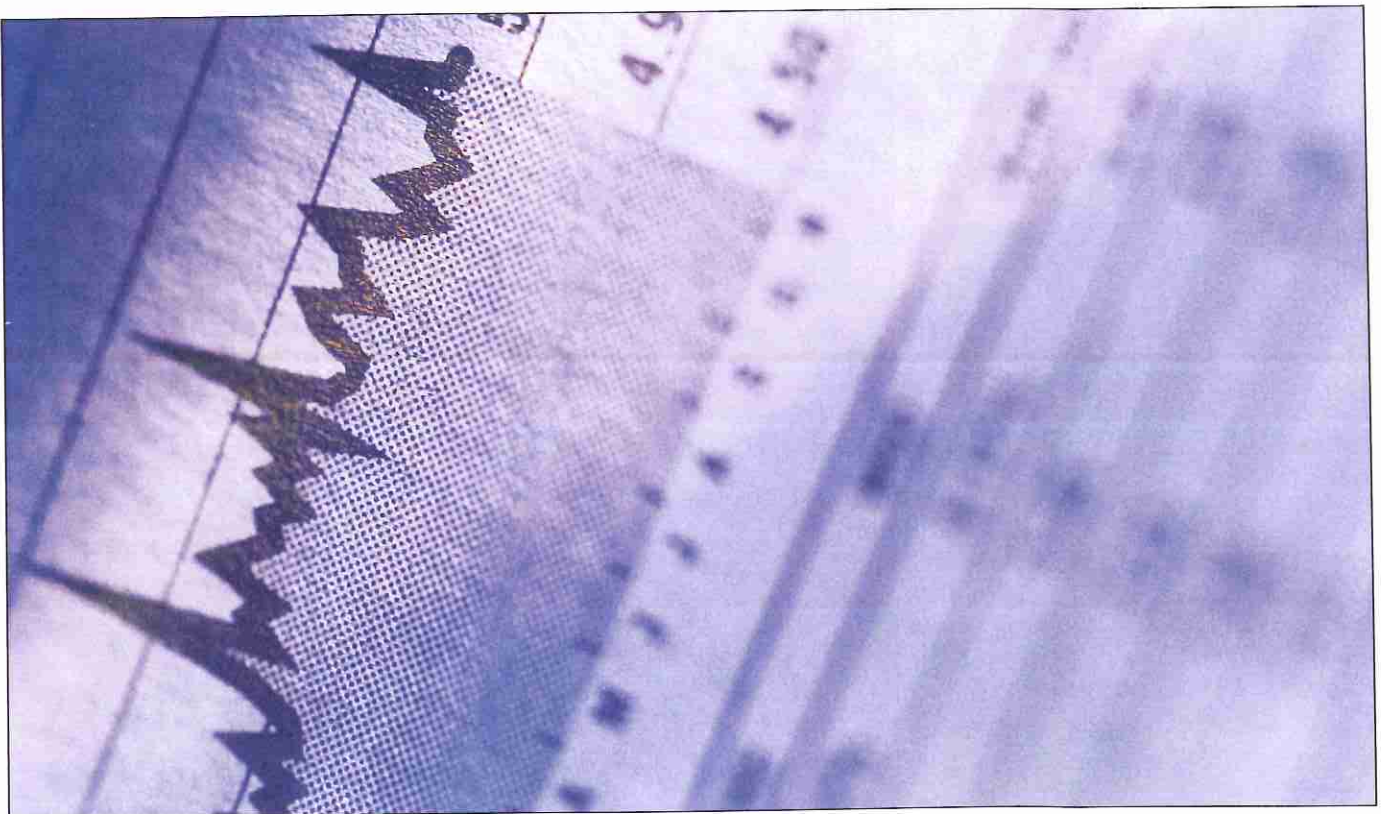
A Look at the Law

Georgia Securities Act–Let the Buyer Beware!

By J. Steven Parker
and Jason R. Doss

Georgia investors beware! On Jan. 24, 2005, in a 4-3 decision, the Supreme Court of Georgia denied certiorari and let stand the decision of the Court of Appeals in *Keogler v. Krasnoff*.[1] In that case, the court held that a chief financial officer who misrepresented his company's financial track record in connection with a securities offering was not liable to investors to whom the misrepresentations were made because the CFO did not intend to deceive the investors. The Court of Appeals imposed the common-law elements of scienter and reasonable reliance as prerequisites for recovery by a purchaser of securities. Plaintiffs now bear a significantly more difficult burden than previously assumed by many state securities lawyers based upon the language and history of the Georgia Securities Act of 1973[2] and dicta contained in a 1983 decision of the 11th U.S. Circuit Court of Appeals.[3]



As a result of *Keogler*, Georgia investors seeking protection pursuant to O.C.G.A. §§ 10-5-12(a)(2)(B) and 10-5-14(a) have less protection than investors in other states whose statutes contain similar provisions. Georgia now stands as the first and only state to find a scienter requirement under a civil liability provision modeled on section 410(a)(2) of the Uniform Securities Act of 1956 (the Uniform Securities Act) and section 12(a)(2) of the Securities Act of 1933[4] (the '33 Act). In addition, Georgia joins Washington as the only state requiring proof of reliance,[5] and joins Louisiana as the only state imposing an affirmative duty of investigation upon purchasers of securities.[6] The rule of *caveat emptor* is therefore fully restored for investors in Georgia.

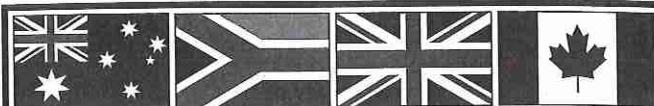
Georgia's civil liability scheme, as interpreted in *Keogler*, is a significant departure from the pattern that emerged in the last 70 years. In 1933 Congress passed the '33 Act, which protected investors by including a provision giving them the right to rescind an investment if a material misrepresentation was made by a company or its officers or underwriters during the offering process.[7] This law changed the general rule from *caveat emptor* (buyer beware) to *caveat venditor* (seller beware). States, including Georgia, followed suit by passing similar statutes as part of their Blue Sky laws.

These statutory provisions forced companies and their officers and underwriters to conduct greater "due diligence," a process whereby they sought scrupulously to verify all facts presented in a prospectus in order to avoid having an investment rescinded based upon negligent or innocent misrepresentations.

The result benefited everyone. While investors achieved a new level of protection, companies gained greater access to capital because the new rules created conditions that generated confidence in the disclosures. The benefits of such a system can be seen in several studies, including the one published in 2003 by the National Bureau for Economic Research. The authors of that study compared the securities regulatory system of 49 countries and identified the chief determinant of successful financial markets to be the existence of rules facilitating private recoveries by investors.[8]

THE *KEOGLER* DECISION

In 1997, William Keogler was introduced by his attorney to Robert Krasnoff, the largest investor in and chief financial officer of a mortgage company based in Tifton, Ga., known as SGE Mortgage Funding Company (SGE). SGE used capital raised from private investors to make mortgage-secured loans to homeowners.[9] Krasnoff told Keogler that SGE had



You can now become an English Solicitor without ever leaving Georgia

How?

- Take an 8-hour open book exam, the Qualified Lawyers Transfer Test (QLTT)*
- Offered exclusively by QLTT International on US soil
- Now available in Chicago, New York and Los Angeles; and '05 dates TBA for Atlanta, Houston, Miami, and Washington D.C.

Why?

- End dependence on outsourcing
- Better serve your clients with global interests
- Increase your billing rates
- Attract new clients with cross-border work
- Open the doors to practice in 48 countries including: Bermuda, Singapore, Hong Kong, Barbados, Jamaica and the Cayman Islands.

Earn 24 MCLE credits
For registration and course materials, call 800-430-3588

www.QLTT.com

* Official qualifying transfer exam of the Law Society of England & Wales

With respect to both scienter and reliance, the Keogler decision is not only incorrect from the standpoint of statutory interpretation, but also is inconsistent with the Legislature's expressed policy of uniform interpretation of the Georgia Securities Act with the securities laws of other states.

an excellent track record, that its investors made money, and that it was a good investment.[10] Thereafter Keogler and his wife invested more than $750,000 in SGE. At no time had either of them requested SGE's financial statements to verify Krasnoff's statements regarding the company.[11]

In September 1998 Krasnoff and two other investors reviewed SGE's books and records and discovered the company was insolvent. Krasnoff filed a petition to place SGE into receivership, which later became a bankruptcy proceeding. The president of the company and several other employees pled guilty to criminal charges relating to their conduct of the company's affairs.[12]

The Keoglers filed a civil action in December 1998 against Krasnoff and others, asserting claims under O.C.G.A. § 10-5-14(a) based upon an alleged violation of O.C.G.A. § 10-5-12(a), which provides in part:

> (a) It shall be unlawful for any person:
>
> . . .
>
> (2) In connection with an offer to sell, sale, offer to purchase, or purchase of any security, directly or indirectly:
>
> . . .
>
> (B) To make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading . . . .

In its charge, the trial court instructed the jury that in order to find in favor of the Keoglers, it must find that Krasnoff acted with scienter, which the court defined as "the false statement . . . knowingly made with a false design or . . . in a severely reckless manner. Severe recklessness is limited to those highly unreasonable omissions or misrepresentations that involve *not merely simple or even an excusable negligence, but an extreme departure from the standards of ordinary care.*"[13]

The court also instructed the jury that in order to find the defendants liable, it must determine that the plaintiffs justifiably relied on the defendant's mispresentation. The court charged the jury "[t]o show justifiable reliance on the misrepresentation or omitted information sufficient to constitute securities fraud, the plaintiffs must show *that with the exercise of reasonable diligence they still could not have discovered the truth behind the fraudulent misrepresentation or omission.*"[14] The type of reliance referred to in the court's charge is customarily referred to in the securities law context as "investor due diligence."[15]

The jury returned a verdict in favor of Krasnoff and against the Keoglers, and judgment was entered on the jury's verdict. On appeal, the Court of Appeals affirmed the judgment of the trial court and upheld the jury charges quoted above as being correct statements of the law.[16]

WHY THE *KEOGLER* ANALYSIS IS FLAWED

One of the Georgia statutory provisions interpreted by the court in *Keogler*, O.C.G.A. § 10-5-12(a)(2)(B), is patterned after section 410(a)(2) of the Uniform Securities Act, which does not include the elements of scienter or reliance. Because the court incorrectly concluded that the Georgia provisions were modeled after section 10(b) of the Securities Exchange Act of 1934[17], it erroneously applied case law involving actions brought under Rule 10b-5, the Securities and Exchange Commission Rule promulgated under section 10(b).[18]

Scienter

With respect to the scienter requirement, the Court of Appeals ignored O.C.G.A. § 10-5-14(a)(2), which provides the remedy for a violation of § 10-5-12(a)(2)(B). O.C.G.A. § 10-5-14(a) states:

> A person who offers or sells a security in violation of paragraph (2) of subsection (a) of Code Section 10-5-12 is not liable under this subsection if:
>
> . . .
>
> (2) The seller did not know and in the exercise of reasonable care could not have known of the untrue statement or misleading omission.

Because this provision expressly relieves a seller from liability if he or she is not negligent in making a misrepresentation or omission, the necessary implication is that a seller *is* liable for negligent misrepresentations or omissions. In finding a requirement of scienter, or a knowing or reckless state of mind, the Court of Appeals rendered section 14(a)(2) meaningless, since any knowing or reckless misrepresentation is by definition knowable in the exercise of reasonable care. It cannot be presumed that the Legislature intended that any part of a statute would be without meaning and therefore mere surplusage.[19]

Other state Blue Sky laws patterned after section 410(a)(2) of the Uniform Securities Act have been interpreted to require only negligence as a basis for liability.[20] It is more accurate, however, to refer to it as an inverse negligence standard, since the defendant may avoid liability by proving himself free of negligence.[21]

Reliance

In finding a reasonable reliance or "investor due diligence" requirement, the Court of Appeals ignored O.C.G.A. § 10-5-14(a), which provides:

> A person who offers or sells a security in violation of paragraph (2) of subsection (a) of Code Section 10-5-12 is not liable under this subsection if:
>
> (1) the purchaser knew of the untrue statement of a material fact or omission of a statement of a material fact . . . .

This subsection clearly establishes *actual* knowledge as the standard that will defeat a purchaser's action. It does not impose any obligation of inquiry upon the purchaser. Other courts interpreting provisions based on Section 410 of the Uniform Securities Act have so concluded.[22] As the Indiana Court of Appeals said in interpreting its version of section 410(a)(2):

> [I]f the Legislature had intended to impose a duty of investigation upon the buyer, it would have expressly included such in the wording of the statute. The proscriptions of [Section 410 (a)(2)], however, embrace a fundamental purpose of substituting a policy of full disclosure for that of caveat emptor. That policy would not be served by imposing a duty of investigation upon the buyer.[23]

With respect to both scienter and reliance, the *Keogler* decision is not only incorrect from the standpoint of statutory interpretation, but also is inconsistent with the Legislature's expressed policy of uniform interpretation of the Georgia Securities Act with the securities laws of other states.[24]

Similarly, if the Court of Appeals had looked to section 12(a)(2) of the Securities Act, the statute upon which section 410(a)(2) of the Uniform Securities Act is based, it would have found that neither scienter nor investor due diligence are required elements.[25]

The Court of Appeals' chief error was relying upon its own prior decision in *GCA Strategic Investment Fund, Ltd. v. Joseph Charles & Associates, Inc.*[26] In that case, the court evaluated the plaintiff's claims of common-law fraud and securities fraud together, since they "involve similar elements."[27] The court went on, in evaluating a claim of "securities fraud under O.C.G.A. 10-5-12(a)," to adopt the elements required in a federal action under Rule 10b-5.[28]

The *Keogler* court should not have considered itself bound by *GCA Strategic Investment Fund*. The claim presented in that case was one for "securities fraud," and therefore was presumably asserted under O.C.G.A. § 10-5-12(a)(2)(A) or (C), subsections that mention fraud specifically. By contrast, O.C.G.A. § 10-5-12(a)(2)(B), does not mention fraud at all. Since it was not clear what subsection of O.C.G.A. § 10-5-12(a) the court had interpreted in *GCA Strategic Investment Fund*, the *Keogler* court could have distinguished the holding as inapplicable to any interpretation of subsection (a)(2)(B).

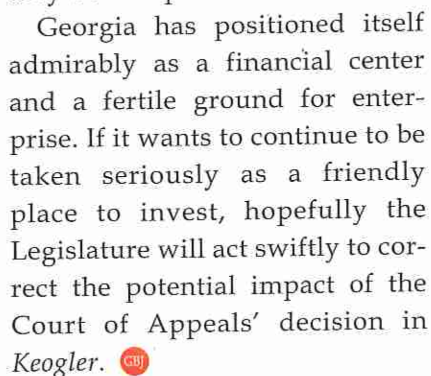
Alternatively, the court could have disapproved of its holding in *GCA Strategic Investment Fund*, which appears to be incorrect even if limited to claims under subsections 12(a)(2)(A) and (C). This is because the elements of the causes of action inferred by a reading of O.C.G.A. § 10-5-14, as discussed *supra*, apply to claims under all three subsections of section 12(a)(2). Furthermore, although claims asserted under all three subsections are sometimes referred to as "securities fraud," that phrase is technically incorrect because the statutes are patterned after a common law claim of rescission, not fraud.[29]

Prior to the decision in *Keogler*, the 11th U.S. Circuit Court of Appeals, while not ruling directly on whether the Georgia Act requires proof of scienter, correctly observed that "[a]rguably, because the language of [Section 12(a) of the Georgia Act] tracks the language of Section 410(a) of the Uniform Securities Act and Section 12(2) of the Securities Act of 1933 . . . . scienter is not required."[30] Unfortunately, the *Keogler* court reached the opposite conclusion by failing to recognize the provisions analogous to O.C.G.A. § 10-5-12(a)(2)(B).

THE IMPLICATIONS OF *KEOGLER*

Keogler leaves many Georgia investors without an effective remedy. Unlike O.C.G.A. § 10-5-12(a)(2)(B), the protections of section 12(a)(2) of the Securities Act apply only to public offerings and not private investments.[31] Additionally, unlike under the Georgia statute, successful litigants under the federal act are not entitled to an award of attorneys' fees, making a federal rescission action an unattractive alternative for all but the wealthiest investors.[32]

Furthermore, the *Keogler* decision may have significant regulatory implications. Investors who are misled often obtain assistance from their state securities regulator, the Secretary of State. Under the new decision, the Secretary of State's powers to enjoin securities issuers or to seek restitution for investors may be hampered.[33]



Georgia has positioned itself admirably as a financial center and a fertile ground for enterprise. If it wants to continue to be taken seriously as a friendly place to invest, hopefully the Legislature will act swiftly to correct the potential impact of the Court of Appeals' decision in *Keogler*.

J. Steven Parker, an attorney at the Atlanta law firm of Page Perry, LLC, is the former director of the Georgia Securities Division and the former assistant commissioner of securities for the State of Georgia.

Jason R. Doss is an attorney with the law firm of Page Perry, LLC. Page Perry, LLC, represents investors across the nation seeking to recover losses from brokers and their firms for engaging in unlawful conduct.

Endnotes

1. 268 Ga. App. 250, 601 S.E.2d 788 (2004), *cert. denied* (Jan. 24, 2005).
2. O.C.G.A. §§ 10-5-1 to -24.
3. *Diamond v. Lamotte*, 709 F.2d 1419 (11th Cir. 1983).
4. 15 U.S.C. § 77l(2) (2004).
5. *Hines v. Data Line Sys., Inc.*, 787 P.2d 8, 12 (Wash. 1990).
6. *Landry v. Thibaut*, 523 So. 2d 1370, 1380 (La. Ct. App. 1988).
7. *Id.*
8. Rafael La Porta et al., *What Works in Securities Laws*, NBER Working Paper No. 9882 (August 2003).
9. Keogler v. Krasnoff, 268 Ga. App. 250, 251, 601 S.E.2d 788, 789 (2004).
10. *Id.* Although these representations were made to Keogler's attorney, the Court of Appeals, for reasons not clear from the record, treated the representations as if they had been made to Keogler himself.
11. *Id.*
12. *Id.*
13. *Id.* at 253, 60 S.E.2d at 791 (emphasis added).
14. *Id.* (emphasis added).
15. *See generally* 12A Joseph C. Long, *Blue Sky Law* § 9:30 (2002)
16. *See Keogler*, 268 Ga. App. at 253-54, 601 S.E.2d at 791-92.
17. 15 U.S.C. § 78j (b) (2004).
18. *See Keogler*, 268 Ga. App. at 255, 601 S.E.2d at 792.
19. *See Transp. Ins. Co. v. El Chico Restaurants, Inc.*, 271 Ga. 774, 776, 524 S.E.2d 486, 488 (1999).
20. *See, e.g., Pottern v. Bache Halsey Stuart, Inc.*, 589 P.2d 1378, 1379 (Colo. Ct. App. 1978)(Colo. Rev. Stat. § 11-51-125(1) does not require scienter); *Bradley v. Hullander*, 249 S.E.2d 486, 494 (S.C. 1978)(S.C. Code Ann. § 62-309(2) requires only negligence); *Sprangers v. Interactive Techs., Inc.*, 394 N.W.2d 498, 503 (Minn. Ct. App. 1986)(Minn. Stat. § 80A.23(b) requires only negligence); *Rousseff v. Dean Witter & Co.*, 453 F. Supp. 774, 779 (N.D. Ind. 1978)(Ind. Code § 23-2-1-19 (a)(2) does not require scienter); *Kittilson v. Ford*, 608 P.2d 264, 265-66 (Wash. 1980)(no requirement of scienter).
21. *See generally* 12A Long, *supra* note 15, §9:23.
22. *See*, e.g., *Bradley*, 249 S.E.2d at 494; *Duperier v. Tex. State Bank*, 28 S.W.3d 740, 745 (Tex. App., 2000); *McCracken v. Edward D. Jones & Co.*, 445 N.W.2d 375 (Iowa Ct. App. 1989)(Iowa Securities Act does not allow reduction of damages based upon comparative fault).
23. *Kelsey v. Nagy*, 410 N.E.2d 1333, 1336 (Ind. Ct. App. 1980).
24. *See* O.C.G.A. § 10-5-10(g) (2004).
25. *See Franklin Sav. Bank of NY v. Levy*, 551 F.2d 521 (2d Cir. 1977)(no scienter required); *Cassella v. Webb*, 883 F.2d at 805,809 (9th Cir. 1989) (constructive knowledge by investor is not a bar to recovery); *MidAmerica Fed. Sav. & Loan Ass'n. v. Shearson/American Express, Inc.*, 886 F.2d 1249 (10th Cir. 1989); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 782 (11th Cir. 1988)(no reliance element in claims brought under §12(a)(2) of the Securities Act of 1933).
26. 245 Ga. App. 460, 537 S.E.2d 677 (2000).
27. *Id.* at 463, 537 S.E2d at 681.
28. *Id.* at 464, 537 S.E.2d at 682.
29. *E.F. Hutton & Co. v. Rousseff*, 537 So. 2d 978 (Fla. 1989); *see generally* 12A Long, *supra* note 15 § 9:23.
30. Diamond v. Lamotte, 709 F.2d 1419, 1423 (11th Cir. 1983)
31. *Gustafson v. Alloyd Co.* 513 U.S. 561 (1995).
32. Under Section 11(e) of the Securities Act, the court may award attorneys' fees in an action brought under Section 12(a)(2) only if it finds the defense is frivolous or was made in bad faith. *Johnson v. Yerger*, 612F.2d 953, 959 (5th Cir. 1980).
33. Although O.C.G.A. § 10-5-14 does not govern administrative or civil actions by the Secretary of State, the *Keogler* court seemed to derive the scienter requirement from O.C.G.A. § 10-5-12(a). Therefore, any action undertaken by the Secretary based upon a violation of that section would arguably require proof of the same elements as a civil action.