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Ninth Circuit Finds that the Limited Partners in a Land Development Project May Sue for Securities Fraud, but the General Partner May Not

In *Reeves v. Teuscher*, 881 F.2d 1495 (9th Cir. 1989), the United States Court of Appeals for the Ninth Circuit held that the limited partners' interests in a land development project were securities within the meaning of federal and state securities laws. However, the court held that the general partner's interest in the development was not a security. The court also found that while the evidence supported the limited partners' Washington Consumer Protection Act claims, the evidence did not support such a claim by the general partner.

Background

In 1974, Wallace Teuscher ("Teuscher") bought 2,400 acres of land known as Badger Mountain South, located in Benton County, Washington. Between October 1975 and January 1, 1976, Teuscher sold 48% of the land through his broker Edward Borkowski ("Borkowski"). Twelve unsophisticated investors bought the property as low-risk investments. In June 1977, Teuscher consolidated his assets with Asghar Sadri ("Sadri"), an experienced real estate investor, and formed a general partnership called Triangle Land Company ("Triangle"). Teuscher contributed his remaining 52% interest in the Badger Mountain South property to the new partnership. In 1981, a limited partnership called BMS, Ltd. ("BMS") was formed to develop the Badger Mountain South property. The twelve investors who purchased 48% of the Badger Mountain South property became limited partners and Triangle became the general partner in BMS. Thus, Teuscher and Sadri were general partners in Triangle which, in turn, was the general partner in BMS.

In 1984, Sadri and the twelve limited partners sued Teuscher and Borkowski (herein referred to collectively as "Teuscher") in the United States District Court for the Western District of Washington. The plaintiffs alleged that Teuscher violated federal, Washington, and Oregon securities laws as well as Washington's Consumer Protection Act by misrepresenting the property value and investment potential of the Badger Mountain South property. After a three-week trial, the jury rendered a verdict in favor of the plaintiffs on all of their claims. Teuscher appealed the jury's verdict to the United States Court of Appeals for the Ninth Circuit.

The Investment Contract Definition of a Security

On appeal, Teuscher argued that the plaintiffs could not recover on their securities law claims because their interests in Badger Mountain South were not securities. The court noted that federal, Oregon and Washington statutory definitions of a security include investment contracts. 15 U.S.C. § 77b(1) (1989); Wash. Rev. Code § 21.20.005(12) (1989); Or. Rev. Stat. § 59.015(16)(a) (1988). An interest satisfies the investment contract definition adopted by the federal and Washington courts when the interest is (1) an investment of money (2) in a common undertaking (3) with profits to come solely from the efforts of others. *S.E.C. v. W.J. Howe Co.*, 328 U.S. 293, 301 (1946). Oregon's definition of an investment contract differed from the federal and Washington definitions only in that Oregon required the profits to come "through the management and control of others," rather than "solely from the efforts of others." *Pratt v. Kross*, 276 Or. 483, 555 P.2d 765, 773 (1976).

The Twelve Limited Partners. Teuscher argued that the twelve limited partners' interests did not meet the third element of the investment contract test. The third element is met when the efforts made by persons other than the investor are the efforts which significantly determine the outcome of the enterprise. Teuscher argued

that the twelve limited partners' efforts significantly affected the success or failure of BMS. The court noted that although the limited partners attended meetings and approved Teuscher's plans for the development, none of the limited partners were sophisticated business people. Furthermore, the limited partners testified that Teuscher represented himself as the manager of BMS, that they relied on Teuscher's purported expertise to make the enterprise a success, and that they merely supplied the capital. The court held that because the twelve limited partners' efforts played almost no role in the success or failure of BMS, their investment in BMS constituted an investment contract.

In order to establish federal and state securities fraud, the twelve limited partners also had to prove that they relied on Teuscher's misrepresentations and omissions in deciding to invest. Teuscher argued that the twelve limited partners had failed to prove this element of their securities fraud case. The court found convincing the limited partners' testimonies that Teuscher had lied to them about the value of the property and its potential as a low-risk investment, and that the investors relied on that information when they decided to invest in BMS.

The court, therefore, upheld the jury's verdict on the twelve limited partners' securities fraud claims.

The General Partner. On the other hand, the court held that due to Sadri's general partnership agreement with Teuscher, Sadri's interest did not meet the third element of the investment contract test. In making this determination, the court focused on the language of the general partnership agreement between Sadri and Teuscher, rather than on how the partnership operated its business.

The general partnership agreement referred to Sadri and Teuscher as "co-partners" with rights governed by the Washington Uniform Partnership Act. Wash. Rev. Code § 25.04 (1989) ("the Partnership Act"). The co-partner interests of Sadri and Teuscher, as defined by the Partnership Act,

included equal rights to manage and control the partnership (Wash Rev. Code §§ 25.04.180(5) and .240(3)), equal access to the business records (Wash Rev. Code § 25.04.190), and limited transferability of the general partnership interests (Wash Rev. Code § 25.04.180(7)). The general partnership agreement also provided that Sadri and Teuscher were to share the profits and losses equally. In addition, the court noted that although Sadri presented evidence that Teuscher had primary responsibility for managing BMS, Sadri presented no evidence that Teuscher prevented Sadri from exercising his partnership rights. Therefore, because Sadri failed to establish the third element of the investment contract definition, the court held that Sadri could not recover under either the federal or state securities laws.

The Washington Consumer Protection Act

Sadri and the twelve limited partners alleged that Teuscher's misrepresentations also violated Washington's Consumer Protection Act. Wash. Rev. Code §§ 19.86.010 - .920 (1989) ("the CPA"). Under the CPA, the plaintiff must prove (1) an unfair or deceptive act or practice (2) in trade or commerce (3) which affected the public interest; (4) injury to plaintiff; and (5) a causal connection between the unfair or deceptive act and the injury suffered. *Travis v. Washington Horse Breeders Ass'n, Inc.*, 111 Wash. 2d 396, 759 P.2d 418, 422-423 (1988). On appeal, Teuscher argued that Sadri and the twelve limited partners had not established the first, third and fifth elements of the test. The court rejected Teuscher's argument with respect to the limited partners, but agreed that Sadri's claim failed because he did not establish that the deceptive acts affected the public interest.

The Twelve Limited Partners. The court stated that to prove the first element, the plaintiff must show that the alleged act had the capacity to deceive a substantial portion of the public. The plaintiff, however, need not demonstrate that the defendant actually in-

tended to deceive anyone. The court held that the twelve limited partners satisfied this first element by showing that the Teuscher's misstatements were made to many investors. In fact, Teuscher sought out any investor who had large amounts of cash. Thus, a substantial portion of the public could have been deceived by Teuscher's misstatements.

Next, the court addressed the public interest element of the twelve limited partners' CPA claims. The defendant's acts affected the public interest if there is a likelihood that others were injured in the same manner as the plaintiffs. The court identified four factors to be considered in determining whether the required public interest element of the CPA claim was satisfied: (1) the act was committed in the defendant's business; (2) the defendant advertised to the public; (3) the plaintiff was actively solicited by the defendant; and (4) the plaintiff and defendant occupied unequal bargaining positions. Not all of these factors need be met, nor is any one dispositive.

In this case, Teuscher acted in the scope of his business. He did not advertise to find investors, but he nonetheless actively solicited investors. Teuscher occupied a superior bargaining position because the twelve limited partners were not sophisticated in the real estate business and Teuscher was their only source of information about the investment. Taking all of the factors into account, the court found that the twelve limited partners had adequately established the public interest element of their CPA claims.

Finally, the court held that the twelve limited partners had established the causation element of a CPA claim. The court found that had the twelve limited partners known the truth about BMS, they would not have invested. Therefore, the twelve limited partners could recover under the CPA.

The General Partner. The court held that Sadri, however, had failed to prove his CPA claim. His participation in the project was not actively solicited by Teuscher. Sadri was a sophisticated businessman with years of experience in

real estate development. He negotiated extensively with Teuscher before forming the general partnership. Thus, the court held that Sadri failed to meet the public interest element of his CPA claim because he did not prove that Teuscher had superior bargaining power. Therefore, the court reversed the jury's decision and directed judgment for Teuscher on Sadri's CPA claim.

Sean J. Hardy

Tenth Circuit Holds that Federal Common Law Limits Uninsured Depositors' Recovery from Insolvent Lending Institution to Pro Rata Share of Assets

In *Downriver Community Federal Credit Union v. Penn Square Bank*, 879 F.2d 754 (10th Cir. 1989), the United States Court of Appeals for the Tenth Circuit held that uninsured depositors who were fraudulently induced to deposit money into the now-defunct Penn Square Bank were entitled to recover only a pro rata share of the bank's assets. In so holding, the court stated that federal common law, rather than state law, governs the post-insolvency relationship between national banks and their depositors.

Background: Credit Unions were Fraudulently Induced to Purchase Certificates of Deposit

In December 1981, Downriver Community Federal Credit Union ("Downriver") and Wood Products Credit Union ("Wood Products") received glowing financial reports regarding the Penn Square Bank of Oklahoma City ("Penn Square"). The reports were made by investment brokers whose fees were paid by Penn Square. In reliance upon these reports, Downriver and Wood Products purchased 4.5 million dollars in Penn

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