

No. 22704-9-III

COURT OF APPEALS, DIVISION III

OF THE STATE OF WASHINGTON

CLARK E. KINNEY, and)	
BARBARA E. KINNEY,)	
individually and the marital)	
community,)	REPLY TO
)	BRIEF OF RESPONDENT
Appellants,)	
)	
vs.)	
)	
KENNETH B. COOK, a single)	
man,)	
)	
Respondent.)	

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I. ARGUMENT

The plaintiffs, Clark E. Kinney and Barbara E. Kinney (the “Kinneys”), submit this reply to the Brief of Respondent submitted by the defendant, Kenneth B. Cook (“Cook”).

A. **The Trial Court erred in determining the Complaint failed to state a claim upon which relief may be granted.**

The Complaint sets forth a claim upon which relief can be granted under the Washington State Securities Act (the “WSSA”). The defendant has not proven beyond a doubt that there are no facts, consistent with the Complaint, that would entitle the Kinneys to relief.

1. The July 2000 transaction was a sale of a security.

Cook describes the July 2000 transaction in very simple terms, i.e., as involving a note issued in a commercial context outside the scope of the WSSA. This description wholly ignores the underlying policy behind securities laws and fails to account for the true substance of the transaction.

The securities acts are remedial in nature and are designed to protect investors from speculative or fraudulent schemes of promoters. *See State v. Argo*, 81 Wn.App. 552, 559, 915 P.2d 1103 (1996), *citing S.E.C. v. Glenn W. Turner Enters.*, 474 F.2d 476, 480-81 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973); Cellular Engineering, Ltd. v. O’Neil, 118

Wn.2d 16, 23, 820 P.2d 941 (1991); State v. Philips, 108 Wn.2d 627, 631, 741 P.2d 24, *review granted* 107 Wn.2d 1024, *aff'd* 108 Wn.2d 627, 741 P.2d 24 (1987); *see also* Hoffer v. State, 113 Wn.2d 148, 152, 776 P.2d 963 (1989), *citing* Haberman v. Washington Public Power Supply System, 109 Wn.2d 107, 125-26, 744 P.2d 1032, 750 P.2d 254 (1987). The WSSA is therefore broadly construed to include an infinite number of transactions in which an investor invests money or other consideration in the risk capital of a venture with the expectation of some valuable benefit to the investor. *See* RCW 21.20.005(12)(a).

The definition of a security “embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits.” Argo, 81 Wn.App. at 558-59, *citing* S.E.C. v. W. J. Howey Co., 328 U.S. 293, 299 (1946). Form should be disregarded for substance and the emphasis should be on economic reality. Argo, 81 Wn.App. at 559, *citing* Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).

Washington courts define a security as (1) an investment of money (2) in a common enterprise and (3) the efforts of the promoter or a third party must have been fundamentally significant ones that affected the investment’s success or failure. ITO Corp. v. Prescott, Inc., 83 Wn.App.

282, 291, 921 P.2d 566 (1996), *citing Cellular Engineering, Ltd.*, 118 Wn.2d at 26-31.

Accordingly, the form of the payment under the terms of the promissory note and pledge agreement is not dispositive. The substance and economic reality of the July 2000 transaction is that the Kinneys invested \$266,534.06 by paying Cook for their 50% interest in the Company. The defendant secretly caused the Company to guarantee his \$4.5 million personal loan and otherwise drained the Company's cash for his personal benefit. These actions were fundamentally significant in affecting the Company's failure and the Kinneys' loss of their investment. Applying the requisite broad interpretation of the WSSA to the facts of this case, the July 2000 transaction clearly involved a security.

Cook therefore mischaracterizes the Kinneys' position by suggesting the Kinneys rely on the family resemblance test. The determination that the July 2000 transaction involved a security is based on significant and well-established Washington and federal law.

Cook attempts to confuse the issues, by arguing the security being transferred is the promissory note. The promissory note, however, is merely the medium of payment. The security being transferred by Cook is the 50 percent interest in the Company, and not the promissory note. The

promissory note was merely a temporary form of payment, not the security itself.

Even if the Court were to entertain Cook's argument, the July 2000 transaction also meets the definition of a security under the family resemblance test set forth in Douglass v. Stanger, 101 Wn.App. 243, 2 P.3d 998 (2000).

The appropriate analysis under this test begins with the presumption that the July 2000 transaction is a security. Id. at 252; Reves v. Ernst & Young, 494 U.S. 56, 64-66 (1990), *aff'd*, 507 U.S. 170 (1993). This presumption is rebutted only if the defendant can show that the note at issue strongly resembles a type of note that does not fall within the definition of a security, i.e., notes delivered in connection with consumer financing, secured by a home mortgage, or other notes used in commercial transactions as opposed to investments, and thus not requiring the regulatory protections of the securities acts. *See* Argo, 81 Wn.App. at 562-63, *citing* Reves, 494 U.S. at 65.

If the note does not strongly resemble a commercial note, the note is a security unless the defendant provides sufficient evidence that it is not a security under the four considerations of the family resemblance test.

See Douglass, 101 Wn.App. at 252-53. Cook has not presented this evidence.

Cook states that the note in Douglass “was determined to be a security because it was issued as part of the transaction in which Douglass invested money and expected to be a participant in the new business enterprise with Stanger.” See Brief of Respondent at 7-8. The same circumstance exists in this case. The Kinneys paid Cook their \$266,534.06 investment with the expectation of being a participant in the business enterprise. The Kinneys had the very same motivation and expectation of the investor in Douglass.

Additionally, the defendant has provided no authority for limiting the protections afforded to investors under Douglass to note holders. Indeed, such a limitation would contradict the very purpose of securities laws.

The purpose of securities laws is to protect investors from the myriad of schemes devised by those seeking the use of money of others on the promise of profits. See Argo, 81 Wn.App. at 558-59; see also Hoffer, 113 Wn.2d at 152. It is not disputed that Cook took the Kinneys’ money on the promise that they would receive future profits of the Company. Unknown to the Kinneys, was the fact that Cook had concealed the

Company's guarantee of his personal debt and that the Company was on the verge of bankruptcy. The Kinneys are entitled to a remedy for this deceptive conduct. The WSSA is the regulatory scheme specifically designed to provide this remedy.

Limiting the Douglass holding to only those investors standing in the position of note holders completely ignores the policy considerations of the WSSA. Such a limitation would leave countless victims of such schemes without any remedy. The July 2000 transaction also meets the definition of a security under the family resemblance test.

2. Cook was a Seller of Securities.

The defendant next argues that he is not liable for his actions undertaken in connection with the July 2000 transaction because he is not a seller of securities. He asserts he is not liable under the WSSA because title to the securities did not directly transfer from him to the Kinneys.

This argument, however, does not reflect the true state of Washington law. Washington law does not limit liability under the WSSA to those individuals from whom title to the securities directly passes.

Our Supreme Court rejected the "strict privity" approach that has since been adopted by the United States Supreme Court and other jurisdictions in favor of a "substantial factor-proximate cause" analysis. Thus, liability under the WSSA is not limited to one who sells securities. Rather,

one may be liable as a seller under the statute if one's acts were a "substantial contributive factor" in the transaction.

Herrington v. Hawthorne, CPA, P.S., 111 Wn.App. 824, 830, 47 P.3d 567, *amended on denial of recon.* 53 P.3d 1019 (2002), *citing* Haberman, 109 Wn.2d at 130-31.

A court must consider three factors in determining whether a defendant's conduct was a "substantial contributive factor" in the transaction:

- (1) the number of other factors which contribute to the sale and the extent of the effect which they have in producing it;
- (2) whether the defendant's conduct has created a force or series of forces which are in continuous and active operation up to the time of the sale, or has created a situation harmless unless acted upon by other forces for which the actor is not responsible; and
- (3) lapse of time.

Haberman, 109 Wn.2d at 131-32; *see also* Hines v. Data Line Systems, 114 Wn.2d 127, 148-49, 787 P.2d 8 (1990); Herrington, 111 Wn.App. at 831.

The Washington Supreme Court's rejection of a "strict privity" requirement was recognized in Brin v. Stutzman, 89 Wn.App. 809, 830, 951 P.2d 291 (1998), *review den.* 136 Wn.2d 1004, 966 P.2d 901 (1998), the case cited by the defendant in his brief. *See* Brief of Respondent at 9. In that case, Division I of the Washington State Court of Appeals explains:

[The] substantial contributing factor analysis simply expands the strict privity approach to sellers so as to include those parties who have attributes of a seller and thus who policy dictates should be subject to liability under RCW 21.20.430(1), but who would escape primary liability for want of privity.

Id. at 829. An individual is therefore a seller under the WSSA if he takes part in the sales process by acting as the “catalyst” between the seller and the buyer. *See Id.* at 830.

Cook attempts to portray himself as a mere bystander and that “the trial court and jury were the acting parties.” *See* Brief of Respondent at 9. This portrayal could not be further from the truth. A review of the facts as set forth in the Complaint demonstrates that Cook was the “catalyst” of the July 2000 transaction.

After the jury’s verdict finding he acted in violation of the WSSA, Cook was required to reinstate the Kinneys as shareholders. (CP 5; CP 40-47) Not content with this result, Cook devised a plan to further defraud the Kinneys. If Cook had not wanted the Kinneys to be shareholders of the Company, he need only have disclosed the \$4.5 million guarantee. The Kinneys would not have invested \$266,534.06 in a bankrupt company.

In this case, however, Cook concealed the \$4.5 million guarantee. The Kinneys had no knowledge of the guarantee when they reviewed the Company’s books and records to determine whether to make the demanded

payment for their 50% interest. The Kinneys therefore believed the Company was financially viable and expected to share in the Company's profits. (CP 6-7; CP 305)

Only months after tricking the Kinneys into paying \$266,534.06 for an investment in a bankrupt company, Cook forced the Company into bankruptcy. (CP 7-8) It was during the bankruptcy proceedings that Cook finally revealed the existence of the guarantee. (CP 8) It is this conduct that had the predominant effect of bringing about the sale in violation of the WSSA. *See Hines*, 114 Wn.2d at 149. Cook has not and cannot present any evidence that he was not the "catalyst" to the defrauding of the Kinneys in July 2000. *See Id.* at 150.

The defendant also cites *Shinn v. Thrust IV, Inc.*, 56 Wn.App. 827, 786 P.2d 285 (1990), *review denied* 114 Wn.2d 1023, 792 P.2d 535 (1990), in support of his argument that he is not a seller of a security. *Shinn*, however, is clearly distinguishable.

In *State v. Argo*, the defendant also cited *Shinn* in an attempt to avoid liability for his conduct in connection with certain loans. The *Argo* court distinguished *Shinn* on the basis that *Shinn* involved a limited partnership agreement which was negotiated between the parties.

Under these circumstances, investors do not need the protections of the securities laws because they have the

ability to dictate the terms of the agreement upon which their investment is based. Here, however, the limited partnership agreement was already in place; [the parties] simply negotiated the exchange of money for options to purchase limited partnership units. When a partnership agreement is already in place, an investor does not have the ability to negotiate the terms of the agreement upon which his or her investment is based. It is such an investment that the securities laws are designed to protect.

Argo, 81 Wn.App. at 565-566.

Upon Cook's declaration of default and demand for payment, the Kinneys were forced to pay \$266,534.06. At the time of this payment, the Company was already in place, had been operated exclusively by Cook for years, and unknown to the Kinneys, was secretly encumbered by Cook's personal debt.

Unlike the investor in Shinn, the Kinneys had no ability to negotiate the terms of the agreement upon which their investment was based. Their only course of action was to pay the amount demanded or not be shareholders. Had the Kinneys known of the \$4.5 million guarantee, they would not have paid Cook the amount demanded.

Moreover, whether a defendant's conduct was a substantial contributive factor is necessarily a question of fact. Herrington, 111 Wn.App. at 831, *citing* Haberman, 109 Wn.3d at 132. Accordingly, the

determination of whether Cook was a seller of a security is a question that should have been left for the trier of fact.

3. A sale of a security occurred on July 26, 2000.

The defendant attempts to confuse the issue of when the sale of a security occurred by listing a barrage of dates and events beginning with events surrounding the Company's formation. The events forming the basis of the Complaint, however, are limited to those surrounding the transaction of July 2000. These events are summarized as follows:

- * On January 6, 2000, when Cook was in sole control of the Company, Cook signed an All Encompassing Guaranty causing the Company to guarantee a \$4.5 million loan made by Mercedes Benz Credit Corporation to Cook's wholly owned limited liability company. (CP 8; CP 305)
- * On July 11, 2000, a Judgment Upon Verdict was entered in a lawsuit filed in the Superior Court of Spokane County, Cause No. 98-205964-2, reflecting the jury's verdict finding Cook in violation of the WSSA. (CP 5; CP 40-45)
- * On July 12, 2000, Cook demanded payment of \$266,534.06 from the Kinneys, without disclosing the existence of the

\$4.5 million loan guarantee or that he was on the verge of forcing the Company into bankruptcy. (CP 6-7; CP 305)

- * After analyzing the Company's books and records, and thereby expecting to receive profits in return for their \$266,534.06 investment, the Kinneys paid Cook the amount demanded on July 26, 2000, in exchange for their 50% interest in the Company. (CP 6)
- * On February 6, 2001, Cook filed an Involuntary Chapter 11 Petition forcing the Company into bankruptcy. (CP 7-8)
- * On August 15, 2001, Cook finally disclosed the existence of the \$4.5 million loan guarantee. (CP 8)

A review of these events demonstrates that a sale of a security occurred on July 26, 2000.

The WSSA broadly defines the term "sale" to include

. . . every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value. "Offer" or "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. . . .

RCW 21.20.005(10). The economic reality of the transaction of July 2000 was a disposition of 50% of the Company in exchange for payment of \$266,534.06. These events constitute a sale of a security under the WSSA.

B. Cook is not entitled to an award of attorneys' fees.

Cook is not entitled to an award of attorney fees under the applicable considerations of RAP 18.9(a). The strong policy to protect investors coupled with the broad definition of a security under the WSSA demonstrates that this appeal has significant arguable basis.

Moreover, as demonstrated by the foregoing, together with the Record as a whole, the defendant has not met his burden under CR 12(b)(6). The Kinneys' appeal from the Trial Court's grant of the defendant's motion to dismiss is not frivolous. Cook's request for attorneys' fees should be denied.

II. CONCLUSION

The Kinneys request the Trial Court be reversed and that this matter be remanded to the Trial Court for further proceedings.

DATED this ~~29th~~ day of December, 2004.



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