

# Kansas Blue Sky Is Not on the Market: The Deconstruction of Public Choice Theory Through the Lens of the Kansas Blue Sky Law

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## I. INTRODUCTION

Kansas, a state not normally recognized for innovation, promulgated the first state regulation governing the sale of securities in 1911.<sup>1</sup> After just a few years, nearly every other state had enacted similar legislation.<sup>2</sup> Kansas recognized that the problem of swindlers promising farfetched returns on imaginary investments was costing the state's citizens millions of dollars.<sup>3</sup> The bank commissioner, J. N. Dolley, decided to take a stand and root out the charlatans.<sup>4</sup> The push to rid the state of swindlers quickly caught the attention of the Kansas legislature, and the first blue sky law was born.<sup>5</sup> The state security regulation is so named because the law was "aimed at 'speculative schemes which have no more basis than so many feet of blue sky.'"<sup>6</sup>

Various forms of regulation, such as the Kansas Blue Sky Law, have been criticized.<sup>7</sup> Commentators argue that regulation is not secure from special-interest influence; thus those governed by regulation, i.e. the general public, are at the mercy of those special interests. These scholars suggest that the regulatory state is controlled only by human self-interest, and that not a single piece of regulation exists to further the interest of public welfare.<sup>8</sup> Additionally, they assert that regulation is a consequence of politicians seeking reelection or fat pockets.<sup>9</sup> These ideas cumulate into a theory called public choice.<sup>10</sup>

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1. WALT MARKLEY, BUILDERS OF TOPEKA 78-79 (1934); see 69A AM. JUR. 2D *Securities Regulation* § 1 (1993).

2. MARKLEY, *supra* note 1, at 79.

3. See *Joe Dolley Is After the Blue Sky Merchants*, TOPEKA CAP. J., Dec. 22, 1910.

4. See *id.*

5. See 1911 Kan. Sess. Laws 133; see also MARKLEY, *supra* note 1, at 78.

6. 69A AM. JUR. 2D, *supra* note 1, at § 1.

7. See Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 512-13 (2000) [hereinafter Ramirez, *Depoliticizing*]. Some have criticized regulatory bodies because "the advent of such vast administrative power amounts to the creation of a 'fourth branch' of government." *Id.* For a specific criticism of the origins of the Blue Sky Law, see Jonathon R. Macey & Geoffrey P. Miller, *Origins of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991).

8. See Ronald A. Cass, *The Meaning of Liberty: Notes on Problems Within the Fraternity*, 1 NOTRE DAME J.L. ETHICS & PUB. POL'Y 777, 790 (1985).

9. See Dorothy A. Brown, *The Invisibility Factor: The Limits of Public Choice Theory and Public Institutions*, 74 WASH. U. L.Q. 179, 182 (1996).

10. See *id.*

Its theorists contend that public choice can be used as a tool to predict the outcomes of regulatory battles and to highlight one of the main problems with America's regulatory scheme: its inability to create regulation in favor of public interest.

As attractive as the public choice theory is, given today's economic and political scandals,<sup>11</sup> it simply cannot explain all circumstances.<sup>12</sup> The enactment of the Kansas legislation regulating the offer and sale of securities illustrates the inadequacy and limitations of public choice theory.

The Kansas Blue Sky Act defies the public choice theory. As a result of a unique cultural context, this regulation has been maintained for more than ninety years for the purpose of protecting Kansas investors; no amount of political pressure or economic power has been able to effect this regulation. This Act stands as a direct challenge to what public choice would predict, especially where business has much at stake. Public choice may be a valuable tool to understand some governmental action, but it is important to understand its limitations.

This note will first define why the regulatory state is unavoidable. Next, it will introduce public choice theory and illustrate how federal securities regulation has been susceptible to the theory. Then, other weaknesses illustrating limitations on public choice will be presented. Finally, this note will discuss Kansas' unique cultural context; the first blue sky law; why Kansas' Blue Sky Law stands in opposition to public choice; and the impact of these facts on public choice theory.

## II. REGULATION: A NECESSARY EVIL

In the last one hundred years, the most significant change in America's style of governance has been the onset of the regulatory state, which emerged in the aftermath of the Great Depression.<sup>13</sup> Numerous New Deal governmental programs and agencies dealing with farming, banking, and securities extended the reach of government.<sup>14</sup> In order to provide the various services, administrative bodies were created to manage the regulatory state, including the Securities Ex-

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11. The American public has been in an uproar since Enron, "America's seventh-biggest corporation[,] . . . evaporate[d] virtually overnight," creating economic upheaval and the loss of thousands of jobs. Kurt Eichenwald, *Audacious Climb to Success Ended in a Dizzying Plunge*, N. Y. TIMES, Jan. 13, 2002, <http://www.nytimes.com/2002/01/13/business.html>.

12. See *infra* text accompanying notes 88-239.

13. See Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote for Bubbles?*, 70 U. CIN. L. REV. 527, 527 (2002) [hereinafter Ramirez, *Bubbles*]. The number of federal employees more than doubled in the years between 1917 and 1940; the number rose from 48,313 to 137,940. United States General Accounting Office, *Where to Put Workers and Their Cars*, <http://www.gao.gov/about/history/wheretoput.html> (last visited Oct. 21, 2002).

14. See Ramirez, *Bubbles*, *supra* note 13, at 527.

change Commission (SEC) and the Federal Deposit Insurance Company (FDIC).<sup>15</sup> The various administrative bodies created regulations that govern far more of Americans' daily lives than the three traditional branches of government — the Judicial, the Executive, and the Legislative — ever influenced.<sup>16</sup>

Prior to the Great Depression, the country suffered a series of "Panics," which culminated in the Stock Crash of 1929.<sup>17</sup> As a result, President Franklin D. Roosevelt introduced several New Deal programs.<sup>18</sup> These programs encompassed areas such as agriculture and collective bargaining.<sup>19</sup> Pushed by the President and created by Congress, the programs managed areas that reached far into American life. Yet, without the regulatory bodies, the American government would be overwhelmed with the management of the agencies' day-to-day operations. Thus, regulation and the regulatory bodies became a necessary evil.

The regulatory bodies were attacked as being unconstitutional because the administrative bodies were handed broad powers.<sup>20</sup> For example, in *Bowsher v. Synar*,<sup>21</sup> an administrative body was charged with giving an independent agency too much power "without being subject to presidential control."<sup>22</sup> Nonetheless, the bodies were upheld as constitutional and even consistent with the American idea of democracy.<sup>23</sup>

More recently, the programs have come under attack for being compromised by the interests of the powerful.<sup>24</sup> Those that govern the administrative bodies answer directly to Congress for their ac-

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15. See Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 34 (2002) [hereinafter Ramirez, *Fear*]. The SEC is a federal administration agency designed to deal with the regulation of securities. *Id.*

16. See Ramirez, *Depoliticizing*, *supra* note 7, at 537.

17. See Ramirez, *Fear*, *supra* note 15, at 34. For more information about the Great Depression and the New Deal, the Franklin and Eleanor Roosevelt Institute organized the New Deal Network, which can be found on the Internet at <http://www.newdeal.feri.org>.

18. Ramirez, *Depoliticizing*, *supra* note 7, at 512. In addition to the SEC and the FDIC, the New Deal also brought the National Labor Relations Board (NLRB) and the Social Security Board. *Id.*

19. See Ramirez, *Fear*, *supra* note 15, at 34.

20. See Ramirez, *Depoliticizing*, *supra* note 7, at 537. "No doubt . . . delegating power to administrative agencies lessens democratic influence, often over important areas of our society." *Id.*

21. 478 U.S. 714 (1986).

22. Ramirez, *Depoliticizing*, *supra* note 7, at 515. "Congress cannot reserve for itself the power of removal of an officer charged with the execution of the laws except by impeachment." *Bowsher*, 478 U.S. at 726.

23. See Ramirez, *Depoliticizing*, *supra* note 7, at 537. "[I]t may be concluded, that a pure democracy, by which I mean a society consisting of a small number of citizens, who assemble and administer the government in person, can admit of no cure for the mischiefs of faction." *Id.* at n.190 (quoting THE FEDERALIST No. 10, at 127 (James Madison) (Isaac Kramnick ed., 1987)).

24. See *id.* at 503 n.3. "[T]he economic theory of regulation . . . recognizes that private interest may subvert regulation." *Id.* (referencing Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 343 (1974)).

tions, most importantly for its budget.<sup>25</sup> Lobbyists have recognized this fragility and have capitalized on it. Each year, entities throw millions of dollars at Congress urging legislators to support proposed regulative changes.<sup>26</sup> Consequently, the regulatory bodies are often squeezed by special interests. This is most prevalent in areas of low-saliency — or issues that the public is unconcerned with such as securities regulation.<sup>27</sup> To most voters, a platform built on maintaining or improving investor remedies is far less sexy than a platform focused on hot-button issues such as abortion, prescription drug coverage, and tax relief. When voter interest is low, regulation is easily influenced by special interests. Further, public choice theorists maintain that no politicians seek to benefit the public, only themselves.<sup>28</sup>

### III. PUBLIC CHOICE THEORY

#### A. *What is Public Choice Theory?*

The term “public choice” is something of a misnomer because it actually refers to private choices: those choices made by persons involved in the political arena to benefit themselves.<sup>29</sup> Nevertheless, Dr. James M. Buchanan described the name: “[c]hoice’ is the act of

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25. *Id.* at 518. Ramirez points out that the independent agencies are subject to pressure from Congress. *Id.* For example, “Congress can limit an agency’s jurisdiction, cut off its appropriations, or ruin a regulator’s career.” *Id.*

26. The shocking addition of the “Thimerosal Clause” into the Homeland Defense Bill illustrates this. See Bob Herbert, *Bill Protects Some Who Don’t Deserve It*, SEATTLE POST INTELLIGENCER (Nov. 28, 2002), [http://seattlepi.nwsource.com/opinion/97563\\_herbert28.shtml](http://seattlepi.nwsource.com/opinion/97563_herbert28.shtml). The Defense Bill, which was enacted in the wake of September 11, included a completely unrelated clause that absolved Eli Lilly and other major pharmaceutical companies of liability for the alleged harmful addition of thimerosal into vaccinations given to children. *Id.* “Thimerosal is a preservative that contains mercury” and is linked to autism and developmental disorders. *Id.* The outrageous addition of this clause is said to be a result of “the fact that the major drug companies have become a gigantic collective cash machine for politicians.” *Id.*

Additionally, Ralph Nader asserted that special interest, specifically megabanks such as Citibank, influenced Congress with money to overturn the Glass-Steagall Act of 1933. Ralph Nader, *The Democrats Bow to the Megabanks*, PROGRESSIVE, <http://www.progressive.org/nad001.htm> (last visited Aug. 24, 2002). This Act, also a New Deal reform, regulated the banking industry and separated banks from other industries, such as securities and insurance. *Id.* Nader contended that Congress caved to special interest with the “Financial Services Modernization Act,” which reversed the Glass-Steagall Act. *Id.* At times, “the legislative effort . . . took on the appearance of a private bill for the giant conglomerate” Citigroup. *Id.* Additionally, Nader stated that “[w]hile Citigroup’s political muscle and deep pockets were particularly visible, none of the major players in the banking, securities, or insurance industries were timid about turning up the lobbying heat or in passing out record campaign funds.” *Id.*

27. Interview with Steven A. Ramirez, Professor of Law, Washburn University School of Law, in Topeka, Kansas (Jan. 9, 2003). This however may be changing with the nation’s current fixation on the market and securities after the Enron and Worldcom debacles. See Frank Rich, *All the President’s Enrons*, N.Y. TIMES, July 6, 2002, <http://www.nytimes.com/2002/07/06/opinion/06RICH.html?todayshdlines>. “[T]he markets had hit their worst half-year finish since 1970, the NASDAQ was at a five-year low, the dollar was on the skids and, despite much evidence to the contrary, a majority of Americans had told CNN/USA Today pollsters that the country was in a recession.” *Id.* See generally *Talk of the Nation*, (National Public Radio, Nov. 5, 2002), <http://discover.npr.org/features/feature.jhtml?wfld=832799>.

28. See Brown, *supra* note 9, at 182.

29. Leon Felkins, *Introduction to Public Choice Theory* (Jan. 10, 1997), <http://www.magnolia.net/~leonf/sd/pub-choice.html> (last revised Nov. 8, 2001).

selecting from among alternatives, [and] '[p]ublic' refers to people."<sup>30</sup> The theory itself is "directed toward the study of politics based on economic principles."<sup>31</sup> Theorists asserted that until public choice was developed, political science professors in universities taught students how politics should ideally work, not how the political system actually operated.<sup>32</sup> Public choice theorists use it as a predictive tool.<sup>33</sup>

Public choice presumes that all who enter into the political process do so for their own selfish intentions.<sup>34</sup> The theory is compelling because it exposes selfish behavior in a number of ways: "[c]itizens act to acquire the biggest piece of the collective resource pie at the lowest cost to themselves; legislators act to acquire reelection; bureaucrats act to acquire more power (bigger budget, wider authority, and so on) while in government and lucrative opportunities via the revolving door when they leave."<sup>35</sup> The theorists consider that "government decisions [are] the product of interest group politics which do not, in general, maximize national welfare."<sup>36</sup> In today's political atmosphere, these motivations seem apparent with every new debate.

Specifically, public choice asserts that smaller, unified coalitions of voters seek legislation advantageous to their position.<sup>37</sup> This system allows individuals with "'concentrated' interests in increased expenditure [to] take a 'free ride' on those with 'diffuse' interests."<sup>38</sup> Consequently, the general taxpayer, one with diffuse interests, is victimized by this system. Interest in day-to-day politics is low, and special interest groups capitalize on the disinterest with pressure or money for legislation in their favor.<sup>39</sup> Accordingly, "legislation is not enacted for the public good," but for the small groups able to sway politics in their favor.<sup>40</sup> Smaller coalitions are persuaded to affect legislation because regulation in their favor will achieve a direct benefit to their special interest. Whereas the general taxpayer does not see a direct benefit of promoting her ideas, she is only stuck with the cost of such promotion.<sup>41</sup> As a result, the "interest groups with the most at

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30. James M. Buchanan Center for Political Economy, *About Public Choice Economics*, <http://www.gmu.edu/jbc/acad/pubchoice.html> (last visited Aug. 24, 2002).

31. Felkins, *supra* note 29.

32. *Id.*

33. Brown, *supra* note 9, at 182. The theory "explain[s] legislative outcomes." *Id.*

34. See Douglas T. Kendall & Eric Sorkin, *Nothing for Free: How Private Judicial Seminars Are Undermining Environmental Protections and Breaking the Public's Trust*, 25 HARV. ENVTL. L. REV. 405, 427-28 (2001).

35. Cynthia R. Farine, *Faith, Hope, and Rationality or Public's Choice and the Perils of Occam's Razor*, 28 FLA. ST. U. L. REV. 109, 110 (2000).

36. Andrew T. Guzman, *Choice of Law: New Foundations*, 90 GEO. L.J. 883, 901 (2002).

37. Felkins, *supra* note 29.

38. *Id.*

39. See *id.*

40. Brown, *supra* note 9, at 182.

41. See Guzman, *supra* note 36, at 901.

stake in a regulatory decision will work most aggressively to influence that decision and are likely to succeed in doing so.”<sup>42</sup>

Professor Dorothy Brown explains public choice through a bid system.<sup>43</sup> Legislation is not passed in favor of public welfare; “[r]ather, it results from a ‘legislative auction’ where the special interest group with the highest ‘bid’ wins the legislator’s services.”<sup>44</sup> The bids are comprised of “campaign contributions, advertising, public relations, votes, and outright bribes.”<sup>45</sup> This system illustrates the impact of special interest influence. Those in opposition to the proposed legislation remain unorganized and incapable of countering the bid of the mobilized group.<sup>46</sup> Accordingly, those in opposition remain powerless and are manipulated by special interest.

The public choice theorists posit that all government regulation is compromised by this self interest, which is evidenced by the federal securities laws. The Securities Act of 1933<sup>47</sup> and the Securities Exchange Act of 1934<sup>48</sup> began with the idea of investor protection in mind.<sup>49</sup> However, after many years, special interest began chipping away at investor rights, and two recent acts completely altered the pro-investor intent of federal securities laws.<sup>50</sup>

One scholar suggested that “special interest groups are able to procure benefits for their group members because those who would oppose the legislation remain unorganized and diffuse.”<sup>51</sup> This proposition describes why securities regulation is vulnerable to special interest influence. Shareholders continue to remain uninformed about the companies in which they are invested. Especially as shareholders become more diversified, it is next to impossible for individual shareholders to keep track of the various companies in which they own stock. Additionally, if taken together, the companies’ information would be overwhelming; therefore shareholders purposely remain uninterested in the company’s internal structure. The number of shareholders is also impossible to mobilize. Thus, the area of securities regulation is particularly vulnerable to special interest influence.

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42. *Id.* at 902.

43. Brown, *supra* note 9, at 182.

44. *Id.*

45. *Id.*

46. *Id.* at 183.

47. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77z-3 (2000)).

48. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78mm (2000)).

49. See Ramirez, *Bubbles*, *supra* note 13, at 533-34. Roosevelt stated that the 1934 Act had the “broad purpose of protecting investors.” *Id.* at 534 (citing H.R. REP. NO. 73-1383, at 1 (1934) (quoting letter from President Franklin D. Roosevelt)).

50. See *supra* text accompanying note 37; *infra* text accompanying note 72.

51. Brown, *supra* note 9, at 183.

B. *Public Choice in Action: The Evolution of Federal Securities Laws.*

In addition to other reforms, the New Deal created federal securities regulation.<sup>52</sup> These federal regulations were enacted in part to protect investors by supplementing various state laws.<sup>53</sup> Investor confidence plummeted after the Great Depression, and Congress intended federal securities regulation to restore that confidence.<sup>54</sup> In addition to augmenting state laws, the federal regulations “mandat[ed] ‘just and equitable principles of trade’ in the securities brokerage industry.”<sup>55</sup> This sought to protect investors by raising the bar on industry standards.<sup>56</sup> Ironically, today these statutes now offer less protection than most states’ blue sky laws and defy the original purpose of federal securities regulation, creating a perfect illustration of public choice in action.<sup>57</sup>

1. The Securities Act of 1933 and The Securities Exchange Act of 1934.

The Securities Act of 1933 (1933 Act) was the first in a series of federal securities regulations.<sup>58</sup> The Securities Exchange Act of 1934 (1934 Act) was passed soon after, and both acts provided substantial protection for the American public. However, special interests have eroded the protection provided by each act to individual investors.<sup>59</sup>

After the Crash in 1929, the market experienced an upheaval, and investors desperately needed a federal act that provided strong remedies in their favor.<sup>60</sup> Congress responded with the 1933 Act, which governed the sale of stock in initial offerings and required registration and full disclosure of the company’s financial reports to the

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52. Ramirez, *Bubbles*, *supra* note 13, at 527-31.

53. *Id.* In addition to supplementing state law remedies for the fraudulent sale of securities, the government was frightened that the American way of life would vanish; “[the] breakdown in free, unregulated securities markets posed a historic threat to ‘honest enterprise’ and capitalism generally.” *Id.* at 528-29 n.10.

54. *Id.* at 528. “The Great Depression demolished investor confidence so thoroughly that investors had ‘grown timid to the point of hoarding’ cash.” *Id.* at 528 n.10.

55. *Id.* at 528.

56. *Id.*

57. *See id.* at 530-31. “New Deal remedies in favor of investors have generally been reversed so that federal law now provides remedies that are more restrictive than those available under state law.” *Id.*

58. *See* Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a to 77z-3 (2000)).

59. *See* Steven Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing With the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1058 (1999) [hereinafter Ramirez, *Arbitration*]. Moreover, Ramirez points out that recent United State Supreme Court decisions have also effectively eroded investor protection. *See* Ramirez, *Fear*, *supra* note 15, at 44 (citing to *Ernst & Ernst v. Hochfelder*, which held that “defendants may *only* be liable under Rule 10b-5 upon a showing that they acted with an intent to deceive, manipulate, or defraud. 425 U.S. 185, 193-214 (1976) (emphasis added)).

60. *See* Brian J. Fahrney, *State Blue Sky Laws: A Stronger Case For Federal Pre-Emption Due To Increasing Internationalization of Securities Markets*, 86 Nw. U. L. REV. 753, 756 (1992).

SEC.<sup>61</sup> When those companies failed to provide the whole truth, investors had a potent rescission remedy.<sup>62</sup> Thus, if shares in a company were not registered, or if the company's registration documents contained a material misrepresentation or omission, then the investors had the ability to rescind and obtain the original value of their investment.<sup>63</sup> After just one year, legislators realized that the 1933 Act would not protect investors in other areas because of its limited scope; therefore the 1934 Act was a necessary addition.

The 1934 Act federalized securities fraud.<sup>64</sup> The new laws included the entire "securities industry [not just initial offerings] and required periodic disclosure for publicly-held companies."<sup>65</sup> The scope of the 1934 Act included secondary market transactions, which are broader than those between the stock issuer and the investor. While this law was preeminent, state remedies still existed under the 1934 Act.<sup>66</sup> Thus, the 1934 Act expanded the scope of securities regulation such that ordinary citizens selling securities were held to the federal anti-fraud standard, as well as to state standards of criminal and civil liability.<sup>67</sup> These Acts were created with the firm intent to protect investors.<sup>68</sup> After many years though, special interest has eroded that initial purpose.

## 2. Where Federal Securities Regulation Went Wrong: The PSLRA.

The Private Securities Litigation Reform Act of 1995 (PSLRA)<sup>69</sup> "restricted private claims generally and class actions in particular."<sup>70</sup> It was designed to protect "investors, issuers, and all who are associated with our capital markets from abusive securities litigation" or strike suits.<sup>71</sup> These suits were seen as a danger to the economy because such actions were filed "in order to extract quick settlements from defendants," where defendants often settled rather than incur

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61. See Securities Act of 1933 §§ 77a to 77z-3; see also Ramirez, *Arbitration*, *supra* note 59, at 1066-67.

62. See Securities Act of 1933 §§ 77a to 77z-3. The disclosure requirement "add[ed] to the ancient rule caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the whole truth on the seller." Ramirez, *Arbitration*, *supra* note 59, at 1067 n.39 (citing H.R. REP. NO. 73-85, at 2 (1934) (quoting letter from President Franklin Roosevelt)). With this addition, Congress hoped that the doctrine would give "impetus to honest dealing in securities and thereby bring back public confidence." *Id.*

63. See Securities Act of 1933 §§ 77a to 77z-3.

64. See Ramirez, *Arbitration*, *supra* note 59, at 1066-67.

65. *Id.*

66. Cf. Ramirez, *Bubbles*, *supra* note 13, at 528.

67. See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a to 78mm (2000)).

68. Ramirez, *Bubbles*, *supra* note 13, at 528.

69. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

70. Ramirez, *Arbitration*, *supra* note 59, at 1058.

71. *Id.* at 1058 n.10.

the high cost of litigation.<sup>72</sup> The thought was that defendants settled even unmeritorious claims in order to avoid litigation, encouraging plaintiffs to bring frivolous suits.<sup>73</sup> Thus, the PSLRA specifically “pre-empted state law claims when raised in class action suits involving publicly-held companies.”<sup>74</sup> The result was that “private enforcement of the federal securities laws” is left in shambles.<sup>75</sup>

After years of cruising along comfortably with the Securities Acts of 1933 and 1934, American investors became more relaxed about maintaining investor protections.<sup>76</sup> This lax attitude allowed special interest groups to pressure the legislature into adopting the changes embedded in the PSLRA.<sup>77</sup> The new Act brought with it heightened pleading requirements; the plaintiff must plead the facts “‘giving rise to a strong inference’ of scienter.”<sup>78</sup> Essentially, the plaintiff must prove that the defendant intended to defraud.<sup>79</sup> Because plaintiffs are often unable to meet this onerous burden, the suits result in a defendants-win situation.<sup>80</sup> Additionally, the PSLRA alters the discovery process in favor of the defendant.<sup>81</sup> The plaintiff is in a catch-22; she is denied discovery of the facts essential to meet the heightened pleading standard, so she is unable to plead the facts necessary for bringing a private claim.<sup>82</sup>

This law scams the investor.<sup>83</sup> It is cast in favor of the defendant, and as such, the PSLRA contradicts the original policy of federal securities regulation. (This law does not supplement state law, but rather, effectively supplants it by only allowing plaintiffs to realistically sue in state court.) Because it was more difficult for class action litigants to be successful under the federal securities regulations, many tried to sue under their own state’s laws.<sup>84</sup> Special interests struck back; Congress passed the Securities Litigation Uniform Standards

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72. *Id.*

73. *See id.*

74. *Id.* at 1059.

75. *Id.* at 1059-60.

76. *See* TWENTIETH CENTURY FUND, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 3 (1980).

77. There seems to be no other explanation; without special interest influence, it is unlikely that Congress would have amended federal securities regulation so unfavorably to investors. Also, this paper does not consider whether the shift in leadership in Congress from Democrat to Republican drove the changes in securities regulation.

78. Ramirez, *Arbitration*, *supra* note 59, at 1074-75 (quoting 15 U.S.C.A. § 78u-4 (b)(2)).

79. *Id.*

80. *See id.* at 1093. Ramirez concluded that “the PSLRA merely rigs private securities claims so that defendants almost always win.” *Id.*

81. *See id.* at 1076.

82. *Id.* at 1075-76.

83. *See* Ramirez, *Fear*, *supra* note 15, at 60 n.166. “Indeed, despite the proliferation of misconduct in the securities industry in the late 1990s[,] . . . [t]he average settlement for claims since the enactment of the PSLRA is as low as 2.29 cents on the dollar . . . arguably an invitation to defraud investors.” *Id.*

84. Ramirez, *Arbitration*, *supra* note 59, at 1058-59.

Act of 1998 (SLUSA)<sup>85</sup> to preempt states' jurisdiction over class action securities lawsuits.<sup>86</sup> Thus, no class action right under state law exists because of SLUSA, and its preemptive reply to the shift of suits to state courts. In order to bring a claim under state law today, the suit may not be a class action, and private action has been essentially eliminated from the federal courts because of the scienter requirement.<sup>87</sup> Accordingly, blue sky law viability exists only in the absence of class action. Plaintiffs must be very careful with their decision to bring suit.

#### IV. PUBLIC CHOICE THEORY BREAKS DOWN

In short, the reduction of investor rights in the area of federal securities litigation illustrates what public choice theorists espouse. Regulation can become the victim to special interest, while the interests of the public fall by the wayside. However, there are limits on the theory. Professor Dorothy Brown introduces one limit: how public choice breaks down with specific race issues and related legislation. Professor Steven Ramirez proffers another: how public choice breaks down when the regulatory process is uniquely structured. This paper submits that the Kansas Blue Sky law presents one more: public choice breaks down in certain jurisdictions with unique characteristics.

##### A. *Race as a High Saliency Issue*

Professor Brown utilized the education system to illustrate one of the failures of public choice theory.<sup>88</sup> She specifically pointed to education reform in New Jersey and described the five legislative responses to that reform.<sup>89</sup> The first, which was actually a judiciary response, began with a New Jersey Supreme Court ruling.<sup>90</sup> The 1973 *Robinson v. Cahill*<sup>91</sup> decision held that the system of education financing in New Jersey violated the state's constitution.<sup>92</sup> At that time, New Jersey's funding for education depended on local property taxes, while the state's constitution required "'thorough and efficient' education for New Jersey students."<sup>93</sup> In response, the state's legislature passed the Public School Education Act of 1975 to increase funding to all schools, but did not fund the act.<sup>94</sup> The New Jersey Supreme Court

85. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections of 15 U.S.C.).

86. See Ramirez, *Arbitration*, *supra* note 59, at 1058-59.

87. *Id.* at 1058-60.

88. Brown, *supra* note 9, at 179.

89. *Id.* at 181.

90. *Id.* at 190.

91. 303 A.2d 273 (1973), *on reargument*, 306 A.2d 65 (N.J. 1973), *cert. denied sub nom. Dickey v. Robinson*, 414 U.S. 976 (1973).

92. *Cahill*, 303 A.2d. at 295-98.

93. Brown, *supra* note 9, at 190.

94. *Id.* at 191.

then enjoined the state from any spending on education, and the entire state's school system was shut down.<sup>95</sup> Thus, in order to reopen schools, the state was forced to pass an income tax that would be enforced statewide.<sup>96</sup>

Thereafter, plaintiffs brought suit to have the new Act held unconstitutional because many students were still not receiving a "thorough and efficient" education.<sup>97</sup> The New Jersey Supreme Court agreed that the Act was unconstitutional as to the students educated in the "twenty-eight 'poorer urban districts.'"<sup>98</sup> It was also discovered that in 1984-85 "seventy-one percent of all minority students in New Jersey were educated in those districts."<sup>99</sup> The state had until the 1991-92 school year to improve its system of spending. Accordingly, by the 1991-92 school year, education spending was required to be substantially the same in the wealthier districts as that in the poorer districts.<sup>100</sup> After this ruling, the legislature responded with the Quality Education Act (QEA), which became the subject of a political battle and in only six months gave way to the QEA II.<sup>101</sup> When the dust settled, the QEAs had only benefited students in those poorer districts by a mere thirty-five percent of the new total state aid.<sup>102</sup> Consequently, the QEA II was declared unconstitutional, and the state had to counter with the Public School Reform Act of 1992, which leveled state funding to schools in the richer and poorer districts.<sup>103</sup>

Public choice would have predicted that, after the initial judicial decision in *Cahill*, individuals would unite to form special interest groups in reaction to the decision.<sup>104</sup> Professor Brown divided the predictions into three subcategories: (1) the "property-rich school districts [would] outbid other special interest groups;" (2) the "education lobby [would] outbid taxpayers;" and (3) the "property-poor districts [would] outbid taxpayers."<sup>105</sup> As the theory predicted, the richer districts were able to outbid the poorer with sheer monetary contributions, while the education lobbyists were able to outbid taxpayers

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95. *Id.* at 191-92.

96. *Id.* at 192.

97. *Id.* at 193.

98. *Id.*

99. *Id.*

100. *Id.* at 194-95.

101. *Id.* at 196. The QEA lasted just six months. *Id.* at 197. The media grabbed hold of the subject, accusing the QEA of benefiting solely minority students. *Id.* at 218. Rather than understand the actual Act, the public believed the media hype in spite of the fact that the QEA benefited more white students than minority students. *Id.* Thus, the political battle resulted in the extinguishment of the Act. *Id.* at 197.

102. *Id.* at 197-98.

103. *Id.* at 204.

104. *Id.* at 204-05. "[T]he special interest groups opposed to the court's intervention went to work." *Id.* at 205.

105. *Id.* at 205-08.

because of their ability to unite.<sup>106</sup> Collectively, the educational unions were able to pressure the state government into legislation favorable to them.<sup>107</sup> Additionally, the property-poor districts were more unified than individual taxpayers and were able to sway legislation in their favor versus the taxpayers.<sup>108</sup> All three of the groups at least partially achieved their goals with the enactment of the QEA. Public choice suggested each of those results.

Despite some accurate predictions, however, the theory failed to predict that the larger, immobilized middle-wealth groups would outbid other smaller, mobilized special interest groups when it came to the QEA.<sup>109</sup> Surprisingly, just six months after enactment, the QEA was dead.<sup>110</sup> The severe reaction by the legislature, passing the QEA II in such a short time, flies in the face of public choice because the theory does not account for ideology or the effect of the media.<sup>111</sup> Brown asserted that public choice was color-blind, and by being so, the theory failed to recognize the racial politics of this country.<sup>112</sup> Moreover, she argued that the theory "suggests that they all have the ability to capture the legislature [yet it] ignores that certain groups cannot capture the legislature because the legislation supported by those groups may cause an otherwise disorganized and disinterested majority to organize and oppose the legislation."<sup>113</sup> The demise of the QEA highlighted this assertion.

The QEA mainly benefited white children; however, because minorities brought the lawsuit that prompted the QEA, the perception was that the law benefited minorities.<sup>114</sup> This perception was emphasized in the media such that the middle-wealth taxpayers were all able to unite and defeat the law within a short amount of time.<sup>115</sup> In spite of their mass numbers and disinterest, the taxpayers defeated a law because of one unifying ideology: racism.<sup>116</sup>

An issue of high-saliency such as racism can halt the predictive power of public choice. The media grabbed onto the idea that the QEA only benefited the children from the poorer school districts and disseminated that information.<sup>117</sup> The middle-wealth taxpayers, incensed that minority children would benefit more so than white chil-

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106. *Id.* at 205-07.

107. *See id.* at 206-07.

108. *Id.* at 208.

109. *Id.*

110. *Id.* at 197.

111. *See, e.g., id.* at 210-17.

112. *Id.* at 211-12.

113. *Id.*

114. *Id.* at 213.

115. *Id.* at 218.

116. *See id.* at 211-19.

117. *Id.* at 218.

dren, became a voice in the legislature that public choice could not predict.<sup>118</sup>

Professor Brown maintained that because public choice “ignores ideology and media influence on the legislative process, [it] cannot predict the political influence that large and diffuse groups have in [that] process.”<sup>119</sup> Thus, Professor Brown illustrated that while public choice is a popular tool to predict outcomes in the legislative process, the theory was fatally flawed where racial politics are concerned.<sup>120</sup>

### B. *The Federal Reserve as a Depoliticized Structure*

Another setting in which public choice breaks down is illustrated by the Federal Reserve (Fed). Professor Steven Ramirez asserted that the Federal Reserve was a depoliticized government entity, cut off from special interest.<sup>121</sup> Ramirez maintained that an agency’s independence can be measured by:

(1) the breadth of its delegation; (2) the extent to which its governing body can be removed by the President; (3) the terms of the members of its governing body, especially its Chair; (4) the method of funding the agency; and (5) the degree to which the agency enjoys bipartisan, long-term political commitment to its independence.<sup>122</sup>

This is a multi-factored test that is broader than single-factor tests previously used, which usually “focused upon the President’s removal power.”<sup>123</sup>

Many have criticized independent government agencies. Scholars believed that no agency existed for public welfare; they asserted that the agencies have been compromised by special interest.<sup>124</sup> Special interest pressure comes from various directions.<sup>125</sup> Legislators, subject to reelection tunnel vision, and regulators, influenced by social pressures, exert control over the agency.<sup>126</sup> Therefore, Ramirez asked not whether agencies are influenced by special interest, but “whether there exists a threshold of independence beyond which an agency is highly resistant to capture.”<sup>127</sup>

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118. *Id.* at 213-14.

119. *Id.* at 222.

120. *Id.*

121. Ramirez, *Depoliticizing*, *supra* note 7, at 504-05. The Federal Reserve is virtually alone in its depoliticized structure. *See id.* at 586.

122. *Id.* at 518.

123. *Id.*

124. *Id.* at 521. The regulatory agencies have been “molded into ‘a friendly protector of private interest rather than an aggressive agent of the public welfare,’ and a means to provide ‘regulated groups with privileged access to government.’” *Id.* (quoting MARVER H. BERNSTEIN, REGULATING BUSINESS BY INDEPENDENT COMMISSION 266 (1955)).

125. *Id.* at 521.

126. *Id.* The social pressures range from “prospective employment to social functions.” *Id.* (quoting BERNSTEIN, *supra* note 124, at 211).

127. *Id.* at 522.

Ramirez asserted that the Fed is such an agency. Because it is highly resistant to capture, the Fed was able to function virtually alone for public welfare free of special interest influence.<sup>128</sup> Ramirez analyzed whether “depoliticized regulation delivers upon its promise of a sounder basis for regulation.”<sup>129</sup> His focus was narrowed to only the Fed’s success “in conducting monetary policy free of political influence.”<sup>130</sup>

At the Fed’s creation in 1913, Congress did not realize the importance of having such an independent agency, nor did it envision the power that the Fed would exert.<sup>131</sup> Initially, the Fed itself did not realize its place in American governance.<sup>132</sup> But by 1935, the Fed had evolved into the entity that it is today, and in 1950 it “exercise[d] its monetary policy might.”<sup>133</sup>

In 1951, the Fed’s power came under question. A conflict with the Treasury Department during the Korean War required mediation from the executive office.<sup>134</sup> President Truman resolved the conflict with the Treasury-Federal Reserve Accord, “which recognized that [the] ultimate authority for monetary policy rested with the Fed.”<sup>135</sup> The Treasury-Federal Reserve Accord also freed the Fed from the executive office’s fiscal policy.<sup>136</sup> Congress’ commitment to the Fed’s independence has also been demonstrated over the years.<sup>137</sup> In 1980, after the Fed was losing membership by banks, legislation was created that made compliance with the Fed’s reserve requirements mandatory.<sup>138</sup> Therefore the executive and legislative branches alike, while remaining special interest free, have protected the power of the Fed.

#### V. KANSAS’ UNIQUE CULTURAL CONTEXT ILLUSTRATES ANOTHER PITFALL OF PUBLIC CHOICE

While the law-making process is compromised by special interest politics, there are ways to depoliticize the process to insulate the structure as much as possible. Professor Brown suggested that this was most prevalent with high-saliency issues such as racism, and Professor Ramirez proposed that the Federal Reserve was another example of public choice breaking down.

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128. *See id.* at 538.

129. *Id.* at 538-39.

130. *Id.* at 539.

131. *See id.* at 540.

132. *See id.*

133. *Id.* at 540-41.

134. *See id.* at 541.

135. *Id.*

136. *See id.*

137. *Id.* at 542-48.

138. *See id.* at 545.

The Kansas Blue Sky Law has steadfastly clung to its ideals of investor protection since 1911.<sup>139</sup> What is different about Kansas from other states? A unique cultural environment developed in Kansas early in its history that combined the agricultural experience with citizen involvement in politics. This environment created an ideal that withstands today: the Kansas Blue Sky Law.

A. *The Cultural Climate in Kansas and the Blue Sky Law's Origin.*

The inordinate birth rate of the 'sucker' is proverbial, and there is no birth-control measure adequate to inhibit the spawning of unscrupulous individuals who prey upon those who are easily duped. Hence we have a Blue Sky Law.<sup>140</sup>

Kansas enjoyed a unique beginning as a state. There were hard times that struck Kansas, from tornadoes to grasshopper plagues.<sup>141</sup> Yet, Kansans continued to prosper and enjoyed active social lives that "often centered around church or school," and most Kansans were aware of and very involved in their government.<sup>142</sup> Political disputes raged in Kansas; for example, there were bitter fights about taxes and the location of county seats.<sup>143</sup>

In addition, Kansans found the Populist movement fashionable in the late 1800s and early 1900s.<sup>144</sup> The Populist movement held appeal for Kansans because the movement saw "itself [as] primarily devoted to furthering and defending the interests and attitudes of ordinary citizens."<sup>145</sup> Kansans were attracted to this ideal because they saw themselves as ordinary citizens.

Often suspicious of "large and powerful organizations," Populists were skeptical of "massive government bureaucracy and corporate privilege" alike.<sup>146</sup> Additionally, the Populist movement advocated that power in the hands of the same individuals for a significant period of time would undeniably promote corruption in those politicians.<sup>147</sup> Accordingly, Populists preferred "regular rotations of authority and

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139. *Compare* Harbor Bus. Blocks Co. v. Gregory, 169 P. 191, 192 (Kan. 1917) (affirming that defendants who violated the Blue Sky Law could be served copies of affidavits even if located outside the state), *with* Brenner v. Oppenheimer, 44 P.3d 364, 380 (Kan. 2002) (holding that defendants violated the Blue Sky Law by acting as a clearing broker, and in spite of a choice-of-law provision, Kansas' public policy outweighed that clause).

140. *Moos v. Landowners' Oil Ass'n*, 15 P.2d 1073, 1076 (Kan. 1932).

141. ROBERT W. RICHMOND, *KANSAS: A LAND OF CONTRASTS* 140-52 (1989). "The ordinary Kansan, who spent most of his time trying to make a decent living for his family, was aware of politics on all levels, and at times he got deeply involved." *Id.* at 152; *see also infra* text accompanying note 148.

142. RICHMOND, *supra* note 141, at 150.

143. *Id.* at 152-53.

144. *See* LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* 7-10 (1958).

145. J.M. Balkin, *Populism and Progressivism As Constitutional Categories*, 104 *YALE L.J.* 1935, 1945 (1995) (reviewing CASS SUNSTEIN, *A RESPONSE TO DEMOCRACY AND THE PROBLEM OF FREE SPEECH* (1993)).

146. *Id.*

147. *Id.*

power[,] . . . [and] popular participation in economic and political structures that affect the lives of ordinary citizens.”<sup>148</sup>

Moreover, Populism was a balance of public and private interests. Populism’s ideals included a rare “conception of self-rule and self-determination, one in which the active participation of the citizenry, when they choose to participate, was encouraged and facilitated.”<sup>149</sup> This private interest required that government allow Populists to make the decisions that govern their personal lives.<sup>150</sup> The public interest balanced this concern by commanding that “ordinary people have a say in the decisions that affect them, [and] that they be able to participate in those structures of power that shape their daily lives.”<sup>151</sup> Thus, according to Populist ideals, Kansans could participate in politics when they chose, while expecting their government to always act on their behalf.

Early in the twentieth century, Kansas stood as a prime target for fraudulent securities transactions proposed by more urban Easterners.<sup>152</sup> With its agricultural background, Kansas was an unsophisticated market with many assets.<sup>153</sup> Kansas citizens were “fat picking” to the stock swindlers.<sup>154</sup> Additionally, prior to the enactment of the blue sky law, there existed no law in any state to punish such acts.<sup>155</sup> As a result of repeated scams involving false investment opportunities, Populist principles became entrenched Kansas ideals.<sup>156</sup> Kansans demanded protective legislation against the charlatans.<sup>157</sup> The Kansas Bank Commissioner answered the demand by forming an investigative bureau to research speculative companies.<sup>158</sup> Soon thereafter, the Kansas legislature recognized the necessity of the bureau and enacted

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148. *Id.* Active participation in Kansas meant *active*. Indeed, a shadow government, consisting of Kansas Populists, took over the Kansas legislature in the early 1900s because they were not satisfied with the government’s activities. Interview with Roger Walter, Adjunct in Law, Washburn University School of Law, in Topeka, Kansas (Sept. 20, 2002).

149. Balkin, *supra* note 145, at 1945.

150. *See id.*

151. *Id.*

152. *See* Will Payne, *How Kansas Drove Out a Set of Thieves*, SATURDAY EVENING POST, Dec. 2, 1911.

153. *See id.* In late 1911, it was noted that Kansas had prospered greatly; in a period of fifteen years, Kansas state bank holdings went from less than fourteen to ninety million. *Id.*

154. *See id.*

155. *See id.* Joseph Dolley commented that “of course, . . . a man might sue . . . or prosecute them . . . under false pretenses; but a man couldn’t do either until after he had lost his money. So far as the law went there seemed nothing to do by way of protecting him from losing his money.” *Id.*

156. *See generally* Kansas Securities Act, KAN. STAT. ANN. §§ 17-1252 to -1268 (2001) (which codified Populist ideals). “Kansas had been a ‘stronghold’ of Populist philosophy. The resulting carryover today is to be found in the relative strictness of Midwestern securities statutes.” Taylor v. Perdition Minerals Group, Ltd., 766 P.2d 805, 809 (Kan. 1988). Indeed, Populist tenets still exist in Kansas, and as recently as 1995, Kansas’ governor Joan Finney referred to herself as a Populist. Carl Manning, *Service Honors Former Governor*, TOPEKA CAP. J., Aug. 2, 2001, [http://www.cjonline.com/stories/080201/kan\\_finneyfuneral.shtml](http://www.cjonline.com/stories/080201/kan_finneyfuneral.shtml).

157. *See Mr. Dolley’s Investment Information Bureau*, TOPEKA CAP. J., Jan. 6, 1911.

158. *See id.*

the Kansas Blue Sky Law to codify protection for the state's investors.<sup>159</sup>

The Kansas Blue Sky Law started as a protective measure.<sup>160</sup> Kansas Bank Commissioner Joseph Dolley acknowledged the burden on Kansas that the swindlers created.<sup>161</sup> There were various examples of cons including those that preyed on farmers promising fat returns from nonexistent mines, plantations located in Central America, or irrigation schemes in the new states.<sup>162</sup> At the time, however, the most onerous schemes preyed on widows.<sup>163</sup> Fake brokers would patrol the obituaries.<sup>164</sup> They would then approach the bereaved widows, lamenting their loss and the fact that the life insurance left by their beloved was inadequate.<sup>165</sup> Thereafter, the widows were coaxed into investing all of the insurance proceeds into phony ventures, and in the end were left with nothing.<sup>166</sup>

Consequently, Dolley, as bank commissioner, felt compelled to offer some form of protection from these false endeavors.<sup>167</sup> From the outside, the connection between counterfeit investments and banking was not clear. Much of the connection had to do with the commissioner himself.<sup>168</sup> Many of the state's citizens hailed Dolley as a financial genius<sup>169</sup> and turned to him for financial advice.<sup>170</sup> Commissioner Dolley received numerous letters and phone calls requesting advice on particular investments or whether it would be possible to retrieve any of the money lost from scams.<sup>171</sup> Additionally, bankers felt the direct effect of the counterfeit schemes because the money

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159. J. OF HOUSE 360 (Kan. 1911).

160. See *Joe Dolley Is After the Blue Sky Merchants*, TOPEKA CAP. J., Dec. 22, 1910. Some commentators have asserted that the Kansas Blue Sky Law was the first form of consumer protection in Kansas. Interview with Roger Walter, Adjunct in Law, Washburn University School of Law, in Topeka, Kan. (Sept. 20, 2002).

161. See *Joe Dolley is After the Blue Sky Merchants*, *supra* note 160.

162. See Payne, *supra* note 152.

163. See *To Censor Stock Sales: Commissioner Dolley Says Some Brokers Prey on Widows*, KAN. CITY J., June 4, 1910.

164. See *id.*

165. See *id.*

166. See *id.*

167. See *id.* An alternative theory posed by Jonathan Macey and Geoffrey Miller suggests that the banking industry's lobbying efforts led to the passage of the Blue Sky Law. See Macey & Miller, *supra* note 7. The authors go so far as to suggest that Dolley exaggerated the problem of fraudulent security sales to advance his own agenda. See *id.* However, the authors admit that their theory cannot fully explain the passage of the Kansas Blue Sky Law. "[T]he blue sky laws were undoubtedly popular at the grassroots level in many states, and the efforts by regulators such as J.N. Dolley . . . appear to have been motivated by an honest, even admirable sense of public service rather than any selfish or venal concerns." *Id.* at 397. Macey and Miller do not attempt to explain why the local banks were able to lobby successfully to defeat the efforts of national investment banks. Indeed, any lobbying done by local banks succeeded because of the unique cultural climate that already existed in Kansas.

168. See *The Cost of Meat Has Not Touched Bottom*, TOPEKA CAP. J., Apr. 30, 1911.

169. See *id.* Joe Dolley was also the chairman of the state committee and the political manager of Governor W. R. Stubbs. *First Break into the Newspapers*, KAN. CITY J., Mar. 20, 1910.

170. See *To Censor Stock Sales*, *supra* note 163.

171. See *id.*

was withdrawn from their banks, so they also pressured Dolley to put a stop to the fake brokers.<sup>172</sup>

Dolley's answer to the conundrum of abolishing the worthless investments in Kansas without actual criminal sanctions was to create an investigative agency.<sup>173</sup> On top of managing the 862 state banks, Commissioner Dolley created the Investment Information Bureau with no budget for this purpose.<sup>174</sup> He sent to the state's newspapers a letter to print; the letter was "an invitation to apply to his office for information as to their investments."<sup>175</sup> The invitation was well-received, and many people wrote to Dolley requesting information regarding ventures about which they had been approached.<sup>176</sup> When Dolley received the letters, he then ordered the pertinent information from the "officers" of the investment company.<sup>177</sup> After receiving the information, if there was any to send, Dolley advised the writer whether to invest in the venture.<sup>178</sup>

In his 1910 report before the legislature, Dolley testified of his success and submitted a proposed piece of legislation, which gave the Bank Commissioner teeth to deal with the fake brokers.<sup>179</sup> By this time, Dolley's bureau had become quite popular, and the proposed legislation was passed quickly into law.<sup>180</sup> On March 10, 1911, the Kansas legislature approved House Bill Number 906, "[a]n act to provide for the regulation and supervision of investment companies, and providing penalties for the violation thereof."<sup>181</sup> Some legislators were hesitant to vest so much power in one person, but decided they would rather have the law than not to protect their constituents.<sup>182</sup> For example, one legislator commented that "the benefits to be de-

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172. See Payne, *supra* note 152.

173. See *Mr. Dolley's Investment Information Bureau*, TOPEKA CAP. J., Jan. 6, 1911.

174. *Id.*; Payne, *supra* note 152. Dolley stated that "there is a well-defined theory at Topeka . . . 'the grand duty of the state government is to protect depositors rather than merely make things pleasant for bankers.'" Payne, *supra* note 152.

175. *Mr. Dolley's Investment Information Bureau*, *supra* note 173. The invitation read as follows:

TO THE PEOPLE OF KANSAS

TOPEKA, April 9, 1910

The State Banking Department has established a bureau for the purpose of giving information as to the financial standing of companies whose stock is offered for sale to the people of Kansas. If you are offered any stock and want information as to the financial standing of the company offering the same, before investing, please write to this department and I will furnish it.

J. N. DOLLEY, State Bank Commissioner.

Payne, *supra* note 152.

176. *Mr. Dolley's Investment Information Bureau*, *supra* note 173.

177. *Id.*

178. See *id.*

179. MARKLEY, *supra* note 1, at 78.

180. See Payne, *supra* note 152.

181. J. OF HOUSE 360 (Kan. 1911).

182. *Id.*

rived from such a law will outweigh any possible evil.”<sup>183</sup> These legislators recognized that Kansas suffered great economic loss as a result of the state’s inability to punish the charlatans.<sup>184</sup> Consequently, they acknowledged the necessity of a blue sky law and created an example for many other states to follow.<sup>185</sup>

The original Blue Sky Law required companies that wanted to sell securities to register with the Bank Commissioner.<sup>186</sup> Then, if the commissioner found, for instance, that the company’s articles of incorporation were inadequate or that the company was insolvent, it was not allowed to peddle securities in the state.<sup>187</sup> Additionally, any falsities with regard to the sale of securities were punishable.<sup>188</sup> Violations of these prohibitions resulted in fines and prison sentences, which could range from one to ten years.<sup>189</sup>

Today, the Kansas Blue Sky Laws’ prohibitions remain virtually the same: it is unlawful for anyone to commit fraud in connection with the sale of securities or to make an “untrue statement of a material fact or to omit . . . a material fact.”<sup>190</sup> But for Kansans, the most important section of the Blue Sky Law is in Kansas Statutes section 17-1268.<sup>191</sup> This section provides a tremendously investor-friendly civil remedy.<sup>192</sup> In contrast to the PSLRA, there is no scienter requirement in Kansas.<sup>193</sup> Once negligence is alleged, that the broker either lied about or omitted a material fact, the burden is on the broker to prove that he “did not know and in the exercise of reasonable care could not have known of the untruth or omission.”<sup>194</sup>

This onerous burden on the untruthful seller creates an uphill battle for a defendant. If it is found that the broker did lie or omit a material fact, the broker is liable for the entire amount invested.<sup>195</sup> The buyer holds a complete rescission remedy.<sup>196</sup> Furthermore, the buyers are entitled to fifteen percent of their investment per year from

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183. *Id.* (statement by J. N. Herr). Another legislator commented that “[w]hile this bill does not exactly meet with my views on this subject, yet, in view of the fact that unscrupulous concerns have drained at least one-half million dollars in the last few years from my county for fake investments, I vote Aye.” *Id.* (statement by W. P. Feder).

184. Dolley estimated that Kansans had lost “somewhere between one and three millions of dollars per annum.” *Joseph Dolley is After the Blue Sky Merchants*, *supra* note 160.

185. *See* MARKLEY, *supra* note 1, at 78-79.

186. *See* Investment Companies- Providing for Regulation and Supervision, 1911 Kan. Sess. Laws ch. 133, § 2 at 210.

187. *See id.* § 6, at 213.

188. *See id.* § 12, at 215.

189. *See id.* § 13, at 215-16.

190. *See* Kansas Securities Act, KAN. STAT. ANN. §§ 17-1253(a)(1) to (2) (1995 & Supp. 2002).

191. *See id.* § 17-1268.

192. *See id.*

193. *See id.* § 17-1268(a).

194. *Id.*

195. *See id.*

196. *See id.*

the date the money was paid to the broker.<sup>197</sup> Fifteen percent is a virtually unheard of return! It is apparent that section 17-1268 is immeasurably protective. The law does not require the injured buyer to prove causation or damages.<sup>198</sup> If it is found that the broker lied or made a material misrepresentation to a buyer, the broker is liable.<sup>199</sup> Additionally, there exists a generous statute of limitations provision.<sup>200</sup> Investors have three years from the date of discovery of the misrepresentation to bring suit.<sup>201</sup> It is obvious that modern-day Kansas Blue Sky legislation offers tremendous protection for its citizens.

Throughout the last century, Kansas securities regulation has created more protection for the consumer as the laws have been refined. The evolution of the Kansas Blue Sky law runs counter to the public choice theory. Theorists would have predicted the weakening of Kansas securities regulation, similar to the weakening in the federal arena where a series of acts that intended to protect investors were crippled by lobbyists. This exception to the public choice theory can be attributed to the unique cultural climate that existed when the laws were created and continue in some form to this day.

### B. *Kansas Blue Sky Law Cases*

One public choice scholar stated “[t]ake almost any government program at random, and a ‘special interest’ counter-majoritarian explanation can be found that is more plausible than the public interest justification for it.”<sup>202</sup> Yet, the Kansas Blue Sky Law vindicates the general public interest of Kansas citizens. There are few counter-majoritarian explanation that can disprove the public interest stance of the Blue Sky Law. As previously discussed, the legislature has defended the public interest. When faced with the opportunity to water down these laws, the state court system still contradicted what public choice would have predicted and upheld the public interest.

The Kansas Supreme Court decided in 1930 that the Blue Sky Law “is to be liberally interpreted” in favor of purchasers to prevent fraud.<sup>203</sup> Additionally, Kansas public policy “favors the regulation of securities transactions for the protection of Kansas investors.”<sup>204</sup>

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197. *See id.*; *see also* Taylor v. Perdition Minerals Group, 766 P.2d 805, 808 (Kan. 1988). A “person who sells a security which is required to be registered under K.S.A. 17-1255 but is not registered,” or if a person sells the security by making “untrue statements of material facts,” that person “may be liable to [the buyer of] the security for the consideration paid for the security plus interest, costs, and attorney fees.” Taylor, 766 P.2d at 808.

198. *See* KAN. STAT. ANN. § 17-1268(a).

199. *See id.*

200. *See* Kelly v. Primeline Advisory, Inc., 889 P.2d 130, 137 (Kan. 1995).

201. *Id.*

202. Cass, *supra* note 8, at 790.

203. Daniels v. Craiglow, 292 P. 771, 772 (Kan. 1930).

204. Brenner v. Oppenheimer & Co., 44 P.3d 364, 380 (Kan. 2002).

Since 1911, the policy behind the Kansas Blue Sky Laws has remained virtually untouched by the Kansas legislature.<sup>205</sup> For ninety years neither the Kansas legislature nor the Kansas courts have fallen prey to special interest groups, and each has continued to preserve the integrity of the Blue Sky Laws.<sup>206</sup>

Early on, the Kansas Supreme Court set precedent in favor of Kansas investors. In 1917, the Kansas Supreme Court held in *Harbor Business Blocks Co. v. Gregory*<sup>207</sup> that the Kansas Blue Sky Law protected Kansas investors when investing in real estate.<sup>208</sup> The investor purchased lots in Contra Costa County, California.<sup>209</sup> These lots were sold to the Kansas investor through a fraudulent “swindle . . . of that familiar, high-handed type which prompted [states] to enact . . . blue sky laws.”<sup>210</sup> The plaintiff, the California corporation that fraudulently sold the lots, brought the action in order to enforce the promissory notes that the defendant, the Kansas investor, executed.<sup>211</sup> The defendant prevailed, and the plaintiff appealed, arguing that certain affidavits were incorrectly admitted into evidence.<sup>212</sup> The Kansas Supreme Court affirmed the ruling, holding that affidavits were “not in any strict sense a writ or process of a court.”<sup>213</sup> Thus, because of their liberal interpretation of affidavits, the court ruled that each was correctly admitted into evidence.<sup>214</sup> Additionally, the court held that the defendant had adequately rescinded the contract with written notice.<sup>215</sup> The plaintiff argued that written notice was insufficient because the subject of the contract was real estate, which required a reconveyance of the deed to rescind the contract.<sup>216</sup> However, the court held that the written notice was sufficient because plaintiff had only conditionally delivered the deeds to the defendant.<sup>217</sup>

In *Taylor v. Perdition Minerals Group, Ltd.*,<sup>218</sup> the Kansas Supreme Court held that “[s]trict liability is imposed on partners, officers, and directors to purchasers of unregistered securities sold in violation of [K.S.A. section 17-1268] regardless of whether the part-

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205. See generally KAN. STAT. ANN. § 17-1252 to -1268 (1995 & Supp. 2002). Originally codified as the Speculative Securities Act in the Kansas Statutes at section 17-1201, the Act has been codified in scattered sections of Chapter 17 throughout its history.

206. See *id.* §§ 17-1252 to -1268.

207. 169 P. 191 (Kan. 1917).

208. *Id.* at 192.

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. See *id.*

215. *Id.* at 193.

216. *Id.*

217. *Id.*

218. 766 P.2d 805 (Kan. 1988).

ner, officer, or director materially aided in the sale.”<sup>219</sup> The court decided that the only way to refute strict liability was to prove that “he or she could not reasonably have had knowledge of the facts by reason of which liability is alleged to exist.”<sup>220</sup> In *Taylor*, four directors sought to prove that because they had not “materially aided in the sale” of securities to Taylor, the Kansas investor, they should not be liable for the sale.<sup>221</sup> However, the Kansas Supreme Court rejected the materially aided standard and instead opted for the knowledge standard.<sup>222</sup> With the more burdensome measure, the directors could not prove that they did not have knowledge of the facts that lead to liability.<sup>223</sup> As a result, in Kansas, directors must have knowledge of what is happening under their noses; they are not allowed to rest on their laurels merely arguing that they did not become involved in the fraudulently sold securities to avoid liability. Kansas demands director involvement.

Recently, in *Brenner v. Oppenheimer & Co.*,<sup>224</sup> the Kansas Supreme Court overturned a well-established contract principle in favor of Kansas public policy.<sup>225</sup> A New York company, L.T. Lawrence, sold Roger Klein and Daniel Brenner unregistered securities.<sup>226</sup> A clearing broker, Oppenheimer & Co., “cleared trades for L.T. Lawrence, which had no authority to clear trades itself.”<sup>227</sup> The agreement signed by the appellants included a choice-of-law clause, which required New York’s laws to govern any litigation resulting from a dispute arising out of the agreement.<sup>228</sup> The appellants alleged that they purchased the brokerage accounts with the belief that Oppenheimer controlled the accounts and relied on Oppenheimer’s reputation.<sup>229</sup> Oppenheimer countered that all customers of L.T. Lawrence were provided a disclosure statement, which stated that L.T. Lawrence acted independently of Oppenheimer.<sup>230</sup> The sale of unregistered securities violated K.S.A. section 17-1255.<sup>231</sup>

The issue of whether a clearing broker was liable “for the sale of unregistered securities [was one] of first impression in Kansas.”<sup>232</sup> The Kansas Supreme Court noted that because “[c]learing brokers are

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219. *Id.* at 806.

220. *Id.*

221. *Id.* at 808.

222. *Id.* at 806.

223. *See id.* at 808.

224. 44 P.3d 364 (Kan. 2002).

225. *Id.* at 380.

226. *Id.* at 367.

227. *Id.*

228. *Id.*

229. *Id.* at 368.

230. *Id.*

231. *Id.* at 369, *see also* KAN. STAT. ANN. § 17-1255 (1995 & Supp. 2002).

232. *Brenner*, 44 P.3d at 370.

. . . able to contract out of liability” with choice of law provisions and that “the introducing brokers are often judgment proof[,] . . . defrauded customers are often left with no legal recourse.”<sup>233</sup> Consequently, the court found that Kansas’ public policy stood in contrast to the choice-of-law provision and held in favor of Kansas citizens’ rights.<sup>234</sup>

A public choice theorist might argue that there was no need to challenge the state laws because they could have been weakened by judicial interpretations. However, as the above cases exemplify, the Kansas Blue Sky Laws have grown stronger through judicial construction.<sup>235</sup> While there are potential criticisms of this exception to the public choice theory, the proposition that the courts have been subject to special interest does not hold true in Kansas.

## VI. THE CHOICE OF LAW PROBLEM AND OTHER CRITICISMS

This note would lead one to believe that business, which would benefit from the overturning of the Kansas Blue Sky Law, has left it alone merely because it would be impossible for special interest to overcome the strong public interest of the Kansas legislature and courts. This may not be the whole story.

Prior to the *Brenner* decision, it may have been possible to eradicate the pesky problem of the Kansas Blue Sky Law simply by attaching a choice-of-law clause in the securities contract. But, after the decision, it is clear that a choice-of-law provision will not cure the blue sky problem.<sup>236</sup> Consequently, those businesses with much at risk from the loss of the ability to choose a forum when dealing with Kansas investors might now feel obligated to seek the overturning of the Blue Sky Law.<sup>237</sup>

On the other hand, choice of law may not be the answer. It is no secret that Kansas is not the most densely populated state. As a consequence of low population, Kansas’ securities regulation may not register on the radar screen of many big businesses. Or, even if corporations are aware of the Blue Sky Law, investors from Kansas may account for such a small percentage of their shareholders that it is not

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233. *Id.* at 380.

234. *Id.*

235. *See generally* Kelly v. Primeline Advisory, Inc., 889 P.2d 130 (Kan. 1995). Until this case, the statute of limitations was unclear; however, *Primeline* defined the statute generously. *See id.* at 137. Because of *Primeline*, the statute of limitations is now three years from the date of discovery of the fraud, which is broader than most statute of limitations. *See id.*

236. *See generally* *Brenner*, 44 P.3d 364 (holding that Kansas public policy overrides choice-of-law clauses).

237. Nevertheless, reversing choice-of-law clauses on public policy grounds is not a new concept. That possibility has always existed. *See generally* Barbour v. Campbell, 168 P. 879 (Kan. 1917) (holding that the contravention of choice of law provisions is a well-known exception). *Brenner* is not quite the slap-in-the-face that it seems.

worth the money it would cost to sway Kansas legislators to overturn the law. If this is the case, the cultural context of Kansas does not explain the staying power of the Kansas Blue Sky Law.<sup>238</sup>

Yet, these explanations do not suffice. Even with a small percentage of shareholders in Kansas, it would seem impossible that the law would stand untouched for close to a century. The rescission right and punitive aspects are far too powerful to ignore. Kansas politics has simply defied public choice by steadfastly clinging to its ideals in the face of special interest.

## VII. CONCLUSION

There is no other way to put it; Kansas' Blue Sky Laws have not fallen prey to special interest influence. The state has held firm in its policy to protect its investors. While the laws have not stood free of challenges, the courts and legislature have steadfastly clung to the ideals established in 1911. The strength of the Kansas Blue Sky Act is a direct reflection of the Kansas cultural context.

Kansas is a state where, as far as securities regulation is concerned, public policy reigns supreme. Public choice could not have predicted that this government program would remain independent, just as it could not have envisioned the independent Federal Reserve or have anticipated a "disinterested" majority's racially driven reaction. While the theory continues to be a valuable predictive tool in some areas, there exist flaws in its sweeping views. Admittedly, it is difficult to measure culture, but regardless of whether one views the Kansas Blue Sky Law as further evidence of public choice's decline or just a mere coincidence, residents of Kansas can be grateful that their government has provided the protection that it has.<sup>239</sup>

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238. Similarly, special interests may have believed that SLUSA offered the protection it sought not only in Kansas, but also coast to coast because SLUSA preempted state securities laws. *See supra* notes 84-86 and accompanying text. However, there is nothing in SLUSA that prohibits claims against brokers; SLUSA merely preempts state security law in the case of class action. *See supra* notes 84-86 and accompanying text.

239. The theory posited by this paper will be tested. If Kansas considers the proposed 2002 Uniform Securities Act for adoption, the door could be opened for special interest to attack the Kansas Blue Sky Law. *See generally* National Conference of Commissioners on Uniform State Laws, *Uniform Securities Act*, <http://www.law.upenn.edu/bll/ulc/securities/2002final.htm> (recommended for enactment July 26 - Aug. 2, 2002).