *served* with the Amended Complaint until a few weeks after the signing of the License Agreement is legally immaterial and inconsequential. M & M and Mr. Martin knew, upon reviewing M & M's bank records in December 2006, that the SEC's claim had merit, *i.e.*, the $550,000 had been received by M & M directly from IFC and thus, M & M's being named as a relief defendant was inevitable. RP 192-195.

CONCLUSION

For the foregoing reasons, the trial court's finding that M & M did not breach paragraph 12.1(g) of the License Agreement should be reversed and judgment should be entered in favor of Mr. Smith in the amount of $600,000, plus pre-judgment interest.

Respectfully submitted this 21st day of April, 2015.

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CERTIFICATE OF SERVICE

I certify under penalty under the laws of the State of Washington that on April 21, 2015, I caused a true and correct copy of the foregoing APPELLANT'S OPENING BRIEF to be delivered by Email and U. S. Mail (1st Class) to the following:

Douglas Shepherd
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2011 Young St., Suite 202
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Kenneth L. Karlberg