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of proof on this issue, the Fourth Circuit concluded that Matthew had a FAPE after his IEP program was implemented.

Because the court found that Matthew was not receiving a FAPE at the time he was hospitalized, the court next examined the issue of whether the Tices' placement of Matthew in Roanoke Valley Psychiatric Center and in the Blue Ridge Center properly served to meet the Act's educational goals. The Fourth Circuit found the record to be factually inadequate for a determination of whether the placement was proper. However, the court remanded this issue to the district court for further consideration because the district court's previous finding on the issue was based upon two incorrect premises. First, the Fourth Circuit found that the district court had incorrectly based its finding on the fact that Matthew was hospitalized while he received educational instruction. The Fourth Circuit found this premise to be incorrect because the Act's definition of special education expressly includes instruction in hospitals and institutions. Second, the Fourth Circuit found that the district court incorrectly deferred to the judgment of the educational authorities before the authorities had developed an IEP. The Fourth Circuit stated that at the time of Matthew's hospitalization, the School Board had made no professional decision regarding a proper IEP. Therefore, the School Board had not made a decision to which deference was due.

Thus, the Fourth Circuit in *Tice* developed a test for determining whether a handicapped child was entitled to reimbursement for medical expenses under the Education of All Handicapped Children Act of 1975. The court held that parties claiming reimbursement under the Act must prove two conditions before obtaining reimbursement for a child's educational expenses during hospitalization. First, the party requesting reimbursement must show that the child was not receiving a FAPE when the hospital renders educational services. Second, the party requesting reimbursement must prove that the child's placement was proper under the Act. If the party requesting reimbursement can meet this burden of proof, then the party is entitled to reimbursement to the extent that the expenses incurred during the hospitalization were incurred for educational services. The Eleventh Circuit followed the *Tice* decision in *Doe v. Alabama State Dep't of Educ.*, 915 F.2d 651, 662 (11th Cir. 1990). The Eleventh Circuit in *Doe*, like the Fourth Circuit in *Tice*, deferred to the educational expertise of the school board after an IEP was already in place.

SECURITIES LAW

Section 5 of the Securities Act of 1933, 15 U.S.C. section 77e (1990) (section 5), requires a person to file a registration statement for all securities and makes it unlawful for any person, directly or indirectly, to sell or deliver after sale an unregistered security. Section 12 of the Securities Act of 1933, 15 U.S.C. section 77*l* (1990) (section 12), provides civil liabilities for violations of section 5. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. section 78j (1990) (section 10(b)), makes it unlawful for any person, directly or indirectly, to use any manipulative or deceptive device in selling an unregistered security that violates rules or regulations that the Commission may promulgate. Rule 10b-5, promulgated under the Securities Exchange Act of 1934 (rule 10b-5), makes it unlawful for any person, directly or indirectly, in connection with the purchase or sale of any security, to defraud any person. Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. 78t(a) (1990) (section 20), makes any person who, directly or indirectly, controls another person liable under any provision of the Securities Exchange Act of 1934 jointly and severally liable with the controlled person unless the controlling person acted in good faith and did not directly or indirectly induce the violation or cause of action.

In *Hunt v. Miller*, 908 F.2d 1210 (4th Cir. 1990), the United States Court of Appeals for the Fourth Circuit considered consolidated appeals involving claims of securities law violations of section 5, section 12, section 10(b), and rule 10b-5 arising from the sale of real estate partnership interests. In addition to the federal securities claims, the Fourth Circuit considered claims involving violations of North Carolina securities law, common law fraud, breach of fiduciary duty, and professional and ordinary negligence. James Bradley (Bradley) owned an option on certain real estate bordering Lake Lanier in Dawson County, Georgia, secured by a $30,000 nonrefundable deposit. Bradley approached William Jordan (Jordan), a broker for Interstate Securities Corporation (Interstate), about financing arrangements available through Interstate. On the basis of this inquiry, Bradley forfeited his option on the Lake Lanier property and the $30,000 nonrefundable deposit and entered into a new purchase contract for the property requiring a $330,000 nonrefundable deposit and a purchase price balance of $3.3 million with financing handled through Interstate.

Jordan, knowing that Interstate did not handle property development deals, attempted to arrange the financing through several of his Interstate clients. Jordan represented to these clients that Dawson Realty, a limited partnership of which he and Bradley were general partners, owned the Lake Lanier property, and that he was selling limited partnership units to raise funds needed as cash collateral on a loan. On this basis, three of Jordan's clients, Arthur Hunt (Hunt), Edgar Ramsey (Ramsey), and Manual Woodworker's, Inc. (Woodworker's), purchased five partnership units totalling $400,000, and Jordan claimed that a mortgage on a portion of the Lake Lanier property secured these limited partnership units. Jordan transferred these proceeds to the owner of the Lake Lanier property to cover the nonrefundable $330,000 deposit.

When Jordan was unable to obtain sufficient funds to cover the remaining purchase price, the entire deal collapsed with Hunt, Ramsey, and Woodworker's losing their entire investment. Subsequently, Hunt, Ramsey, and Woodworker's sued Jordan, Bradley, and Interstate, alleging federal securities law violations. Bradley cross-claimed against Jordan and Interstate. Hunt, Ramsey, and Woodworker's also sued Michael Miller, the attorney that Jordan hired for the Dawson Realty project. Miller acted as the attorney for all Dawson Realty transactions, and on two separate occasions Miller advised both Ramsey and Woodworker's that the Dawson property represented a good deal. When Miller learned that Jordan did not have the funds to proceed with the project, Miller notified Hunt, Ramsey, and Woodworker's that they may have been defrauded.

After a three week trial, the district court submitted special interrogatories to the jury. The jury found Jordan liable for selling unregistered securities and for securities fraud, and the jury found Miller professionally negligent. As for Interstate, the jury determined the following: that Interstate was a controlling person within the meaning of section 20; that Interstate had failed to properly supervise Jordan; that in his dealings, Jordan acted in the same manner as that authorized by Interstate and within the scope of his apparent authority as an Interstate employee. As for Bradley, the jury found him not liable for the investor's losses and found that Jordan had committed a fraud against Bradley. The jury also returned punitive damages awards for the investors and Bradley in the special verdict. Based on the jury's special verdict the district court entered judgment awarding compensatory damages of $400,000 to Hunt, Ramsey, and Woodworker's and $30,000 to Bradley. The district court held that Jordan, Miller, and Interstate were jointly and severally liable for the compensatory damages. However, the district court held that Miller was not jointly and severally liable for the $30,000 to Bradley and for $160,000 to Hunt and Ramsey because Miller was not involved in the initial Dawson Realty transactions. The district court also entered judgment on the punitive damages holding Jordan and Interstate jointly and severally liable for $320,000 to Woodworker's, $480,000 to Hunt and Ramsey, and $70,000 to Bradley. Additionally, the district court ordered Jordan and Interstate to pay the attorney fees for Hunt, Ramsey, and Woodworker's. Interstate and Miller appealed the district court's judgement.

On appeal, the Fourth Circuit first addressed the district court's denial of Interstate's motion for a directed verdict. Interstate had moved for a directed verdict in its favor claiming that Interstate was not liable to the investors because the investors knew that Interstate was not involved in the deal. On the basis of *Cooper v. Dyke*, 814 F.2d 941, 944 (4th Cir. 1987), the Fourth Circuit refused to disturb the district court's ruling unless the Fourth Circuit concluded that on the evidence presented, without weighing the evidence or assessing the credibility of the witnesses, a reasonable jury could have returned a verdict only for the defendants. After reviewing the record, the Fourth Circuit found that abundant evidence existed to support the district court's decision not to direct a verdict for Interstate and to support the subsequent verdict by the jury. The record showed that Jordan was an employee and representative of Interstate during the entire transaction, and that Jordan performed all of his dealings from his Interstate office. Furthermore, in at least one instance, Jordan transferred money from an existing Interstate account to pay for a limited partnership unit, and the managers responsible for monitoring all Interstate transactions never questioned the appearance of this transaction on Interstate's books despite their admission that they had to supervise Jordan more than any other Interstate employee.

Interstate next asserted that under *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388 (4th Cir.), *cert. denied*, 444 U.S. 868 (1979), it was entitled to a new trial because of an omission from the jury instructions. In *Carpenter* the Fourth Circuit held that a controlling person may avoid liability under section 20 by having in place an adequate system of internal control and by maintaining the system in a diligent manner. Based on *Carpenter*, Interstate contended that the district court should have instructed the jury to find Interstate liable only if the jury believed that Interstate culpably participated in the transaction. Reviewing this claim, the Fourth Circuit stated that Interstate misread the holding in *Carpenter* as requiring a finding of culpable negligence, and the Fourth Circuit held that the district court's jury instruction adequately tracked the holding in *Carpenter*. The district court's jury instruction asked the jury to determine if Interstate took adequate precautionary measures to prevent an employee from causing an injury, supervised Interstate employees in an adequate and reasonable fashion, and maintained this system in a diligent manner. Interstate also claimed that the district court erred in not instructing the jury on the possible contributory negligence of the investors. The Fourth Circuit concluded that this omission was harmless error because the verdict against Interstate rested on multiple theories of liability.

Interstate also appealed the district court's award of punitive damages to the investors and Bradley. The Fourth Circuit upheld the punitive damage award on the basis of the plaintiffs' common law claims rather than their securities claims because punitive damages are unavailable under federal securities law claims. In *Carras v. Burns*, 516 F.2d 251, 259-60 (4th Cir. 1975), the Fourth Circuit held that section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. section 78bb(a) (1990), forecloses punitive damages in a rule 10b-5 action.

As for the remaining issues on appeal, the Fourth Circuit upheld the award of attorney's fees under section 78A-56(a)(2) of the North Carolina Securities Act, N.C. GEN. STAT. section 78A-56(a)(2) (1990). Section 78A-56(c) of the North Carolina Securities Act, N.C. GEN. STAT. section 78A-56(c) (1990) (section 78A-56(c)), provides an affirmative defense against the award of attorney's fees if the controlling person proves that they did not know of the facts giving rise to liability. Interstate claimed that they sustained the burden of proof required to invoke the affirmative defense that section 78A-56(c) provides. The Fourth Circuit held that under *Walker v. Action Indus.*, 802 F.2d 703, 710-11 (4th Cir. 1986), *cert. denied*, 479 U.S. 1065 (1987), Interstate could not invoke the defense on appeal because Interstate failed to plead the defense and did not submit the defense to the jury in the special interrogatories at trial. As for Miller, the Fourth Circuit agreed that the district court erred in omitting a jury instruction about Miller's contributory negligence defense. The Fourth Circuit, relying on *United Leasing v. Miller*, 60 N.C. App. 40, 44-54, 298 S.E.2d 409, 412-18 (1982), *rev. denied*, 308 N.C. 194, 302 S.E.2d 248 (1983), concluded that North Carolina law recognizes contributory negligence as a defense to professional negligence. Weighing the evidence in the record in the light most favorable to Miller, the Fourth Circuit held that the evidence reasonably supported an inference of contributory negligence. Because the district court failed to admit the appropriate instruction, the Fourth Circuit reversed the judgement against Miller and remanded for a new trial as to Miller.

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To obtain federal question jurisdiction under the Securities Act of 1933, 15 U.S.C. section 77 *et. seq.* and the Securities Exchange Act of 1934, 15 U.S.C. section 78 *et.seq.*, a plaintiff's claim must involve a security. Under both acts, an investment contract qualifies as a security. In *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-299 (1946), the Supreme Court held that a contract is an investment contract whenever a "person [1] invests his money [2] in a common enterprise [3] and is led to expect profits solely from the efforts of the promoter or a third party. . . ." The third prong of the *Howey* test refers to the degree of control an investor has over the investment enterprise. Because the Supreme Court did not clearly articulate in *Howey* whether courts should determine control by looking only to the terms of the contract or by also looking to outside circumstances, courts have had difficulty applying the third prong of the *Howey* test.[166]

In *Bailey v. J.W.K. Properties, Inc.*, 904 F.2d 918 (4th Cir. 1990), the Fourth Circuit examined whether, under the third prong of the *Howey* test, only the language of the contract or the actual circumstances surrounding the contract are determinative of the type of control an investor has over an investment enterprise. The Fourth Circuit recognized that when considering either the contract or the circumstances surrounding the contract, the examining court must determine if the investor actually had control over the profitability of the enterprise. If an investor has control over the profitability of the enterprise, the investor does not have an investment contract. Consequently, the investor does not have a security and, therefore, will have no cause of action under the Securities Act of 1933 or the Securities Exchange Act of 1934.

The events leading to this appeal began when the plaintiffs, individual businessmen, entered into two contracts with the defendant regarding the defendant's cattle breeding program. In the first contract, the plaintiffs agreed to purchase cattle embryos from the defendant. The contract provided that the plaintiffs could select their own embryos. In the second contract, the defendant agreed to care for and market the cattle produced by the embryos. This agreement provided that the plaintiffs could direct the care of the cattle and could terminate the agreement at any time. The plaintiffs relied upon the defendant to select embryos suitable for crossbreeding and to crossbreed the resultant cattle. The plaintiffs expected to earn a profit

166. *See* Rivanna Trawlers Unlimited v. Thompson Trawlers, 840 F.2d 236 (4th Cir. 1988) (stating that courts should not always literally construe the Supreme Court's *Howey* test); SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (considering whether to adopt a narrow or broad construction of *Howey* test); Waterman v. Alta Verde Industries, Inc., 643 F.Supp. 797, 804 (E.D.N.C. 1986), *aff'd*, 833 F.2d 1006 (4th Cir. 1987) (deciding to consider surrounding circumstances of investment to determine if investment contract was involved).

by developing a crossbreed of cattle and selling the embryos of the new crossbred cattle.

The plaintiffs alleged that the defendant abandoned the breeding program due to unfavorable changes in the tax laws. The plaintiffs further alleged that the defendant made inadequate disclosures concerning the cattle breeding program in violation of federal securities laws. The defendant moved to dismiss the action for failure to state a claim under the federal securities laws, arguing that the cattle breeding contracts were not investment contracts or any other type of security. The United States District Court for the Western District of Virginia appointed a magistrate to conduct discovery on the issue of whether the plaintiffs' contracts with the defendant qualified as securities. The magistrate found that the contracts were an investment in a common enterprise, satisfying the first two prongs of the *Howey* test. Under the third prong of the *Howey* test, however, the magistrate determined that the plaintiffs did not expect profits solely from the efforts of the defendant. The magistrate held that, according to the language of the contract, plaintiffs had the authority to exercise control over their investments. The magistrate determined, therefore, that the plaintiffs did not expect profits solely from the efforts of the defendant. Consequently, the magistrate held that the plaintiffs had no investment contract and no claim under the federal securities laws. The district court adopted the magistrate's views and granted the defendant's motion to dismiss. The plaintiffs appealed to the United States Court of Appeals for the Fourth Circuit, arguing that they had no control over the profitability of the investment enterprise because circumstances surrounding the agreements effectively prevented them from exercising control.

To resolve the dispute, the Fourth Circuit looked to the purpose of the federal securities laws and to the language of the Supreme Court's decision in *Howey*. The Fourth Circuit found that one of the primary goals of the federal securities laws is to protect investors through full disclosure of the information investors need to make informed decisions. In *Howey* the Supreme Court recognized that investors who do not have control over their investments need "full and fair disclosure" more than investors who are able to control their investments. The Supreme Court further stated in *Howey* that an investment contract "embodies a flexible rather than static principle," and that in determining whether an investment contract exists a court should consider "economic reality" over form. Thus, the Fourth Circuit concluded that the three pronged *Howey* test allows courts to consider the practicalities and realities of the contractual relationship in addition to the language of the contract.

The Fourth Circuit further supported its decision to consider the surrounding circumstances of an agreement by distinguishing *Bailey* from *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988), in which the Fourth Circuit held that certain partnership interests were not investment contracts. In *Rivanna* a partnership agreement allowed the general partners to exercise majority control, and the Fourth Circuit found that the partners did in fact exercise their authority. The Fourth

Circuit determined that in *Bailey*, however, the investors acted as individuals and, although the investors possessed authority under the contract to control their investments, the investors did not exercise their authority.

After distinguishing *Bailey* from *Rivanna*, the Fourth Circuit then examined whether the plaintiffs could have, but chose not to, exercise their authority. The Fourth Circuit found that the plaintiffs were experienced businessmen and had the knowledge to raise and sell cattle for slaughter. The Fourth Circuit found, however, that the plaintiffs had no expertise in selecting embryos for a cattle breeding program or in managing a cattle breeding program. The defendant, on the other hand, had the special expertise needed to select embryos which would produce maximum profits. This fact tended to make the plaintiffs rely heavily on the defendant's expertise. According to the Fourth Circuit, another limitation on plaintiffs' control over the enterprise was the lack of available alternatives. The plaintiffs stated that they would have had to travel to Texas to find a breeding program similar to the defendant's. The Fourth Circuit also found that plaintiffs had limited control over their investment because of the interdependence present in a cattle crossbreeding program. That is, because no single investor owned enough cattle to manage his own breeding program, the program required coordination by one entity. The only available organizer was the defendant, Albemarle Farms. The Fourth Circuit concluded that because of plaintiffs' lack of experience and expertise, the lack of readily available alternative sources, the need for one entity to coordinate the cattle breeding program, and the circumstance that plaintiffs acted as individuals, that plaintiffs were not realistically able to exercise the authority granted by the agreements. The Fourth Circuit determined, therefore, that the agreements qualified as investment contracts and that the defendant's motion to dismiss should not have been granted.

In *Bailey* the Fourth Circuit held that courts should consider the realities limiting plaintiffs control over investments in determining whether an agreement is an investment contract. Following its decision in *Bailey*, the Fourth Circuit is in agreement with the Ninth Circuit regarding consideration of the circumstances surrounding a contract to determine the degree of control an investor exercises over his investments.[167] Both circuits have held that courts should look to surrounding circumstances to determine whether investors could in fact exercise control over their investments. The Fourth Circuit's *Bailey* decision discourages investors from passively letting third parties make decisions by requiring investors to prove that circumstances effectively precluded them from exercising their authority before the court will find that an investment contract existed. The *Bailey* decision also circumvents the prospect that investment promoters could limit their disclosure obligations through skillful contract drafting.

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167. SEC v. Glenn W. Turner Enter., Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (adopting a broad interpretation of *Howey* test).