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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

LC2020-000322-001 DT 12/21/2021

HONORABLE DANIEL J. KILEY

CLERK OF THE COURT
P. McKinley
Deputy

SMITH & COX L L C
WILLIAM ANDREW SMITH
KIMBERLY ANN SMITH
CHRISTOPHER SPENCE COX
BETH COX

MARK D CHESTER

v.

THE ARIZONA CORPORATION COMMISSION (001)

JAMES DUANE BURGESS

JUDGE KILEY
OFFICE OF ADMINISTRATIVE HEARINGS
REMAND DESK-LCA-CCC

AFFIRMED AS MODIFIED & REMANDED

Arizona Corporation Commission Decision No. 77747

Appellants Smith & Cox, LLC ("Smith & Cox"), William Andrew Smith ("W.A. Smith"), Christopher Spence Cox ("Cox"), Kimberly Ann Smith, and Beth Cox (collectively, "Appellants") appeal from the October 2, 2020 Opinion and Order (the "Final Decision") of Appellee Arizona Corporation Commission ("Appellee" or the "Commission"). For the following reasons, this Court modifies the restitution award and otherwise affirms.

FACTUAL BACKGROUND & PROCEDURAL HISTORY

Viewed in the requisite light most favorable to sustaining the administrative decision, *see Shorey v. Ariz. Corp. Comm'n*, 238 Ariz. 253, 258 ¶ 14 (App. 2015), the relevant facts can be summarized as follows:

W.A. Smith and Cox formed Smith & Cox, a limited liability of which they were both managing members, in January 2009. Index of Record ("I.R.") A-92, Final Decision at pp. 23, 26-27, 55; I.R. C-17, Articles of Organization. Later that year, Smith & Cox became licensed in Arizona as an investment advisor, and W.A. Smith became licensed as an investment advisor representative. I.R. A-92, Final Decision, at p. 55; *see also* I.R. C-18, C-19.

From October 2013 through November 2015, W.A. Smith and Smith & Cox sold 53 income stream investments to 21 clients for a total of $2,776,952.62. I.R. A-92, Final Decision, at p. 55. As Cox later testified, he was present during the meetings that W.A. Smith had with potential investors at the Smith & Cox office to present the income stream investments. I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at p. 772.

An income stream investment consisted of a transaction pursuant to which a veteran who was receiving an income stream from a military retirement pension or disability benefits would appoint BAIC, Inc. ("BAIC") or SoBell Corp. ("SoBell") as his or her agent to sell part of the future payments from that income stream in exchange for a discounted lump sum payment.[1] I.R. A-92, Final Decision, at p. 6. W.A. Smith, Smith & Cox, and other promoters would match an investor with a particular veteran, and the former would purchase the latter's future income stream for a specific term. *Id.* at pp. 6-7. The investor (*i.e.*, buyer) and the veteran (*i.e.*, seller) would enter into a Contract for the Sale of Payments which required the seller to direct his or her monthly payments into an escrow account maintained by a South Carolina law firm named Upstate Law Group, LLC ("ULG"). *Id.* After deducting fees and other charges, ULG would then distribute the monthly payments to the buyer. *Id*. If the seller were to default by stopping the deposit on his or her monthly pension or disability payments into ULG's escrow account, Performance Arbitrage Company ("PAC") was to make the payments to the buyer for the remaining duration of the investment term. *Id*. at p. 7. *See also* I.R. C-88, Purchase Assistance Agreement between BAIC and investor, at pp. ACC001506 – ACC001510.

Investors were told that the income stream investments were "totally vetted" and would yield a rate of return of at least 5%. I.R. A-92, Final Decision, at p. 9; I.R. C-87 at p. ACC003508 (Purchase Application listing "Effective Rate of Return" as "5%"); I.R. C-88 at p. ACC001487 (Purchase Application listing "Effective Rate of Return" as "5%"); I.R. C-89 at p. ACC005279 (Purchase Application listing "Effective Rate of Return" as "5%"); I.R. C-51

[1] The principal of BAIC and SoBell was Andrew Gamber ("Gamber"). I.R. A-92, Final Decision, at pp. 18, 20, 56.

(Income Stream Investment Summary reflecting "Annual Eff. Rate[s] of Return" ranging from 5.00% to 8.45%).

W.A. Smith and Cox failed, however, to disclose other information to investors, including that (1) federal law might prohibit the sale or assignment of veterans' pension or disability benefits; (2) numerous Cease and Desist Order and/or Consent Orders had been entered in at least four states against Gamber and his previous company for securities violations involving the sale of military pension and disability benefits; and (3) since June 2013, W.A. Smith has been the subject of an I.R.S. lien for unpaid taxes in the amount of over $125,000. I.R. A-92, Final Decision, at pp. 18-20, 40-41, 56-57, 59. *See also* 38 U.S.C. § 5301(a)(1) ("Payments of benefits due or to become due under any law administered by the Secretary [of Veterans Affairs] shall not be assignable except to the extent specifically authorized by law[.]").

Contrary to Appellants' representations about the purportedly low-risk nature of the investments, the default rate on the investments was high, and many of the investors lost much, if not the majority, of their investments. Investor Susan Hill, for example, testified that she received a total of only $64,047.63 back from her $106,000.00 investment. I.R. A-92, Final Decision, at p. 16. Investor Dean Hebb testified that he received less than $25,000 in return for his $128,000 investment. *Id*. at p. 11.

The Securities Division of the Commission (the "Division") initiated administrative proceedings in 2018 with the filing of a Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist, Order for Restitution, Order for Administrative Penalties, Order of Revocation, and Order for Other Affirmative Action against W.A. Smith, Cox, Smith & Cox, Gamber, BAIC, SoBell, ULG, and others. I.R. A-92, Final Decision, at pp. 2-3. At the conclusion of the administrative proceedings, the Commission issued the Final Decision in which it determined, *inter alia*, that the income stream investments constitute "securities" within the meaning of A.R.S. § 44-1801(27); that W.A. Smith and Smith & Cox offered and sold securities in violation of A.R.S. §§ 44-1841 and -1842; that W.A. Smith and Cox directly or indirectly controlled Smith & Cox; and that Cox had failed to meet his burden of proving a "good faith" defense to "control person" liability pursuant to A.R.S. § 44-1999(B). *Id*. at pp. 59-60. In the Final Decision, the Commission ordered various remedies, including restitution in the principal amount of $2,574,103.38, for which W.A. Smith and Cox, along with their marital communities, Smith & Cox, and other respondents would be jointly and severally liable. *Id*. at pp. 60-61.

Appellants filed a timely Notice of Appeal. This Court has jurisdiction pursuant to Ariz. Const. art. 6, § 14 and A.R.S. §§ 12-124(A), 12-905(A), and 44-1981.

ISSUES PRESENTED

Did the Commission abuse its discretion or otherwise err in concluding that the pension income stream transactions constitute "securities" as defined in A.R.S. § 44-1801(27)?

Did the Commission abuse its discretion or otherwise err in determining that Cox is liable under a "control person" theory of liability?

Did the Commission abuse its discretion or otherwise err in determining the amount of restitution to be awarded?

STANDARD OF REVIEW & APPLICABLE LEGAL PRINCIPLES

The Court's review of a final decision by the Commission is limited to "whether the administrative action was illegal, arbitrary, capricious or involved an abuse of discretion." *Hirsch v. Ariz. Corp. Comm'n*, 237 Ariz. 456, 461-62 ¶ 18 (App. 2015) (citation and internal quotations omitted). An abuse of discretion will be found if the record does not provide substantial support for the agency's decision, or if the agency committed an error of law in making its decision. *See Carey v. Soucy*, 245 Ariz. 547, 552 ¶ 19 (App. 2018) ("A court abuses its discretion where the record fails to provide substantial support for its decision or the court commits an error of law in reaching the decision."). The party challenging the Commission's decision has the "burden" of "show[ing] by clear and satisfactory evidence that the Commission's decision was unreasonable or unlawful." *Ariz. Corp. Comm'n v. Pacific Motor Trucking Co.*, 116 Ariz. 465, 467 (App. 1977).

"In reviewing the facts determined by" the Commission, the reviewing court does not "reweigh the evidence," and will affirm the decision "if substantial evidence supports" it. *Nutek Info. Sys., Inc. v. Ariz. Corp. Comm'n*, 194 Ariz. 104, 107 ¶ 15 (App. 1998). *See also DeGroot v. Ariz. Racing Comm'n*, 141 Ariz. 331, 336 (App. 1984) ("[I]n order to reverse the agency's decision, the trial court must find that there was no substantial evidence to support the agency decision."). The "substantial evidence" required to affirm an agency decision will be found to exist "if either of two inconsistent factual conclusions are supported by the record." *Eastern Vanguard Forex, Ltd. v. Ariz. Corp. Comm'n*, 206 Ariz. 399, 409 ¶ 35 (App. 2003). *See also Wales v. Ariz. Corp. Comm'n*, 249 Ariz. 263, 269 ¶ 19 (App. 2020) ("Substantial evidence exists if the evidentiary record supports the decision, even if the record would also support a different

conclusion."). Moreover, a court reviewing a decision by the Commission "view[s] the evidence in the light most favorable to upholding the Commission's decision." *Shorey*, 238 Ariz. at 258 ¶ 14.

The determination of the credibility of witnesses "is a matter within the province of the trier of fact," *Pugh v. Cook*, 153 Ariz. 246, 247 (App. 1987), and the trier of fact may accept all, part, or none of a particular witness's testimony. *Callender v. Transpacific Hotel Corp.*, 179 Ariz. 557, 562 (App. 1993).

Courts review questions of law *de novo*. A.R.S. § 12-910(F).

An administrative agency's decision will be affirmed if it is correct for any reason, even a reason not relied upon by the agency itself. *See Lewis v. Ariz. St. Personnel Bd.*, 240 Ariz. 330, 334 ¶ 15 (App. 2016) (administrative agency's decision "will [be] affirm[ed] if any reasonable interpretation of the record supports the decision"); *BNSF Ry. Co. v. Ariz. Corp. Comm'n*, 228 Ariz. 481, 485 ¶ 12 (App. 2012) ("The court of appeals will affirm the trial court's decision if it is correct for any reason[].") (citation and internal quotations omitted).

DISCUSSION

A. The Commission Did Not Commit an Error of Law, or Abuse Its Discretion, in Determining that the Investments Constitute "Securities" Within the Meaning of the Act.

In Appellants' Opening Brief, Appellants argue, first, that the income stream investment at issue in this case "is not a security and, therefore the Arizona Securities Act does not apply." Opening Brief ("Opening Brief" or "O.B.") at p. 16. In response, Appellee argues that "[t]he Commission correctly found" that the investments at issue constitute "securities" as the term is defined in A.R.S. § 44-1801(27). Answering Brief ("Answering Brief" or "A.B.") at pp. 17, 20, 26.

A.R.S. § 44-1801(27) defines "security" to include, *inter alia*, "any note," "evidence of indebtedness," or "investment contract." The Commission determined that the income stream investments at issue here fall within the definition of each of these three categories of "securities." I.R. A-92, Final Decision, at pp. 34-35, 36 ("[W]e find that the income stream investments are…investment contracts[,]…evidences of indebtedness[,]…[and] notes within the meaning of A.R.S. § 44-1801(27)."). Appellants challenge this determination, asserting that "the

pension income streams" at issue here do not qualify as "securities" under "*any* of those categories." O.B. at p. 16 (emphasis added).

Federal courts have interpreted the term "evidence of indebtedness" as used in the Securities Act of 1933 "to include all contractual obligations to pay in the future for consideration presently received." *U.S. v. Austin*, 462 F.2d 724, 736 (10th Cir. 1972). *See also Sec. & Exch. Comm'n v. G. Weeks Sec., Inc*., 483 F.Supp. 1239, 1243 (W.D.Tenn. 1980) ("'Evidence of indebtedness' has been defined as a contractual obligation to pay in the future for consideration presently received.") (citation and internal quotations omitted); *MacKethan v. Peat, Marwick, Mitchell & Co*., 439 F.Supp. 1090, 1094 n.8 (E.D.Va. 1977) ("The term 'evidence of indebtedness' includes all contractual obligations to pay in the future for consideration presently received," citing *Austin*); *Searsy v. Commercial Trading Corp*., 560 S.W.2d 637, 641-42 (Tex. 1977) ("'Evidence of indebtedness' is [a] term taken from the Federal Securities Act of 1933" that "has been defined to mean 'all contractual obligations to pay in the future for consideration presently received'.") (citations omitted).

Because, as Appellants acknowledge, the "definition of 'security'" set forth in Arizona's Securities Act "is virtually the same as that contained in the Securities Act of 1933," O.B at p. 16, the Court finds federal case law defining "security" to be instructive. *See also Nutek*, 194 Ariz. at 108 ¶ 16 (recognizing that, because the definition of "security" under the Act "is substantially similar to the definition of securities in…the Securities Act of 1933," "Arizona courts therefore look to federal courts to guidance in interpreting the [Act]."). Moreover, to adhere to the federal court's broad definition of "evidence of indebtedness" would be consistent with Arizona case law recognizing that the Act should be "liberally construed to effect its remedial purpose of protecting the public interest." *Eastern Vanguard*, 206 Ariz. at 410 ¶ 36.

The Court therefore will construe the term "evidence of indebtedness" in accordance with the definition found in federal case law, *i.e*., a contractual obligation to pay in the future for consideration presently received. *See, e.g*., *Austin*, 462 F.2d at 736.

The transactions at issue here certainly fit within this definition. Indeed, W.A. Smith himself acknowledged as much in his testimony during the administrative proceedings. When asked whether the income stream investments represent "an agreement for [a] veteran to pay" a portion of "his or her future retirement or disability benefits" to "the investor, in exchange for a discounted lump sum," W.A. Smith agreed with that characterization, stating, "It seems like it would be accurate." I.R. C-9, W.A. Smith Examination Under Oath, at p. 109.

Appellants argue that "[t]he pension income streams" at issue here "are not 'evidences of indebtedness' under the [Act]" because, they contend, "evidences of indebtedness" are "defined as 'payment for the use of money'." O.B. at p. 31. The contracts at issue here, they insist, are not "payments for the use of money." *Id*. In support of their contention, they rely on *United States v. Jones*, 450 F.2d 523 (5th Cir. 1971) for the proposition that the term "evidence of indebtedness" "embraces only such documents as promissory notes which on their face establish a primary obligation to pay the holders thereof a sum of money." O.B. at p. 31, *citing Jones*, 450 F.2d at 525.

For two reasons, the Court rejects Appellants' argument on this point.

First, Appellants never raised it during the administrative proceedings below. Instead, they argued that the contracts at issue do not constitute "investment contracts," adding, in a conclusory manner, that "the Division's alternate theories of the product being a note or evidence of indebtedness (both of which would be securities under its analysis) simply do not apply under the facts of this case." Response Brief of Respondents W.A. Smith and Cox, attached as I.R. A-84, at p. 23. As the Commission correctly found, during the administrative proceedings Appellants presented no "argument, analysis, or authority" to support their contention that the contracts were not "evidences of indebtedness" except "to state that this theory 'simply does not apply under the facts of this case'." I.R. A-92, Final Decision, at p. 35 (internal punctuation omitted). By failing to present this argument during the proceedings below, Appellants waived it on appeal. *See Pavlik v. Chinle Unified Sch. Dist. No. 24*, 195 Ariz. 148, 151 ¶ 8 (App. 1999) ("Generally, a failure to raise an issue before an administrative tribunal precludes judicial review of that issue unless it is jurisdictional" or involves "the competence of a board to hear a dispute brought before it.").

Second, the nature of the income stream investments belies Appellants' contention that the transaction does not constitute "payment for the use of money." In this respect, the Court finds persuasive Appellee's argument that

> [t]he income stream investments are 'payment for the use of money' on both sides of the transaction because the veterans agree to provide their future pension or disability payments to the investors in exchange for the immediate use of the investors' lump sum investments, and the veterans accept the lump sum payments in exchange for the investors' use of the pension or disability payments in the future.

A.B. at p. 19.

The Court therefore finds that the Commission did not commit an error of law, or otherwise abuse its discretion, in finding that the transactions at issue here constitute "evidences of indebtedness," and are, therefore, "securities" within the meaning of A.R.S. § 44-1801(27).

In light of this determination, the Court finds it unnecessary to resolve the parties' dispute over whether the income stream investments *also* constitute "notes" and/or "investment contracts" within the meaning of A.R.S. § 44-1801(27).

B. The Commission Did Not Commit an Error of Law, or Abuse Its Discretion, in Determining that Cox Failed to Meet His Burden of Establishing a Defense to "Control Person" Liability.

The Commission determined that "Cox is a control person of Smith & Cox," and therefore that Cox, as well as W.A. Smith, is "jointly and severally liable" to the investors "to the same extent as Smith & Cox[.]" I.R. A-92, Final Decision, at pp. 45-46. In so finding, the Commission expressly determined that "Cox failed to meet his burden of" satisfying the elements of the defense to a finding of "control person" liability set forth in A.R.S. § 44-1999(B). *Id*. Appellants challenge the Commission's determination that "Cox failed to establish a good faith defense from control person liability" as "contrary to Arizona law and…not supported by the evidence." O.B. at p. 33. Appellee, by contrast, contends that "substantial evidence and Arizona law support the Commission's finding." A.B. at p. 37.

With respect to control person liability, A.R.S. § 44-1999 provides in pertinent part,

> Every person who, directly or indirectly, controls any person liable for a violation of section 44-1991 or 44-1992 is liable jointly and severally with and to the same extent as the controlled person to any person to whom the controlled person is liable *unless the controlling person acted in good faith and did not directly or indirectly induce the act underlying the action*.

A.R.S. § 44-1999(B) (emphasis added). The statute thus establishes a defense to liability for a control person who "acted in good faith and did not directly or indirectly induce the act underlying the action." A.R.S. § 44-1999(B).

As Appellee correctly notes, "Appellants do not dispute the Commission's finding that Cox is a control person of Smith & Cox." A.B. at p. 37. Instead, Appellants assert merely that "the Commission erred when it found that Cox failed to establish a good faith defense" to

liability. *Id*. *See also* O.B. at p. 47 (asserting that Cox "met his burden with regard to both prongs" of A.R.S. § 44-1999(B), without disputing that Cox is a "control person" within the meaning of that statute).

The Arizona Court of Appeals has held that A.R.S. § 44-1999(B) imposes "presumptive control liability on those persons who have the *power* to directly or indirectly control the activities of those persons or entities liable as primary violators." *Eastern Vanguard,* 206 Ariz. at 412 ¶ 42 (emphasis in original). Cox's status as a control person of Smith & Cox thus presumptively exposes him to liability under A.R.S. § 44-1999(B). *Id*. Moreover, Appellants' contention that Cox "took no active role in persuading or prevailing upon clients to purchase the product," O.B. at p. 47, even if true, does not establish a defense to control person liability under A.R.S. § 44-1999(B). On the contrary, a finding of control liability "may be premised on the *power* to control[,] and does not require *actual participation* in the wrongful conduct[.]" *Eastern Vanguard*, 206 Ariz. at 413 ¶ 44 (emphasis added).

To successfully establish a defense pursuant to A.R.S. § 44-1999(B), a control person must "demonstrate[s] *both* good faith *and* lack of inducement." *Eastern Vanguard,* 206 Ariz. at 413 ¶ 48 (emphasis added). Here, the Commission found that Cox "failed to satisfy his burden of proving that the good faith exception of A.R.S. § 44-1999(B) applies," and so found Cox "jointly and severally liable to the same extent as Smith & Cox for its violations of A.R.S. § 44-1991(A)." I.R. A-92, Final Decision, at pp. 45-46.

1. The Record Supports the Commission's Determination That Cox Failed to Establish the "Good Faith" Element of the A.R.S. § 44-1999(B) Defense to Control Person Liability.

To satisfy the "good faith" element of a defense under A.R.S. § 44-1999(B), a control person must,

> [a]t the minimum,…establish that [he or she] exercised due care by taking reasonable steps to maintain and enforce a reasonable and proper system of supervision and internal control[s].

Eastern Vanguard, 206 Ariz. at 414 ¶ 50 (citations and internal quotations omitted). Here, in finding that Cox failed to meet his burden of establishing the "good faith" element of the A.R.S. § 44-1999(B) defense, the Commission found as follows:

> Cox was aware of the warnings of the SEC Alert and knew of the risks associated with the income stream investments. Cox was present during [W.A. Smith's] presentation of the income stream investments to potential investors and knew that the presentation did not include the SEC Alert or mention of the risks associated with the income stream investments. Indeed, the presentation relayed the opposite sentiment, that the income stream investments were safe and secured [*sic*] investments and totally vetted.

I.R. A-92, Final Decision, at p. 45. This determination is amply supported by the record, including by Cox's own testimony during the administrative proceedings.

As W.A. Smith admitted, Smith & Cox never engaged counsel to obtain advice on whether the investments were securities. I.R. B-9, W.A. Smith Examination Under Oath, at pp. 73-74. Instead, according to W.A. Smith, Elliott Smith ("E. Smith"), Smith & Cox's "chief compliance officer," was the only person that Smith & Cox ever engaged to obtain advice on whether the investments constituted "securities." *Id*. at pp. 28-29, 37-38, 74.

On August 21, 2013, E. Smith sent, to Cox and W.A. Smith, a copy of Investor Bulletin (the "S.E.C. Alert") issued by the Securities and Exchange Commission ("S.E.C.") warning, *inter alia*, that "Federal law may restrict or prohibit retirees from 'assigning' their pension to someone else." I.R. C-129, S.E.C. Investor Bulletin, at p. ACC006697. E. Smith sent Cox and W.A. Smith the S.E.C. Alert as an attachment to an email in which E. Smith advised them to "read it carefully before proceeding with this business activity" and to "make sure" they were "prepared to discuss" the "risks and issues" with prospective investors. I.R. C-129, August 21, 2013 email to Cox and Smith, at p. ACC006697.

In his testimony, Cox acknowledged receiving the S.E.C. Alert from E. Smith. I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at pp. 770, 809. He further acknowledged reading the portion of the S.E.C. Alert stating that "structured settlement income stream products may or may not be securities." *Id*. at p. 811. *See also* I.R. C-129 at p. ACC006698 ("[I]nvestors should be aware" that "[p]ension and structured settlement income-stream products may or may not be securities…"). When asked if he considered the information contained in the S.E.C. Alert to be a "red flag," Cox replied, "I would say maybe light pink." I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at p. 810. He acknowledged that the S.E.C. Alert "was definitely something that [he] talked to [W.A. Smith] about." *Id*. at p. 809. Cox admitted that he knew at that time that "if a product is a security it either needs to be registered or be exempt from registration," and he knew that he did not have a license to sell

securities. *Id*. at pp. 811-12. Accordingly, he knew that the question of whether or not the income stream transactions constituted securities "was an issue to…be delved into." *Id*. at p. 811.

Moreover, by the time Smith & Cox began placing investors in these transactions in October 2013[2], E. Smith had already made clear to Cox and W.A. Smith that his misgivings about the transactions had become so great that he had decided to withdraw entirely, without even charging for his services. *See* I.R. C-135, August 29, 2013 email from E. Smith to Cox and W.A. Smith, at p. ACC006768. E. Smith concluded his email with the warning,

> I am growing more uncomfortable with my role in this matter. Even if, at the end of this process, there is no apparent reason you should not go forward with this, I cannot provide any certainty that everything that is out there has been uncovered…I am trying to ask the right questions, but it seems like we are spinning our wheels, and not necessarily getting all the responses we are asking for.
>
> …If you are looking for a guarantee that this deal is on the up and up, that none of the principals have problematic backgrounds or that at some point governmental authorities won't crack down on it, I am not currently and will not be able to provide it.

I.R. C-135, August 29, 2013 email from E. Smith to Cox and W.A. Smith, at p. ACC006768. Cox admitted that E. Smith's August 29, 2013 email was "a red flag," stating that the email "made me question" whether E. Smith "was actually going to get answers for us, if he was going to do what we asked him to do." I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at p. 815.

Although he considered the question of whether the income stream investments constituted securities to be an issue that should be "delved into," I.R. B-8 at p. 811, Cox further admitted that he did not, in fact, "delve into" that issue. Instead, Cox's testimony made clear that he simply washed his hands of the matter. When asked why Smith & Cox thereafter proceeded to "mov[e] forward" with the transaction, Cox testified that, "[a]fter" receiving "the last email from Elliott [Smith]," he "turned it over to [W.A. Smith]," adding, "I put my trust in him." I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at pp. 819-20. Cox also testified that, after E. Smith "sort of pushed it back" and "said 'I'm done'," he "kind of put the ball a little bit

[2] When asked if "the earliest sale of one of these products was in October 2013," W.A. Smith replied, "[T]hat sounds about right." I.R. B-9, Smith Examination Under Oath, at p. 32.

in [W.A. Smith's] court," and W.A. Smith "kind of took the ball from there." *Id*. at p. 768. He added that, before he "agree[d] to have…Smith & Cox offer this product," W.A. Smith "reassured" him that "he felt very comfortable with it." *Id*. Cox went on to testify that he was present during the meetings that W.A. Smith had with potential investors to present the income stream product. *Id*. at p. 772.

Cox was aware, at the time, that W.A. Smith had been previously sanctioned by Indiana state officials in 2008 for engaging in the sale of unregistered securities. I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at pp. 817-18. *See also* I.R. C-22 at p. ACC006063 – ACC006064. In light of Cox's awareness of what Appellee aptly calls W.A. Smith's "past poor judgment on whether an investment was a security," A.B. at p. 38, Cox had reason to doubt that he could reasonably rely on W.A. Smith's assessment of whether the transactions at issue here constituted securities. Nevertheless, by Cox's admission, after receiving the warning from E. Smith, he simply deferred to W.A. Smith to determine whether or not the transactions constituted securities.

The fact that, after learning of the S.E.C. Alert - - which Cox admitted was, if not a "red flag," a flag that was at least "light pink" - - Cox abdicated his supervisory responsibility as a control person and simply deferred to W.A. Smith is, by itself, enough to show that Cox failed to "exercise[] due care by taking reasonable steps to maintain and enforce a reasonable and proper system of supervision and internal control[s]." *Eastern Vanguard*, 206 Ariz. at 414 ¶ 50. The ignorance that results from willful blindness is not good faith. *Cf. Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 608 B.R. 181, 196 (S.D.N.Y. Bankr., 2019) ("If a person who is not under an independent duty to investigate nonetheless intentionally chooses to blind himself to the red flags that suggest a high probability of fraud, his willful blindness to the truth is tantamount to a lack of good faith.") (citations and internal quotations omitted). Cox's admissions on this point, in other words, establish that he failed to act in good faith.

The evidence in the record establishes that, although E. Smith was the only person to whom Smith & Cox had turned for advice on whether these transactions constituted securities, Cox nonetheless allowed Smith & Cox to proceed with the transactions after E. Smith warned Cox he was unable to confirm that "this deal is on the up and up." I.R. C-135, August 29, 2013 email from E. Smith to Cox and W.A. Smith, at p. ACC006768. Cox simply put blinders on, ignored the red (or "light pink") flags that he saw, and deferred to his partner's opinion despite knowing of his partner's history of selling unregistered securities. The Court therefore affirms, as supported by the record, the Commission's determination that Cox failed to meet his burden of

establishing the "good faith" element of his claimed defense pursuant to A.R.S. § 44-1999(B). *See* I.R. A-92, Final Decision, at p. 46.

2. The Record Supports a Finding That Cox Cannot Establish the "Lack of Inducement" Element of the A.R.S. § 44-1999(B) Defense to Control Person Liability.

Although the Commission made no findings about the second, "lack of inducement" prong of the defense established by A.R.S. § 44-1999(B), the record also supports a finding that Cox did, indeed, induce potential investors to invest in the income stream investments. The Smith & Cox marketing brochure that was provided to potential investors touted the expertise of the firm's principals, stating that, "[a]fter a combined 30 years in the financial services industry, the firm's founders have proven track records and a long list of financially secure and satisfied clients." I.R. C-111 at p. ACC006426. Claiming that W.A. Smith is "widely recognized as an expert on veterans' benefits," the brochure states that Smith & Cox "create[s] balanced financial strategies to protect and grow clients' wealth." *Id*. Moreover, the brochure includes a quote attributed to Cox that vouches for the integrity of Smith & Cox's principals, stating, "We [*i.e*., W.A. Smith and Cox] grew up with Midwestern values." *Id*. As Appellee correctly argues, Cox cannot now "disown" the assurances that his firm provided to investors in the firm's "own marketing brochure." A.B. at p. 47.

Moreover, Cox's testimony during the administrative proceedings makes clear that he played a key role in inducing potential investors to invest in the income stream investments. In his testimony, Cox admitted that he attended the meetings W.A. Smith held with clients "when the pension stream investment products were presented between 2013 and 2015." I.R. B-8, Transcript of Administrative Hearing on June 26, 2019, at p. 772. Although he insisted that W.A. Smith was "always" the one who "presented the pension stream fund" investments to potential investors while he presented insurance products, *id*. at p. 773, he acknowledged that he and W.A. Smith had complementary roles during these client meetings. *Id*. at pp. 798-99. He further testified that he would "spend a lot of time with our clients" and try to establish a rapport with them because he wanted them to "trust" and "rely on" him. *Id*. at p. 800. Cox's own testimony thus establishes that, by attending W.A. Smith's presentations and trying to establish a rapport with the clients to induce their trust and reliance, Cox did, indeed, induce the investors to participate in the income stream investments.

The testimony of investor Lois Zettlemoyer ("Zettlemoyer") confirms the important role that Cox played in winning over the trust and confidence of potential investors. Zettlemoyer

testified that she and her husband met Cox and W.A. Smith "at an information dinner" in late 2014, and then met with them again "at their offices." I.R. B-6, Transcript of Proceedings on 6/24/19, at pp. 184-85. She further testified that she and her husband "decide[d] to engage Smith & Cox as [their] investment advisors" because, she said, "We felt compatible with them, and it seemed like we had a good relationship." *Id*. at p. 189. She later added, "they had nice offices and they looked good and we liked them." *Id*. at p. 198. She made clear, however, that, during their conversations with Cox and W.A. Smith, she and her husband "were talking mostly to [Cox]." *Id*. at p. 189. She added that, although "we liked them both," "I thought we were a little more compatible with [Cox]." *Id*. She also testified that she developed "trust" in Smith & Cox because of the "personal conversations" she had with them and the social "events" they hosted, such as "a barbecue" and "a wine tasting party," that helped "build community." *Id*. at p. 199.

Another investor, Susan Hill ("Hill"), gave similar testimony about meeting Cox and W.A. Smith when they invited her and her husband to a "complimentary" "lunch session" to "learn about the services they provided," after which they met with Cox and W.A. Smith at "their offices." I.R. B-6, Transcript of Proceedings on 6/24/19, at pp. 342-44. Hill thought Cox and W.A. Smith "seemed very nice and confident and professional." *Id*. at p. 345. She testified that "[she] and [her] husband liked" the fact that Cox and W.A. Smith "seemed to want to really build a rapport," adding, "We did all seem to have a connection." *Id*. at p. 345.

The testimony of the investors makes clear that Cox's efforts to establish a relationship of trust with potential clients was at least part of what led them to participate in the income stream investments through Smith & Cox.

Moreover, the record contains evidence that refutes Cox's claim that he was simply a passive observer during W.A. Smith's presentations to clients. One of the investors, Dean Hebb ("Hebb"), testified that, after "talking to them both," *i.e*., Cox and W.A. Smith, and "listening to their presentation," he thought "they seemed like good guys." I.R. B-5, Transcript of Proceedings on 6/21/19, at p. 115. Hebb testified that what he "remember[s] most" from the presentation given by Cox and W.A. Smith was "the fact that their concentration was not on fast high returns but it was more on securing our money and making sure that our investments were sound and would give us the returns that they promised." *Id*. at pp. 115-16. Referring to the income stream investments, Hebb testified that "they" - - not just W.A. Smith, but *both* W.A. Smith *and* Cox - - represented that "it's one of the most safe investments you can get," and that "it is totally vetted." *Id*. at p. 121. When asked if "one of them or both of them" told him "that this investment" - - the investment Hebb described as "the pension flow" - - "was very safe," Hebb replied, "They both did." *Id*. at p. 163. Hebb further testified that, although Cox and W.A. Smith

presented different alternative investment opportunities, they both stated "that the pension was the safest." *Id*. at pp. 163-64. Hebb later reiterated that both Cox and W.A. Smith "talk[ed]" to him "about pension flow. *Id*. at p. 163. When asked if "one of them or both of them" told him "that this investment was very safe," Hebb replied, "They both did." *Id*. at p. 163. Hebb's testimony constitutes evidence to support a finding that Cox had an active role in persuading investors to participate in the income stream investments.

The fact that the record shows that Cox did, in fact, induce the violations of A.R.S. § 44-1991(A) establishes a second, independent basis for affirming the Commission's determination that Cox had failed to meet his burden of providing that the defense afforded by A.R.S. § 44-1999(B) applies here. *See BNSF Railway*, 228 Ariz. at 485 ¶ 12, 268 P.3d at 1142 ("The court of appeals will affirm the trial court's decision if it is correct for any reason[].") (citation and internal quotations omitted).

C. With the Exception of the Correction Identified by Appellee, the Commission Did Not Commit an Error of Law, or Abuse Its Discretion, in Its Restitution Order.

The remedies ordered by the Commission include an award of restitution to the investors in the amount of $2,574,103.38 payable by Appellants, jointly and severally.[3] I.R. A-92, Final Decision, at p. 52. This figure was determined by calculating the total amount that was paid by all 21 investors, or $2,776,952.62, and deducting $202,849.24, the total amount that two investors (Hebb and John McLeod) testified had already been repaid to them. *Id*. at p. 51. The Commission further ordered that, "[i]f [Appellants] can prove investors have received additional payments, [Appellants] can provide such proof to the Commission and the Commission will offset those amounts from the total restitution awarded." *Id*. at p. 52.

Appellants do not challenge the Commission's determination that the net amount that was paid by all 21 investors (after adjusting for the repayments to Hebb and John McLeod) is $2,574,103.38, nor do Appellants dispute that this figure is the proper starting point for calculating restitution. Appellants argue, however, that, when calculating restitution, "there should have been a substantial offset" from this amount to account for "income stream payments received by" other investors. O.B. at p. 48. Appellants further argue that the burden should fall on the Division, and not on them, to establish the amount of the income stream payments received by the investors. *Id*. at p. 49. The Division, they contend, is "in the best, and only, position to present such evidence" because the Division could "subpoena or otherwise obtain the

[3] The Commission also entered a restitution award, in a different amount, against a non-party to this appeal. I.R. A-92, Final Decision, at p. 52.

payment records from [ULG]," the South Carolina law firm that acted as escrow agent for the receipt and disbursement of income stream payments. *Id*. at p. 49. Appellants therefore ask that this Court remand the matter to the Commission for "supplemental proceedings to establish the true amount of losses" that the investors actually sustained. *Id*. at p. 50.

In response, Appellee acknowledges that investor Susan Hill received income stream payments of $64,047.23, and that "the $64,047.23" repayment to Hill "inadvertently was not" credited against Appellants' restitution obligation. A.B. at p. 49. Noting that the Commission's Final Decision states that Appellants will be given credit, against the total restitution award, for any repayments received by additional investors, Appellee asserts that "the Commission will reduce Appellants' restitution obligation by $64,047.23 to $2,510,056.15." *Id*. at pp. 49-50.

Appellee goes on to argue that, with that exception, Appellants are entitled to no relief. Asserting that "the amounts of any other repayments" received by other investors "is unknown," Appellee asserts that "it is Appellants' burden," not the Division's, "to present evidence" of any additional repayments. A.B. at p. 50. After all, Appellee maintains, "payment is an affirmative defense." *Id*. Moreover, they contend, Appellants could have elicited testimony from the investors at the administrative hearing about the amount of income stream payments they received, but failed to do so. *Id*. "Having failed to present the evidence they now wish they had presented at the hearing," Appellee concludes, "Appellants are not entitled to 'supplemental proceedings'" before the Commission to address the restitution issue again. *Id*.

After reviewing the parties' filings and the authorities cited therein, the Court agrees with Appellee that the burden is on Appellants to establish the amount of the offsets to which they are entitled against the restitution award. Such a conclusion is consistent with Arizona case law recognizing that "[p]ayment is an affirmative defense" and that "the burden is upon the defendant to prove payment with some affirmative evidence." *B & R Materials, Inc. v. U.S. Fidelity & Guaranty Co.,* 132 Ariz. 122, 124 (App. 1982). Further, such a conclusion would be consistent with the well-established rule that "the burden of establishing any offset to a restitution order should fall on the defendant." *U.S. v. Sheinbaum,* 136 F.3d 443, 449 (5th Cir. 1998). Application of this rule is particularly appropriate in securities cases in which defendants often structure transactions in such a manner that exactitude in identifying losses is difficult, if not impossible. *See S.E.C. v. Rooney*, 2014 WL 3500301 at *4 (N.D.Ill., July 14, 2014) (explaining that joint and several liability for defendants in securities enforcement action is appropriate because, "[g]enerally, apportionment" among various defendants "is difficult or even practically impossible because the defendants have engaged in complex and heavily disguised transactions"). *Cf. S.E.C. v. Hughes Capital Corp.*, 124 F.3d 449, 455 (3rd Cir. 1997) (holding

that "[i]mposing the burden upon the defendant of proving the propriety of the apportionment of the disgorgement amount in securities cases is appropriate and reasonable."; "[T]he risk of uncertainty" in determining amount of defendant's "ill-gotten profits" "should fall on the wrongdoer whose illegal conduct created that uncertainty.") (citation and internal quotations omitted). The investors were Appellant's clients, and Appellants had the opportunity to keep track of the monthly payments sent to their clients while the transactions were ongoing. Additionally, as Appellee points out, Appellants had the opportunity to elicit testimony from the investors during the administrative proceedings to establish the amount of their investments they had recovered. With the exception of the additional $64,047.23 credit against Appellants' restitution obligation as conceded by Appellee, the Court finds that Appellants are entitled to no relief on their challenge to the restitution award.

DISPOSITION & ORDERS

In accordance with the foregoing,

IT IS ORDERED modifying Decision No. 77747 of the Arizona Corporation Commission by reducing the restitution award from $2,574,103.38 to $2,510,056.15.

IT IS FURTHER ORDERED affirming Decision No. 77747 of the Arizona Corporation Commission in all other respects.

IT IS FURTHER ORDERED remanding this matter to the Arizona Corporation Commission for such further proceedings, if any, as may be appropriate.

No matters remain pending in connection with this appeal. This is a final order pursuant to JRAD 13 and Ariz.R.Civ.P. 54(c).

_____
THE HON. DANIEL J. KILEY
Judge of the Superior Court

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