SECONDARY LIABILITY FOR SECURITIES FRAUD: GATEKEEPERS IN STATE COURT

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ABSTRACT

The recent economic meltdown exposed numerous Ponzi schemes. When promoters of fraudulent ventures are unable to provide restitution to their victims, plaintiffs seek out other sources of repayment including professionals and other secondary participants in the transactions that precipitated their losses. Although most scholars agree that professionals can perform an important role in deterring securities fraud, scholarly opinions vary widely on the appropriate liability regime, if any, that these gatekeepers should face.

While civil liability for secondary participants in securities fraud was once well accepted in the federal courts, in 1994 the Supreme Court invalidated such claims as beyond the purview of Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5. In contrast, there is a robust tradition of aiding and abetting liability in most state blue sky statutes. Unlike the federal implied Rule 10b-5 cause of action, state blue sky laws contain express secondary liability statutes that do not have strict scienter standards or rigorous pleading requirements. Indeed, some state statutes are negligence based and contain burden-shifting provisions that require non-seller defendants to establish that they were not negligent in failing to discover the seller's fraud.

This Article traces the development of secondary liability under state securities laws and contrasts various state regimes and their federal counterparts. It also reviews federal efforts to restrict states from adjudicating securities related claims. Relying on available empirical evidence, the Article ultimately concludes that Congress should reverse its propensity of the last decade to preempt state securities actions and should recognize the valuable contribution of such actions in addressing fraud, particularly fraud committed upon retail investors.

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I. INTRODUCTION

The recent economic meltdown stemming from the housing crisis exposed numerous Ponzi schemes—from Madoff to Palm Beach Capital—which were no longer able to masquerade as profitable enterprises under the strain of catastrophic market realities.[1] As a result, victims in ever increasing

[1] *See* Pl.'s Compl., SEC v. Bruce F. Prévost, 2010 WL 4222864 (D. Minn. filed Oct. 14, 2010) (Trial Pleading) (securities fraud case involving investment fund managers who funneled more than one billion dollars of their clients' money into a multibillion dollar Ponzi scheme); Pl.'s Second Am. Compl. for Violations of the Fed. Sec. Laws, SEC v. Med. Capital Holdings, Inc., 2010 WL 2189038 (C.D. Cal. filed Mar. 16, 2010) (Trial Pleading) ("Defendants misappropriated approximately $20.4 million of the $74.7 million raised through sale of MP VI notes to pay purported administrative fees to MCC."); Pl.'s Compl., SEC v. Sunwest Mgmt., Inc., 2009 WL 1284041 (D. Or. filed Mar. 2, 2009) (Trial Pleading) (alleging Sunwest nursing home empire was in fact an illegal Ponzi scheme); Jane J. Kim, *Cracking Down on 'Private Placement'*

numbers are filing lawsuits alleging misrepresentations in connection with a variety of securities transactions. When promoters of fraudulent ventures are unable to provide restitution, plaintiffs seek out alternate sources of repayment including those who aided or facilitated the original transactions. Imposition of this secondary liability largely impacts professionals including attorneys, accountants, and investment bankers. Although most scholars agree that professionals can perform an important role in deterring securities fraud,[2] scholarly opinions vary widely as to the appropriate gatekeeper liability regime.[3] Civil liability for secondary participants in securities fraud was once well accepted in federal courts.[4] In 1994, however, the United States Supreme Court invalidated such claims as beyond the purview of Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)") and Rule 10b-5, the most widely utilized antifraud provisions in the federal securities laws.[5] Fifteen years later, in conjunction with recent financial reform legislation, Congress again considered the wisdom of reinstating private civil aiding and abetting liability for Rule 10b-5 securities fraud.[6]

Investments, WALL ST. J., Mar. 27, 2010, http://online.wsj.com/article/SB10001424052748704211704575139831790780958.html (detailing increase in private placement fraud); Steve Stecklow, *In Echoes of Madoff, Ponzi Cases Proliferate*, WALL ST. J., Jan. 28, 2009, at A1, *available at* http://www.pyramidschemealert.org/PSAMain/news/PonziCasesProliferate.pdf ("At least six suspected multimillion-dollar fraud cases have emerged this month alone, many of them alleged Ponzi schemes . . . .").

[2]There is voluminous literature on the efficacy of gatekeepers in business transactions. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 334-36 (2006) (suggesting reforms to improve gatekeeping roles of various professionals); *accord* Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1022 (1993) (discussing whether "use of enforcement actions against professional advisers" are an efficient regulatory regime); Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 55 (1986) (discussing criteria to evaluate gatekeeper liability strategies); Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 891 (1984) ("[G]atekeeper liability will thwart a class of offenses that are unreachable through enterprise-level or managerial sanctions.").

[3]*Compare* Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L.Q. 491, 492 (2001) (recommending that gatekeepers have a modified strict liability regime without a due diligence defense), *with* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 MINN. L. REV. 323, 324 (2007) (recommending that gatekeepers be rewarded rather than punished).

[4]*See, e.g.*, Farlow v. Peat, Marwick, Mitchell & Co., 956 F.2d 982, 986 (10th Cir. 1992).

[5]*See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994). The Court reaffirmed its view in Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008).

[6]In 2009, Senator Arlen Specter introduced a bill to restore civil aiding and abetting liability for Rule 10b-5 and other 1934 Act violations. *See* Liability for Aiding and Abetting Securities Violations Act of 2009, S. 1551, 111th Cong. § 2(2) (2009). In 2010, Senator Specter, on behalf of himself and eleven others introduced an amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") to restore aiding and abetting liability. Dodd-Frank

It is interesting to note, however, that any discussion of the appropriate role of state law was absent from this recent debate. In contrast to the current federal regime, there is a robust tradition of aiding and abetting liability in most state blue sky statutes.[7] Secondary liability is perhaps alleged most often in state court litigation over failed private offerings where the promoter is insolvent, such as the recent two-billion dollar Medical Capital promissory note Ponzi scheme.[8] Many of these state actions target professionals who fail to detect the fraudulent activity of their clients. Unlike the federal implied Rule 10b-5 cause of action, state blue sky laws contain express secondary liability statutes that do not have strict scienter standards or rigorous pleading requirements.[9] Indeed, some state statutes are negligence based and contain burden-shifting provisions that require non-seller defendants to establish that they were not negligent in failing to discover the seller's fraud.[10]

The increasing number of state court civil suits to redress securities fraud is a logical consequence of federal preemption of state authority over securities offerings. In 1996, as part of the National Securities Market Improvement Act ("NSMIA"),[11] Congress preempted state regulatory authority over Rule 506 private placements, which represent the bulk of private offerings. As a result, many allegedly fraudulent securities offerings now take place as preempted private placements that are virtually unregulated by any federal or state governmental agencies.[12] As a consequence, private state civil suits, including those naming secondary defendants, are necessary to fill this enforcement vacuum.[13]

Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z (enacted July 21, 2010). Ultimately the aiding and abetting issue was consigned to a GAO study. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

[7]*See, e.g.*, Alan R. Bromberg & Lewis D. Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALB. L. REV. 637, 659 (1987) ("Aiding-abetting has been recognized in state securities statutes since the mid-1950s.").

[8]Class Action Compl., Benson v. JP Morgan Chase Bank, 2009 WL 3874046 (N.D. Cal. filed Nov. 5, 2009) (Trial Pleading) (class action against bank as aider and abettor of private placement securities); Class Action Compl. for Or. Sec. Law Damages Claim Not Subject to Mandatory Arbitration, D. Kurtz's Canyon Crest, LLC v. Davis Wright Tremaine LLP, 2009 WL 1265855 (Or. Cir. filed Feb. 26, 2009) (Trial Pleading) (class action complaint against attorneys that drafted disclosure document in failed senior housing venture).

[9]*See infra* notes 110-14 and accompanying text.

[10]*See infra* Part III.A.

[11]National Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of 15 and 29 U.S.C.).

[12]*See* Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL J. CORP. L. 151, 156-58 (2010) (examining NSMIA's legislative history).

[13]Occasionally state regulators will also bring enforcement actions against secondary defendants. *See, e.g.*, Admin. Compl., *In re* Sec. Am., Docket No. 2009-0085 (Secretary of the

This Article explores the appropriate relationship between these state blue sky laws and federal Rule 10b-5 jurisprudence. This Article concludes that Congress should reverse its propensity of the last decade to preempt state securities actions and recognize the valuable contribution of such actions in addressing securities fraud, particularly fraud upon retail investors.

Part II briefly reviews the current federal regime imposing civil liability for securities fraud, including congressional and judicial limitations restricting this cause of action. It then explains that under judicial interpretations of the federal antifraud securities statutes, secondary liability is largely confined to designated statutory "control persons."

Part III contrasts the federal scheme with the more plaintiff-friendly state blue sky laws. Part III demonstrates that there is a robust tradition in state blue sky laws imposing secondary liability for securities fraud and that, under some state statutes, professionals can be liable for failing to serve as effective gatekeepers.

Part IV discusses congressional preemption of state securities class actions and the limitations imposed upon these state liability schemes by the Dormant Commerce Clause. Part IV then explains the rational divide between national markets and private placements and suggests that, perhaps by accident, state civil suits escape the problems that continue to plague federal class actions.

Part V explores the policy implications of state laws that fundamentally differ from the federal system, and sometimes, each other. It examines the costs and benefits of the most aggressive blue sky statutes and argues that state experimentation should continue without congressional interference. This Article concludes with the observation that state securities antifraud laws operate on an important and appropriate stage and suggests that Congress resist any calls for further preemption.

II. SECONDARY LIABILITY UNDER THE FEDERAL SECURITIES STATUTES

A. *1934 Act—Rule 10b-5 Jurisprudence*

The vast majority of private securities litigation in the federal courts involves Section 10(b) of the 1934 Securities Exchange Act ("1934 Act")[14] and Rule 10b-5[15] that prohibit fraud in connection with the purchase or sale

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Commonwealth of Mass. filed Jan. 26, 2010) (Trial Pleading) (enforcement action against broker-dealer).

[14]Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006).

[15]17 C.F.R. § 240.10b-5 (2010).

of securities.[16] Courts have consistently implied a private cause of action under Rule 10b-5[17] and over time, along with occasional tinkering by Congress, have established the elements of the private claim. As set forth by the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo*,[18] to establish a prima facie case under Rule 10b-5, a private plaintiff must plead and prove (1) a material misrepresentation or omission by the defendant;[19] (2) scienter;[20] (3) a connection between the misrepresentation or omission and the purchase or sale of a security;[21] (4) reliance upon the misrepresentation or omission;[22]

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[16]Rule 10b-5 was drawn from Section 17(a) of the 1933 Act:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5; Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006). Perhaps surprisingly, while there is a rich judicial precedent interpreting Rule 10b-5(b) as prohibiting material omissions and misstatements of fact, there are very few cases directly addressing clauses (a) and (c), sometimes cumulatively deemed "fraud-by-conduct." Ronald J. Colombo, *Cooperation with Securities Fraud*, 61 ALA. L. REV. 61, 70 (2009) (quoting O'Connor v. R.F. Lafferty & Co., 965 F.2d 893, 898 (10th Cir. 1992)); *cf.* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158-60 (2008) (discussing fraud by conduct in the context of secondary actors).

[17]*See, e.g.*, Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). *Kardon* held that Rule 10b-5 included a private right of action. This holding, adopted by an overwhelming majority of lower courts, was ultimately endorsed by the U.S. Supreme Court in 1971. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); *see also* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 79 (2006) (citing Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971)); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976).

[18]544 U.S. 336, 341-42 (2005).

[19]Under applicable Supreme Court precedent, "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

[20]To establish scienter, the plaintiff must prove the defendant intended to "deceive, manipulate, or defraud" the plaintiff. *Ernst & Ernst*, 425 U.S. at 193. Among the federal circuit courts, this intent requirement is satisfied by knowledge and varying degrees of recklessness. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007). The Supreme Court in *Tellabs* also clarified the pleading standard for scienter:

> [T]he inference of scienter must be more than merely "reasonable" or "permissible"—it must be cogent and compelling, thus strong in light of other explanations. A complaint will survive . . . only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged.

Id. at 324.

[21]*See Blue Chip Stamps*, 421 U.S. at 730 (acknowledging a private cause of action under Rule 10b-5 and establishing standing requirements as limited to "purchasers" or "sellers" of securities).

(5) economic loss;[23] and (6) loss causation.[24] In 1995, Congress, in an effort to curb what it deemed vexatious litigation, enacted the Private Securities Litigation Reform Act ("PSLRA").[25] The PSLRA imposed severe procedural hurdles for Rule 10b-5 plaintiffs. For example, to defeat a motion to dismiss, before any discovery plaintiffs must state with particularity facts detailing the fraud and "giving rise to a strong inference that the defendant acted with [scienter]."[26]

Until 1994, secondary participants in securities fraud transactions, such as attorneys, accountants, underwriters, and banks, faced civil aiding and abetting liability as well as potential primary liability under Rule 10b-5.[27] However, the scope of aiding and abetting liability and the distinctions from a primary violation under Rule 10b-5 were never clear. Given the universal judicial recognition of Rule 10b-5 aiding and abetting liability before 1994, litigants and courts had little need to parse out the distinctions between secondary and primary liability.[28] While somewhat murky, the elements of Rule 10b-5 secondary liability were generally

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[22]*See* Basic Inc. v. Levinson, 485 U.S. 224, 241-50 (1988) (reiterating the importance of the reliance element and establishing the rebuttable presumption of "fraud-on-the-market"). In *Stoneridge*, the Supreme Court held that the reliance element of Section 10b and Rule 10b-5 requires that investors be aware of the defendant's role in the challenged transaction. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159 (2008).

[23]In *Dura Pharm. v. Broudo*, the Court cites 15 U.S.C. § 78u-4(b)(4) as authority for the necessity of proving economic loss; the cited provision, however, actually refers to loss causation. 544 U.S. 336, 338 (2005); *see also* 15 U.S.C. § 78u-4(b)(4) (2006) ("[T]he plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter *caused the loss* for which the plaintiff seeks to recover damages." (emphasis added)).

[24]*Dura Pharm.*, 544 U.S. at 338.

[25]Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

[26]*Id.* (codified as amended at 15 U.S.C. § 78u-4(b)(2) (2006)). Among its many other provisions, the PSLRA provides: a discovery stay pending a motion to dismiss, *id.* (codified as amended at 15 U.S.C. § 78u-4(b)(3)(B)); a statutory safe harbor (unavailable under most state blue sky laws) for forward-looking statements, *id.* (codified as amended at 15 U.S.C. § 78u-5(c); lead plaintiff criteria, *id.* (codified as amended at 15 U.S.C. § 78u-4(a)(3)); a safe harbor for forward-looking statements, *id.* (codified as amended at 15 U.S.C. § 77z-2); and a proportionate liability system, *id.* (codified as amended at 15 U.S.C. § 78u-4(f)).

[27]Retracing the historical development of aiding and abetting liability as established in *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673 (N.D. Ind. 1966), Professor Fischel noted, "*Brennan*'s underlying rationale was immediately followed by other courts," and liability for aiding and abetting a Rule 10b-5 violation became part of securities law jurisprudence. Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 83-85 (1981).

[28]Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1224 n.8 (10th Cir. 1996) ("Commentators have long recognized vagaries in the borders between primary and secondary liability.").

premised on a secondary participant knowingly providing substantial assistance to the primary violator.[29]

In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, a closely divided Supreme Court held that the statutory text of Section 10(b) of the 1934 Act did not support aiding and abetting liability in private civil actions under Rule 10b-5,[30] a holding reversing the prior law in every circuit.[31] The *Central Bank* decision also rendered uncertain the continuing ability of the SEC to bring enforcement actions based upon aiding and abetting liability.[32] In 1995, as part of the political compromise surrounding the enactment of the PSLRA,[33] Congress expressly restored to the SEC (but not to private plaintiffs) the ability to bring aiding and abetting civil actions against secondary actors who knowingly provide substantial assistance to persons who violate the 1934 Act, including Rule 10b-5.[34]

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[29]Pettit v. Am. Stock Exch., 217 F. Supp. 21, 28-29 (S.D.N.Y. 1963) (first court to articulate aiding and abetting liability and formulating knowledge and substantial assistance elements); *accord* Cleary v. Perfectune, Inc., 700 F.2d 774, 777 (1st Cir. 1983) (listing "knowing and substantial assistance of the primary violation" as an element of aiding and abetting liability); IIT, an Int'l Inv. Trust v. Cornfield, 619 F.2d 909, 922 (2d Cir. 1980) (listing "'knowledge' of th[e] violation on the part of the aider and abettor" and "'substantial assistance' by the aider and abettor" as elements of liability (citations omitted)); *Brennan*, 259 F. Supp. at 680 (following *Pettit* and codifying the elements).

[30]Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 170-78 (1994). This opinion was perhaps presaged in *Ernst & Ernst v. Hochfelder*, where the Court noted that "[i]n view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule . . . ." 425 U.S. 185, 191 n.7 (1976). Based on this comment, at least one scholar expressed doubt about the continued viability of secondary civil liability under Section 10(b) and Rule 10b-5. *See* Fischel, *supra* note 27, at 88.

[31]*Cent. Bank*, 511 U.S. at 192 (Stevens, J., dissenting) ("In *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5.").

[32]The Court's reasoning strongly suggested that the SEC may have been without the generalized authority to pursue aiders and abettors in the absence of a specific statutory grant. *Id.* at 176-85.

[33]Lewis D. Lowenfels & Alan R. Bromberg, *A New Standard for Aiders and Abettors Under the Private Securities Litigation Reform Act of 1995*, 52 BUS. LAW. 1, 3-5 (1996) (detailing political compromise).

[34]Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 757 (codified as amended at 15 U.S.C. § 78t(f) (1995)). Sections 80b-9 and 78t of the Dodd-Frank Act empower the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the 1934 Act. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1862 (2010) (codified at 15 U.S.C. §§ 80b-9, 78t). In addition, the Dodd-Frank Act provides, for the first time, that the SEC may pursue aiding and abetting claims under the Securities Act, the Investment Company Act, and the Investment Advisers Act. Dodd-Frank Wall Street Reform & Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1861-62 (2010) (codified at 15 U.S.C. §§ 78j, 80b-9).

In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, the Supreme Court confirmed its *Central Bank* holding that Section 10(b) of the 1934 Act and Rule 10b-5 do not support civil aiding and abetting liability.[35] The Court explained, however, that while not liable as "aiders and abettors," secondary actors may still face primary liability exposure under Rule 10b-5, but only if their conduct satisfies "each of the elements or preconditions for liability."[36] In finding against plaintiffs who alleged that business partners of the primary violator should be liable as participants in a scheme to defraud, the Court stated that the critical Rule 10b-5 element of reliance was missing.[37] Plaintiffs could point to no evidence that investors in any way relied upon the defendants' conduct.[38] Furthermore, the Court refused to presume reliance based upon the "fraud-on-the-market" theory, finding it inapplicable when the non-sellers' role in the fraud was not communicated to the public.[39] Therefore, under the current Rule 10b-5 jurisprudence, investors can only state a claim against those who can be deemed "primary violators" upon whom investors relied.[40]

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[35]Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 156-58 (2008).

[36]*Id.* at 158. *See also Cent. Bank*, 511 U.S. at 191 (finding that professionals such as attorneys, accountants, and banks could be liable as primary violators of Rule 10b-5); Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 267 (6th Cir. 1998); Trust Co. of La. v. N.N.P. Inc., 104 F.3d 1478, 1487 (5th Cir. 1997) (holding an attorney liable, under a primary liability analysis, for a materially misleading omission made in connection with the sale of securities); Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 486-87 (3d Cir. 1994) (finding a law firm can face primary liability for material misstatements or omissions despite the fact that the opinion letters in question disclaimed liability for the validity of the information).

[37]*Stoneridge*, 552 U.S. at 158-61.

[38]*Id.* at 159.

[39]*Id.*

[40]*See Stoneridge*, 552 U.S. at 159. The Supreme Court, however, did not provide, in *Stoneridge* or *Central Bank*, any guidance as to what type of conduct would make a secondary actor a primary violator under the securities statutes. *See, e.g.*, *In re* Enron Corp. Sec., Deriv. & ERISA Litig., 235 F. Supp. 2d 549, 583 (S.D. Tex. 2002). Allowing the district courts to define "primary violator" has resulted in a circuit split with the Second, Tenth, and Eleventh Circuits applying the more rigid "bright line test," and the Third and Ninth Circuits applying the more lenient "substantial participation test." *Id.* at 583-86. The "bright line test" requires that the secondary actor make a publicly disseminated material omission or misrepresentation prior to the investment decision, *id.* at 583, whereas the "substantial participation test" requires only that the secondary actor play a significant role in the drafting or creation of a false or misleading statement, *id.* at 585. The Tenth Circuit specifically criticized the liberal "substantial participation test," alleging that it undermines *Central Bank*'s termination of aiding and abetting liability. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1226 n.10 (10th Cir. 1996); *see also* Affco Invs. 2001, L.L.C. v. Proskauer Rose, L.L.P., 625 F.3d 185, 194 (5th Cir. 2010) ("[A] 'secondary actor' . . . can be held liable in a private section 10(b) action only for false statements attributed to that secondary actor at the time of dissemination" (citing Pac. Inv. Mgmt. LLC v. Mayer Brown LLP, 603 F.3d 144, 148 (2d Cir. 2010))); *Pac. Inv. Mgmt. LLC*, 603 F.3d at 161 (rejecting the "creator standard" and holding that a "[s]econdary actor . . . can be held liable in a private damages action brought pursuant to . . . Rule 10b-5(b) only

B. *1933 Act—Sections 11 and 12(a)(2)*

Section 11 of the Securities Act of 1933,[41] while not necessarily an antifraud statute, provides for civil liability for misrepresentations in a registered offering against the issuer and specified secondary defendants, such as officers, directors, and underwriters.[42] Defendants, other than the issuer, have a due diligence defense that differs slightly according to the secondary actor's role in preparing the registration statement.[43]

Section 12(a)(2) of the 1933 Act provides an alternative express private cause of action against sellers for misrepresentations to purchasers with whom they are in privity.[44] The Supreme Court, however, has confined this remedy to misrepresentations in the context of public offerings.[45] Section 12(a)(2) does not expressly provide for aiding and abetting liability and even before the *Central Bank* decision, most courts refused to imply aiding and abetting liability under this provision.[46] Most commentators

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for false statements attributed to the secondary actor [defendant] at the time of dissemination").

[41]Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006).

[42]*Id.* § 11(a), 15 U.S.C. § 77k(a).

[43]*Id.* §§ 11(b)(3), (c); Securities and Exchange Commission, 17 C.F.R. § 230.176 (2006) (providing circumstances for determining reasonable investigation and grounds for belief under Section 11 of the Securities Act of 1933). See *In re* WorldCom, Inc. Sec. Litig., 2005 WL 638268, at *3-*12 (S.D.N.Y. Mar. 21, 2005), for a comprehensive analysis of the Section 11 due diligence defense.

[44]Securities Act of 1933 § 12(2), 15 U.S.C. § 77l(a)(2) (2006). Defendants who solicit purchasers are treated as sellers, and thus, can face primary liability. *See* Pinter v. Dahl, 486 U.S. 622, 643-45 (1988). While *Pinter* involved the definition of seller, Section 12(a)(1) of the 1933 Act has come to represent a unified "seller" definition applicable to Section 12(a)(2) as well. Ryder Int'l Corp. v. First Am. Nat'l Bank, 943 F.2d 1521, 1527 n.11 (11th Cir. 1991) ("Since *Pinter*, all the courts that we are aware of which have again considered the scope of section [12(a)(2)], have used or adopted the definition of seller as enunciated in *Pinter*."); *see also In re* Craftmatic Sec. Litig. v. Kraftsow 890 F.2d 628, 634-36 (3d Cir. 1989) (citing cases that applied the *Pinter* definition of "seller" to Section 12(a)(2)).

[45]Gustafson v. Alloyd Co., 513 U.S. 561, 575-78 (1995). The courts are still wrestling with the issue of whether a particular offering is public or private for purposes of *Gustafson*. *See, e.g.*, Yung v. Lee, 432 F.3d 142, 149-50 (2d Cir. 2005) (holding the defendant not liable under Section 12(a)(2) even though the misleading prospectus prepared in connection with a private transaction was identical to that disseminated for a parallel public offering); *cf. In re* Enron Corp. Sec., Deriv. & ERISA Litig., 310 F. Supp. 2d 819, 859-67 (S.D. Tex. 2004) (applying a broad reading of section 12(a)(2), denying a motion to dismiss, and basing analysis heavily on the fact that a private offering memorandum nearly mirrored a public offering prospectus); *see also In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 624-27 (S.D.N.Y. 2007) (acknowledging the split, rejecting *Enron*, and following *Yung*). A last minute amendment to the Dodd-Frank Act that attempted to overturn *Gustafson* was ultimately not included in the final legislation. 156 CONG. REC. S3562 (daily ed. May 11, 2010) (the proposed amendment was titled the "Gustafson Fix").

[46]*See Craftmatic Sec. Litig.*, 890 F.2d at 637; *see also* Royal Am. Managers, Inc. v. IRC Holding Corp., 885 F.2d 1011, 1017 (2d Cir. 1989); Schlifke v. Seafirst Corp., 866 F.2d 935, 942 (7th Cir. 1989).

believe that while *Central Bank* involved Rule 10b-5 of the 1934 Act, its reasoning equally applies to Section 12(a)(2) of the 1933 Act,[47] and virtually every court after *Central Bank* has agreed.[48]

C. *Control Person Liability*

Under the current federal securities law regime, secondary liability outside of Section 11 is largely confined to express, control person civil liability provisions set forth in Section 15 of the 1933 Act ("Section 15") and Section 20(a) of the 1934 Act ("Section 20(a)").[49] However, there is disagreement among the circuits as to the elements necessary to establish "control."[50] This disagreement stems from the appropriate participation standard needed to establish a prima facie case.[51] In some circuits, courts find liability based upon control status alone; they do not require allegations that the defendant exercised control over the particular transaction that gave rise to the violation.[52] Other courts utilize the "culpable participation test," and reason that control persons are not liable unless they actively

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[47]*See, e.g.*, 12A JOSEPH C. LONG, BLUE SKY LAW §§ 9:7–9:8 (2010); *see also* THOMAS LEE HAZEN, LAW OF SEC. REG. § 7.13 (2009).

[48]*See* Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1215 (1st Cir. 1996) (requiring a direct solicitation for liability under Section 12); *see also* Lone Star Ladies Inv. Club v. Schlotzsky's, Inc., 238 F.3d 363, 370 (5th Cir. 2001) (finding no recovery under section 12 in a firm commitment underwriting "because the public does not purchase from the issuers"); Tsirekidze v. Syntax–Brillian Corp., 2009 WL 275405, at *3-*11 (D. Ariz. Feb. 4, 2009) (dismissing claim against auditor but allowing claims against other direct sellers to proceed).

[49]Securities Act of 1933 § 15, 15 U.S.C. § 77o (2006); Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2006). Section 15 of the 1933 Act provides for vicarious liability for persons controlling Sections 11 and 12 violators unless they can prove inverse negligence. 15 U.S.C. § 77o. Section 20(a) of the 1934 Act imposes liability upon those control persons who violate any title of the 1934 Act. It also provides an affirmative defense for actions in good faith and non-inducement of any violation. 15 U.S.C. § 78t(a).

[50]"Control" is undefined in both statutes. The absence of a definition of control in sections 15 and 20(a) was apparently a purposeful congressional omission. Securities Exchange Bill of 1934, H.R. REP. NO. 73-1383, at 26 (1934) ("It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted."). The Securities Exchange Commission defines "control" as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (2010). Most courts adopt (or at least refer to) this SEC definition. *See, e.g.*, Laperriere v. Vesta Ins. Grp., Inc., 526 F.3d 715, 723 (11th Cir. 2008); *see also* Maher v. Durango Metals, Inc. 144 F.3d 1302, 1305 (10th Cir. 1998).

[51]*See* Erin L. Massey, *Control Person Liability Under Section 20(A): Striking a Balance of Interests for Plaintiffs and Defendants*, 6 HOUS. BUS. & TAX L.J. 109, 114-122 (2005) (describing disparate tests among the circuits); *see also* Loftus C. Carson II, *The Liability of Controlling Persons Under the Federal Securities Acts*, 72 NOTRE DAME L. REV. 263, 273-89 (1997) (discussing the determination of control person status).

[52]*See, e.g.*, Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1573-74 (9th Cir. 1990).

participated in the fraudulent transaction.[53] Still, other courts take an intermediate position, finding control person liability if the person actually exercised control over the operations or if the person had the ability to control the transaction or act giving rise to the primary violation—even if the power was not exercised.[54]

Both Sections 15 and 20(a) provide affirmative defenses. Section 15 provides a "due diligence" defense—control persons will be liable unless they "had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."[55] Courts that have considered this defense generally find that it contains a negligence standard.[56] Under Section 20(a), however, there is no control person liability if the controlling parties establish that they "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[57] Courts have interpreted this defense to require controlling persons to show affirmatively that they were not reckless.[58]

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[53]*See* Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998) (explaining that to establish a prima facie case, the plaintiff must show, among other things, that the control person was a culpable participant in a meaningful sense); *see also* Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 885-86 (3d Cir. 1975) (imposing liability on those controlling persons who participated in the fraud in a meaningful sense). Courts adopting this standard are forced to confront the PLSRA's enhanced pleading standards. *See In re* Refco, Inc. Sec. Litig., 503 F. Supp. 2d 611, 631-33 (S.D.N.Y. 2007).

[54]City of Monroe Emps. Ret. Sys. v. Bridgestone Corp., 387 F.3d 468, 484-85 (6th Cir. 2004); *accord* Harrison v. Dean Witter Reynolds, Inc., 974 F.2d 873, 880-81 (7th Cir. 1992) (rejecting culpable participation test); Metge v. Baehler, 762 F.2d 621, 630-31 (8th Cir. 1985) (rejecting the culpable-participation test in favor of the controlling person test so as to preserve good faith and lack of participation as affirmative defenses). In determining whether a defendant possessed the requisite degree of control, "'the courts have given heavy consideration to the power or potential power to influence and control the activities of a person, as opposed to the actual exercise thereof.'" *In re* Mut. Funds Inv. Litig., 566 F.3d 111, 130 (4th Cir. 2009) (quoting *Rochez Bros., Inc.*, 527 F.2d at 890-91).

[55]Securities Act of 1933 § 15, 15 U.S.C. § 77o (2006).

[56]*Refco*, 503 F. Supp. 2d at 660-61 (finding that the negligence allegation was sufficient under section 15 of the 1933 Act but not under Section 20(a) of the 1934 Act).

[57]Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (2006).

[58]*E.g.*, G.A. Thompson & Co. v. Partridge, 636 F.2d 945, 959-60 (5th Cir. 1981). This view is supported in *dicta* by the U.S. Supreme Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.28 (1976) (listing Section 20(a) as one of the 1934 Act provisions that requires more than negligence).

III. SECONDARY LIABILITY UNDER STATE BLUE SKY LAWS

A. *The State Antifraud Approach*

Secondary liability under state law is derivative and requires proof of a valid claim against a primary violator, ordinarily the seller of securities.[59] The state approach to primary liability for securities fraud is quite different from the federal scheme. Most state statutes are modeled generally on the 1956 Uniform Securities Act ("USA"), as amended in 1958,[60] or the 2002 USA (together with the USA, the "Uniform Acts").[61] Both contain securities fraud civil liability provisions that track Section 12(a)(2) of the 1933 Act.[62] Under these statutes, sellers of securities who make material misrepresentations or omissions are liable to their purchasers for rescissionary damages unless they can "sustain the burden of proof that [they] did not know, and in the exercise of reasonable care could not have known, of the untruth or omission."[63] The 2002 USA gives defrauded sellers a similar cause of action against purchasers who buy securities by means of a material misrepresentation.[64] Similarly, many states with non-uniform

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[59]*See* Conn. Nat'l Bank v. Giacomi, 699 A.2d 101, 118-19 (Conn. 1997); *see also In re* Enron Corp. Sec., Deriv. & ERISA Litig., 388 F. Supp. 2d 780, 787 (S.D. Tex. 2005); *cf. In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 284-85 (3d Cir. 2006) (holding that in connection with federal control person liability it is not necessary to name the primary violator as a defendant in the suit).

[60]UNIF. SEC. ACT (amended 1958), 7C U.L.A. 746 (2006 & Supp. 2010) (superseded 1985 & 2002).

[61]UNIF. SEC. ACT (2002), 7C U.L.A. 1 (Supp. 2010). At present, 17 states and the U.S. Virgin Islands have adopted the 2002 USA. *Id.* The 1956 Act, as amended in 1958, was substantially enacted at various times by 37 states. Richard B. Smith, *A New Uniform Securities Act*, 6 No. 9 WALLSTREETLAWYER.COM: SEC. ELEC. AGE 8 (2003). The USA was also amended in 1985, but very few states enacted that version. *Id.* State statutes, however, even if based on uniform acts, are not necessarily uniform. *See generally* Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws*, 35 J. CORP. L. 327, 329-32 (2009) (providing background on the uniform lawmaking process).

[62]*See* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006) (governing civil liabilities arising in connection with prospectuses and communications). The civil liability for misrepresentations clause of the 1956 USA is contained in Section 410(a)(2), UNIF. SEC. ACT § 410(a)(2) (amended 1958), 7C U.L.A. 888 (2006) (superseded 1985 & 2002); the corresponding clause of the 2002 USA is Section 509(b), UNIF. SEC. ACT § 509(b) (2002), 7C U.L.A. 163 (2006).

[63]UNIF. SEC. ACT § 410(a) (amended 1958), 7C U.L.A. 888; UNIF. SEC. ACT § 509(b)(1) (2002), 7C U.L.A. 163; *see also In re* Access Cardiosystems, Inc., 404 B.R. 593, 640 (Bankr. D. Mass. 2009) (noting that USA places a heavy burden on the seller to show that she did not know of the misrepresentation).

[64]UNIF. SEC. ACT § 509(c) (2002), 7C U.L.A. 163-64. Some states that have not adopted the 2002 USA have similarly extended liability to purchasers. *See, e.g.*, OR. REV. STAT. § 59.127 (West, Westlaw through Ch. 7 of 2011 Reg. Sess.).

statutes have liability provisions that mirror Section 12(a)(2) of the 1933 Act and the Uniform Acts.[65]

Unlike the implied Rule 10b-5 federal cause of action, under these state antifraud formulations, plaintiffs need not prove that the seller acted with scienter.[66] Rather, consistent with Section 12(a)(2) of the 1933 Act,[67] sellers are liable to purchasers (and vice versa) unless they can meet the affirmative defense that they "did not know, and in the exercise of reasonable care could not have known, of the untruth or omission."[68] In addition, reliance and causation are not usually required elements for the state privity-based antifraud causes of action.[69] Unlike Section 12(a)(2),

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[65]ARIZ. REV. STAT. ANN. § 44-1998 (West, Westlaw through 2011 1st Reg. Sess.); CAL. CORP. CODE § 25401 (West, Westlaw through Ch. 1 of 2011 Reg. Sess.); GA. CODE ANN. § 10-5-54, 10-5-58 (West, Westlaw through 2010 Reg. Sess.); LA. REV. STAT. ANN. § 51:712(A)(2) (West, Westlaw through 2010 Reg. Sess.); N.D. CENT. CODE § 10-04-15, 10-04-17 (West, Westlaw through 2009 Reg. Sess.); OHIO REV. CODE ANN. § 1707.41(A) (West, Westlaw through 2011 portion of 2011-2012 Gen. Assem.); TENN. CODE ANN. § 48-2-122(a)(1) (West, Westlaw through 2010 Reg. Sess.); TEX. REV. CIV. STAT. ANN. art. 581-33(A) (West, Westlaw through 2009 Reg. Sess.). New York does not recognize a civil private right of action for rescission for securities fraud. *See* CPC Int'l Inc. v. McKesson Corp., 514 N.E.2d 116, 118-19 (N.Y. 1987).

[66]*Compare* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (Rule 10b-5 violation dependent upon a finding of scienter), *with* People v. Johnson, 262 Cal. Rptr. 366, 367 (Cal. Ct. App. 1989) (holding that proof of scienter is not required under California's version of Rule 10b-5), Foster v. Alex, 572 N.E.2d 1242, 1245 (Ill. App. Ct. 1991) (holding that proof of scienter is not required under § 12(G) of the Illinois Securities Act), *and* Busse v. Pac. Cattle Feeding Fund No. 1, Ltd., 896 S.W.2d 807, 815 (Tex. App. 1995) ("The Texas Securities Act does not require proof of scienter.").

[67]Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006).

[68]UNIF. SEC. ACT § 410(a) (amended 1958), 7C U.L.A. 888 (2006); *see also* LONG, *supra* note 47, § 9:23 (Professor Long refers to this as an "inverse negligence standard" because the defendant must prove that she was not negligent—a high standard that is rarely met); *infra* notes 120-23 and accompanying text.

[69]UNIF. SEC. ACT § 509(b) cmt. 4 (2002), 7C U.L.A. 166 ("Unlike the current standards on implied rights of action under Rule 10b–5, neither causation nor reliance has been held to be an element of a private cause of action under the precursor to Section 509(b)."). Most courts find that reliance is not a required element for state privity based antifraud causes of action. Kaufman v. I-Stat Corp., 754 A.2d 1188, 1197 (N.J. 2000) (holding that reliance is not required as an element of securities fraud under New Jersey's Uniform Securities Law); Everts v. Holtmann, 667 P.2d 1028, 1033 (Or. Ct. App. 1983) (finding that reliance on omission or misrepresentation is not required under OR. REV. STAT. § 59.115); Gohler v. Wood, 919 P.2d 561, 562 (Utah 1996) ("[Utah's] antifraud provisions do not require proof of reliance."); *see generally* LONG, *supra* note 47, § 9:117.19–:117.35 (explaining that the overwhelming majority of states that have adopted the Uniform Act, as well as many non-Uniform Act states with similar liability provisions, have held that reliance is not required). Some courts, however, require reliance by analogy to Rule 10b-5 precedents. Reeves v. Teuscher, 881 F.2d 1495, 1501 & 1501 n.12 (9th Cir. 1989) (citing Ninth Circuit precedent and asserting in *dicta* that reliance is a required element under the Washington and Oregon fraud statutes); *In re* Infocure Sec. Litig., 210 F. Supp. 2d 1331, 1366 (N.D. Ga. 2002) ("The Georgia Act is similar to Rule 10b–5, and requires the same elements of proof."); State v. Marsh & McLennan Cos., 2011 WL 613515, at *4 (Or. Ct. App. Feb. 23, 2011) (suggesting in *dicta*

however, the state civil liability provisions cover any sales—not just those by means of prospectus.[70]

Most state blue sky laws also contain a general antifraud provision that tracks Section 17(a) of the 1933 Act ("Section 17(a)") and Rule 10b-5;[71] although, many statutes provide, in accordance with the Uniform Acts, that there is no private civil liability—express or implied—for violations of these general antifraud provisions.[72] Some state statutes, however, including some that otherwise track the Uniform Acts, have modified their civil liability sections and provide an express private cause of action under the state version of Rule 10b-5.[73] Still other states have civil liability statutes that reference violations of the general antifraud statute, rather than including a misrepresentation clause in the liability provision itself.[74] While these latter

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that the current OR. REV. STAT. § 59.115 may include a reliance requirement); Hines v. Data Line Sys., Inc., 787 P.2d 8, 12 (Wash. 1990) (requiring reliance under Section 21.20.010 of the Revised Code of Washington).

Causation has also been excluded as a requirement for state causes of action. *Hines*, 787 P.2d at 12-13 (finding causation is not a required element under Washington's Rule 10b-5 analogue, Section 21.20.010); *accord* Dunn v. Borta, 369 F.3d 421, 432-33 (4th Cir. 2004) (holding that because causation is not referenced in Section 13.1-522(A)(ii) of Virginia's Annotated Code, it is not a required element); Ritch v. Robinson-Humphrey Co., 748 So.2d 861, 862 (Ala. 1999) (finding that Section 8-6-19(a)(1) of the Alabama Securities Act does not contain a causation element).

[70]Under federal precedents, the term "prospectus" for purposes of Section 12(a)(2) is narrowly defined as "a document that describes a public offering of securities by an issuer or controlling shareholder." Gustafson v. Alloyd Co., 513 U.S. 561, 584 (1995); *see also supra* note 45.

[71]Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006). Rule 10b-5 was modeled on Section 17(a) of the 1933 Act. *See* Sprangers v. Interactive Tech., Inc., 394 N.W.2d 498, 503 (Minn. Ct. App. 1986). Civil plaintiffs rarely invoke Section 17(a) because it is extremely doubtful that courts will imply a private cause of action under this statute. *See* Landry v. All Am. Assurance Co., 688 F.2d 381, 389-91 (5th Cir. 1982) (finding no private right of action under Section 17(a)); *see also* Bath v. Bushkin, Gaims, Gaines & Jonas, 913 F.2d 817, 819-20 (10th Cir. 1990) (joining the majority in holding that there is no private cause of action under Section 17(a)); *In re* Wash. Pub. Power Supply Sys. Sec. Litig., 823 F.2d 1349, 1358 (9th Cir. 1987) (holding that no private right of action exists under Section 17(a)); CPC Int'l Inc. v. McKesson Corp., 514 N.E.2d 116, 120-24 (N.Y. 1987) (examining and discussing the circuit split on the issue and holding that there is no implied cause of action under Section 17(a)).

[72]Section 410(h) of the 1956 USA expressly provides that the act "does not create any cause of action not specified in this section or section 202(e)" (dealing with broker-dealer surety bond). UNIF. SEC. ACT § 410(h) (amended 1958), 7C U.L.A. 888 (2006). Similarly, the Official Comments to Section 501 of the 2002 USA state that there is no civil liability, express or implied, for a Section 501 violation. UNIF. SEC. ACT § 501 cmt. 7 (2002), 7C U.L.A. 150 (2006). Not all uniform act states, however, adopted these limiting provisions. Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027, 1063 (1992) ("Only half of the forty or so Uniform Securities Act jurisdictions adopted [§ 410(h)]"). In the absence of a statutory limitation, some state courts have implied a private cause of action under the general antifraud provisions. *See, e.g.*, Carothers v. Rice, 633 F.2d 7, 9-12 (6th Cir. 1980).

[73]ARIZ. REV. STAT. ANN. § 44-1991(B) (West, Westlaw through 2011 1st Reg. Sess.); OR. REV. STAT. § 59.137 (West, Westlaw through Ch. 7 of 2011 Reg. Sess.).

[74]TENN. CODE ANN. § 48-2-122(c) (West, Westlaw through 2010 Reg. Sess.); WASH. REV.

statutes still require privity, and may contain an inverse negligence culpability standard, other elements of the cause of action, such as reliance and causation, are less certain as courts may tend to apply Rule 10b-5 precedent.[75]

Express causes of action for securities fraud contained in the majority of blue sky laws are privity based,[76] and unlike Rule 10b-5, they do not provide civil liability for secondary market transactions. Some exceptions, however, do exist. For example, California's blue sky statute has an express cause of action that extends to market manipulation in the secondary market.[77] Furthermore, Oregon adopted an express cause of action for violations of its Rule 10b-5 clone that extends to secondary market transactions.[78] Uncertainties remain, however, as to the elements of these causes of action. For example, the culpability standard for sellers is not specified in the Oregon statute.[79] While state courts often follow federal precedent in interpreting state statutes that parallel federal legislation, it is unclear under the Oregon statute whether the culpability standard is (1) scienter consistent with Rule 10b-5[80] and Section 17(a)(1) of the 1933 Act;[81] (2) negligence consistent with Sections 17(a)(2) and (3) of the 1933 Act;[82]

CODE § 21.20.430 (West, Westlaw through 2011 legislation).

[75]Keogler v. Krasnoff, 601 S.E.2d 788, 791-92 (Ga. Ct. App. 2004) (requiring reliance under the former version of the Georgia Act incorporating the general antifraud statute into the civil liability section); Hines v. Data Line Sys., Inc., 787 P.2d 8, 12 (Wash. 1990) (requiring reliance under the Washington statute). *But see* Green v. Green, 293 S.W.3d 493, 508 (Tenn. 2009) (overturning prior precedent to hold that no reliance is required under Tennessee statute).

[76]*See, e.g.*, Lubin v. Sybedon Corp., 688 F. Supp. 1425, 1453 (S.D. Cal 1988) (discussing that "strict privity" is required for antifraud claims under California law).

[77]CAL. CORP. CODE § 25400 (West, Westlaw through c. 1 of 2011 Reg. Sess.), *preempted by In re* Fed. Nat'l Mortg. Ass'n Sec., Deriv. & ERISA Litig., 503 F. Supp. 2d 25, 31 (D.D.C. 2007); CAL. CORP. CODE § 25500. The California statute does not require privity, but unlike Rule 10b-5 and the Oregon provision, it does require the defendant to be a purchaser or seller (or offeror) of the securities. *See* Murphy v. BDO Seidman, LLP, 6 Cal. Rptr. 3d 770, 784 (Cal. Ct. App. 2003) ("[T]he statute's language limits liability to actual sellers or buyers of, or someone who offers to buy or sell, a security.").

[78]OR. REV. STAT. § 59.137 (West, Westlaw through Ch. 7 of 2011 Reg. Sess.).

[79]*Id.*

[80]*See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that a private cause of action will not be actionable under Rule 10b-5 without proof of scienter).

[81]*See, e.g.*, Aaron v. SEC, 446 U.S. 680, 701-02 (1980) (holding that section 17(a)(1) of 1933 Act requires scienter).

[82]*Id.* (finding that scienter is not a necessary element to violate Sections 17(a)(2) and (3) of the 1933 Act); *see also* Orthologic Corp. v. Columbia/HCA Healthcare Corp., 2002 WL 1331735, at *5 (D. Ariz. Jan. 7, 2002) (adopting the bifurcated approach of *Aaron* for state antifraud statutes). *See generally* Keith A. Rowley, *Muddy Waters, Blue Skies: Civil Liability Under the Mississippi Securities Act*, 70 MISS. L.J. 683, 717-20 (2000) (arguing that neither reliance nor scienter are required under Section 717(a)(2) of the Mississippi Securities Act); Kurt M. Saunders, Comment, *Proof of Fault in Actions for Securities Fraud: A Cloud in Pennsylvania's Blue Sky*, 46 U. PITT. L. REV. 1083, 1094-97 (1985) (arguing that Pennsylvania's Securities Act does not require scienter in a

(3) strict liability with an affirmative defense of non-negligence consistent with Section 12(a)(2) of the 1933 Act;[83] or (4) strict liability.[84] Moreover, the Oregon legislature did not specify whether: (1) the express private causes of action for secondary market transactions require reliance and causation by analogy to the implied Rule 10b-5 cause of action, (2) certain federal presumptions such as the "fraud-on-the-market" theory are available to establish reliance, or (3) other federal ameliorative doctrines, such as the "bespeaks caution" doctrine, apply under Oregon law.[85] In *State v. Marsh & McLennan Cos.*,[86] the Oregon Court of Appeals held that the Oregon statute imposing liability in connection with secondary market transactions requires reliance,[87] and that the "fraud-on-the-market" reliance presumption is not available under Oregon law.[88]

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civil action brought under a provision similar to Rule 10b-5 but rather the provision should be interpreted in line with Section 17(a) of the 1933 Act).

[83]*See In re* Fuwei Films Sec. Litig., 634 F. Supp. 2d 419, 435 (S.D.N.Y. 2009) (discussing the pleading requirements for Section 12(a)(2)).

[84]*See* OR. REV. STAT. § 59.137 (West, Westlaw through Ch. 21 of the 2011 Reg. Sess.). Indeed, Section 59.137's legislative history suggests that seller liability under the Oregon statute is strict. *See Hearing on H.B. 3666 Before the H. Comm. on Rules & Pub. Affairs*, Tape 120A, 2003 Leg., Reg. Sess. (Or. 2003) (statement of Rep. Dan Doyle, Chairman, H. Comm. on Rules & Pub. Affairs).

[85]*See Hearing on H.B. 3666 Before the H. Comm. on Rules & Pub. Affairs*, Tape 120A & B, 2003 Leg., Reg. Sess. (Or. 2003). The judicially created "bespeaks caution doctrine" deems projections accompanied by adequate cautionary language immaterial as a matter of law. *See In re* Donald J. Trump Casino Sec. Litig.–Taj Mahal Litig., 7 F.3d 357, 364 (3d Cir. 1993). This doctrine may not apply in state court actions. *Compare* Lagen v. Balcor Co., 653 N.E.2d 968, 973-74 (Ill. App. Ct. 1995) (concluding that because the federally endorsed "bespeaks caution doctrine" mirrors reliance and materiality elements, it is equally applicable under state law), *with* Bondholder's Recovery Team v. St. Therese Home, Inc., 1993 WL 515810, at *2 (Minn. Ct. App. Dec. 14, 1993) (finding that the "bespeaks caution doctrine" does not apply to state common law claims). The statutory "bespeaks caution doctrine," now imbedded in both the Securities Act of 1933 § 27A, 15 U.S.C. § 77z-2 (2006), and the Securities Exchange Act of 1934 § 21E, 15 U.S.C. § 78u-5 (2006), would of course be inapplicable for state causes of action.

[86]2011 WL 613515 (Or. Ct. App. Feb. 23 2011).

[87]*Id.* at *7-*8.

[88]*Id.* at *8. Both state and federal courts have reached near consensus regarding the unavailability of the "fraud-on-the-market" doctrine under state blue sky laws. *See* Garcia v. Meded Chevrolet, Inc., 240 P.3d 371, 381 (Colo. App. 2009) ("We are also persuaded by a variety of state cases that have similarly rejected the invitation to apply a fraud on the market theory to presume reliance and causation in common law fraud or statutory deceit lawsuits."); Malone v. Brincat, 722 A.2d 5, 13 (Del. 1998) (deciding not to recognize a state cause of action for "fraud-on-the-market"); Lee v. Carter-Reed Co., LLC, 2009 WL 2475314, at *6 (N.J. Super. Ct. App. Div. Aug. 14, 2009) ("Application of [the 'fraud-on-the-market'] theory is confined to federal securities fraud litigation.").

B. *Secondary Liability Under State Antifraud Statutes*

Perhaps the biggest difference between state blue sky antifraud statutes and the federal scheme lies in the liability of secondary actors, generically known as aiders and abettors.[89] The imposition of express liability for secondary actors under state blue sky laws is much more expansive than the federal scheme.[90] Generally, under state statutes, secondary defendants are jointly and severally liable to the same extent as the seller.[91] Under many state statutes, secondary liability extends not only to defined control persons, but also to others who participate or materially aid in the securities transaction.[92]

1. Control Person Liability

Most blue sky laws contain a provision imposing liability upon persons who "control" a seller who is liable under the acts.[93] Like the

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[89]Commentators sometimes use the generic term "aiding and abetting" liability to refer to express secondary liability under state blue sky laws. Traditional aiding and abetting liability, however, is premised on knowing substantial assistance. *See* LONG, *supra* note 47, § 9:94; *see also* Lowenfels & Bromberg, *supra* note 33, at 2 (describing elements of aiding and abetting liability). As noted above, this is not the typical culpability standard for secondary liability under state blue sky laws. Nonetheless, in addition to express provisions for secondary liability in state blue sky statutes, some state courts, even post-*Central Bank*, have implied civil aiding and abetting liability using traditional aiding and abetting norms. *See, e.g.*, Wojtunik v. Kealy, 394 F. Supp. 2d 1149, 1170 (D. Ariz. 2005) (noting the United States Supreme Court's holding in *Central Bank*, but confirming the continued availability of a private right of action for aiding and abetting under Section 44-1991(A) of the Arizona Revised Statute).

[90]According to the SEC, forty-nine of fifty states authorize private rights of action against persons who aid and abet violations of state securities laws. *See Securities Litigation Uniform Standards Act of 1997: Hearing on S. 1260 Before the Subcomm. on Sec., S. Comm. on Banking, Housing, & Urban Affairs*, 105th Cong. (1997) (prepared testimony of Hon. Arthur Levitt, Jr., Chairman, and Hon. Isaac C. Hunt, Jr., Comm'r, U.S. Securities and Exchange Commission), *available at* http://banking.senate.gov/97_10hrg/102997/witness/sec.htm.

[91]In a recent opinion by a California Appellate Court, the Panel found that the statutory rescission remedy requires privity of contract between the plaintiff and defendant. Viterbi v. Wasserman, 2011 WL 72203, at *1 (Cal. Ct. App. Jan. 11, 2011). Unlike the language in the Uniform Acts, *see* UNIF. SEC. ACT § 509(b) (2002), 7C U.L.A. 163 (2006), the California statute literally provides damages as a remedy only to those who have sold their securities, CAL. CORP. CODE § 25501 (West, Westlaw through Ch.14, 16-17 of 2011 Reg. Sess.). This holding, while a controversial interpretation of the California statute, will nonetheless make it quite difficult for those defrauded in private placements who still own their investments to obtain damages from secondary defendants.

[92]*See* UNIF. SEC. ACT § 410(b) (amended 1958), 7C U.L.A. 888 (2006); UNIF. SEC. ACT § 509(g) (2002), 7C U.L.A. 164-65 (2006).

[93]UNIF. SEC. ACT § 410(b) (amended 1958), 7C U.L.A. 888; UNIF. SEC. ACT § 509(g) (2002), 7C U.L.A. 164-65 (2006).

confusion surrounding control person liability under Section 15 of the 1933 Act and Section 20(a) of the 1934 Act, states have differing interpretations of the requirements for control person liability.[94] This uncertainty, however, is less significant under state blue sky laws because most statutes specifically name partners, officers, and directors of the seller as parties with secondary liability due solely to their respective status.[95] There is usually no requirement that these named control parties participate in the challenged securities transaction.[96]

2. Brokers-Dealers and Issuer-Employees

Virtually all state statutes extend liability beyond control persons to other enumerated persons who may be associated with and materially aid or participate in the securities transaction. Statutes based upon the Uniform Acts extend liability to non-sellers who are broker-dealers or issuer-employees who materially aid in the sale.[97] At the same time, to the extent broker-dealers or issuer-employees solicit purchases or sales, they too are deemed "sellers" under the *Pinter* definition[98] and most state interpretations of "seller."[99]

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[94]*Compare* Schuster v. Anderson, 413 F. Supp. 2d 983, 1012 (N.D. Iowa. 2005) ("[T]he Eighth Circuit has held that in order to be secondarily liable under the statute, a controlling person need not actually participate in the alleged violation."), *and* Hines v. Data Line Sys., Inc., 787 P.2d 8, 14 (Wash. 1990) ("[I]nvestors need show only that the defendant 'directly or indirectly control[led] [the] seller.' The statute does not require the plaintiff to prove that the defendant 'culpably participated' in the alleged violation.") (citing WASH. REV. CODE § 21.20.430(3)), *with* Grand v. Nacchio, 217 P.3d 1203, 1208-10 (Ariz. Ct. App. 2009) (noting that participation is a required element under Arizona's control person liability statute).

[95]UNIF. SEC. ACT § (410)(b) (amended 1958), 7C U.L.A. 888; UNIF. SEC. ACT § 509(g) (2002), 7C U.L.A. 165. Some states have modified the Uniform Acts to include additional categories of control persons, such as LLC managers. *See, e.g.*, OR. REV. STAT. § 59.115(3) (West, Westlaw through Ch. 7 of 2011 Reg. Sess.).

[96]*See, e.g.*, Hellum v. Breyer, 123 Cal. Rptr. 3d 803, 809-10 (Cal Ct. App. 2011) (under California law, outside directors can have secondary liability regardless of their participation in the transaction or their control status). Under a few statutes, however, the named control persons must materially aid in the sale. *See, e.g.*, FLA. STAT. § 517.211(1)-(2) (West, Westlaw through 2011 1st Reg. Sess.) (requiring personal participation or aid by control person).

[97]UNIF. SEC. ACT §§ 509(g)(3)-(4) (2002), 7C U.L.A. 165; UNIF. SEC. ACT § 410(b) (amended 1958), 7C U.L.A. 888 ("[E]very employee of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with and to the same extent as the seller . . . ."). Broker-dealer customer disputes usually proceed through arbitration. *See* Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 459, 459 (2008); Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123, 124 (2005).

[98]Pinter v. Dahl, 486 U.S. 622, 642, 647 (1988) (For the purposes of securities law, the definition of "seller" includes both the "owner who passed title, or other interest in the security, to

3. "Others" Who Materially Aid or Participate in the Securities Transaction

Beyond these enumerated persons, many state statutes extend secondary liability to other persons who materially aid or participate in the securities transaction; these statutes differ, however, on which additional classes of people are impacted and on the definition of "materially aid" or "participate."

Statutes based upon the Uniform Acts extend secondary liability to sellers' agents who materially participate in the sale.[100] Under common law, the definition of "agent" can be quite broad and may include employee agents as well as others, such as professional advisors who work on behalf of a principal.[101] In other sections of the Uniform Acts, the term "agent" is a defined term limited to individuals who act on behalf of issuers or broker-dealers to effect or attempt to effect securities transactions and who, absent an exemption, must register under the Uniform Acts.[102] Under this definition, the term "agent" means only individuals who help to sell securities,[103] a position buttressed by the placement of the term "agent" next

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the buyer for value," and "the person who successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner").

[99]OR. REV. STAT. §§ 59.115, 59.137 (West, Westlaw through Ch. 12 of 2011 Reg. Sess.) (imposing liability upon sellers and those who successfully solicit the sale); *see also In re* Trade Partners, Inc. Investors Litig., 2008 WL 3875396, at *18 (W.D. Mich. Aug. 15, 2008) (Michigan courts apply the *Pinter* definition of seller under the MUSA); Hilliard v. Black, 125 F. Supp. 2d 1071, 1083 (N.D. Fla. 2000) ("The definition of 'seller' under section 517.211. Florida Statutes, has been expanded to include those who solicit the sale of securities."); Hooper v. Freedom Fin. Grp., Inc., 784 N.W.2d 437, 444 (Neb. 2010); Meyers v. Lott, 993 P.2d 609, 612-13 (Idaho 2000) (finding the *Pinter* definition of seller—the "financial benefit" test—applicable under Idaho securities law); Gordon v. Drews, 595 S.E.2d 864, 870 (S.C. Ct. App. 2004) ("financial benefits test" applicable under South Carolina securities law); State v. Williams, 390 S.E.2d 746, 749 (N.C. Ct. App. 1990) (North Carolina applies the *Pinter* definition of "seller"). *But see* Apollo Capital Fund, LLC v. Roth Capital Partners, LLC, 70 Cal. Rptr. 3d 199, 221 (Cal. Ct. App. 2007) (California does not use the federal definition of seller); Klein v. Oppenheimer & Co., 130 P.3d 569, 576 (Kan. 2006) (holding that although the *Pinter* definition of "seller" is applicable in a private right of action under the Kansas Securities Act, it should not be applied where secondary liability, such as for broker-dealers, is expressly provided in the statute); Hoffer v. State, 776 P.2d 963, 964 (Wash. 1989) (retaining definition of "sellers" based upon "substantial contributive factor" that pre-dated *Pinter*). Some of these states may have chosen to apply a narrow and exclusive definition of seller because they have broad aiding and abetting statutes that already encompass a broad spectrum of collateral participants. *E.g.*, CAL. CORP. CODE § 25403 (West, Westlaw through Ch. 14, 16-17 of 2011 Reg. Sess.); IND. CODE § 23-19-5-9 (West, Westlaw through P.L. 27-2007).

[100]UNIF. SEC. ACT § 509(d) (2002), 7C U.L.A. 164-65 (2006).

[101]RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (2006).

[102]UNIF. SEC. ACT §§ 401(b), 201(a) (amended 1958), 7C U.L.A. 817, 777 (2006); UNIF. SEC. ACT §§ 102(2), 402(a) (2002), 7C U.L.A. 22-23, 106 (2006).

[103]Ward v. Bullis, 748 N.W.2d 397, 402-05 (N.D. 2008) (finding that a secondary defendant must meet statutory definition to be liable as an "agent" under blue sky law); *accord*

to the term "brokers" in the secondary liability provisions of the uniform statutes.[104] Many potential secondary defendants, particularly professionals such as attorneys and accountants, would not qualify as agents under this definition unless they became involved in the sales efforts.[105] On the other hand, some courts have taken a more expansive view and define agent, for secondary liability purposes, according to its broader common law definition[106] which could include outside professionals working for the issuer.[107]

The 2002 USA extends secondary liability beyond agents and employees to persons "associated with" the issuer who materially aid in the sale.[108] Nothing in the official comments, however, explains this addition and at present, there is no precedent explaining the term "associated with." A few statutes, such as those in California, Ohio, Oklahoma, Oregon, and

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Bristow v. Mourot, 260 S.W.3d 733, 735 (Ark. Ct. App. 2007) ("An 'agent,' for our purposes, is any individual who represents a securities issuer in effecting or attempting to effect the sale of securities." (citing ARK. CODE ANN. § 23-42-102(1)(A) (West Supp. 2005))); Kirchoff v. Selby, 703 N.E.2d 644, 651-52 (Ind. 1998) (finding that the statutory definition of agent controls).

[104]UNIF. SEC. ACT § 410(c) (amended 1958), 7C U.L.A. 888; UNIF. SEC. ACT § 509(g)(4) (2002), 7C U.L.A. 165 ("[A] person that is a broker-dealer, agent, investment adviser, or investment adviser representative."). The term "agent" was replaced with the term "sales representative" in the unpopular Revised Uniform Securities Act of 1985, UNIF. SEC. ACT § 605(d) (1985), 7C U.L.A. 297, but the modification was short-lived and "agent" reappeared without comment in the 2002 USA. UNIF. SEC. ACT § 509(g)(4), 7C U.L.A. 165; *see also* Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 BERKELEY BUS. L.J. 1, 14-15 (2005).

[105]*Bristow*, 260 S.W.3d at 735 (holding that the buyer's former employer is not an agent under statutory definition, as he did not participate in selling efforts on behalf of issuer); *accord In re* Infocure Sec. Litig., 210 F. Supp. 2d 1331, 1366 (N.D. Ga. 2002) ("[A]ttorneys for the seller, who perform duties within the normal ambit of transactional professionals, may not be held liable as an 'employee' or 'agent' of the seller [under the Michigan Securities Act.]"); Baker, Watts & Co. v. Miles & Stockbridge, 620 A.2d 356, 368 (Md. Ct. Spec. App. 1993) (noting that an attorney is not an agent merely by virtue of performing professional services), *superseded on other grounds*, MD. R. CIV. P. 2-504.

[106]Baker, Watts & Co. v. Miles & Stockbridge, 876 F.2d 1101, 1109 (4th Cir. 1989) (reversing district court for applying statutory definition of agent when state law was unsettled on the issue); *accord* Quick v. Woody, 747 S.W.2d 108, 111 (Ark. 1988) (finding that the mother of seller participated in the sale and holding her liable as an agent); Jenson v. Touche Ross & Co., 335 N.W.2d 720, 729 (Minn. 1983) (requiring, in accordance with the common-law definition of agency, that the principal exercise control over the agent).

[107]Arthur Young & Co. v. Reves, 937 F.2d 1310, 1327 (8th Cir. 1991) (holding that auditors can be subject to secondary liability); *see also* Walco Invs., Inc. v. Thenen, 881 F. Supp. 1576, 1586 (S.D. Fla. 1995) (holding that law firms may be liable for providing professional services that are related to securities); Powell v. H.E.F. P'ship, 835 F. Supp. 762, 765 (D. Vt. 1993) (holding that a law firm who performed professional services may be considered an agent under Vermont law).

[108]UNIF. SEC. ACT § 509(g)(3) (2002), 7C U.L.A. 164-65 (2006).

Texas, further extend secondary liability to "any person" who participates or materially aids in the sale.[109]

Under most blue sky provisions, secondary liability does not attach unless the defendants "participate" or "materially aid" in the securities transaction.[110] While ultimately a factual inquiry,[111] state courts apply differing legal definitions of these terms of art. Many courts take a broad view and define "participate" or "materially aid" to require something less than the pre-*Pinter* "substantial factor test" used to define seller[112] or the "substantial assistance" requirement stemming from traditional aiding and abetting liability.[113] Judicial opinions in a few states make clear that professional service that goes beyond ministerial tasks can qualify as material aid.[114] In other jurisdictions that impose general material aid or participant liability, however, there are stated statutory exceptions for some professionals, such as attorneys and accountants, who perform only routine

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[109]CAL. CORP. CODE § 25504.1 (West, Westlaw through Ch. 14, 16-17 of 2011 Reg. Sess.); OHIO REV. CODE ANN. § 1707.43(A) (West, Westlaw through 2011 portion of the 2011-2012 Legis. Sess.); OKLA. STAT. ANN. tit. 71, § 1-509(g)(5) (West, Westlaw through 2010 2d Reg. Sess.); OR. REV. STAT. § 59.137(1) (West, Westlaw through Ch. 12 of 2011 Reg. Sess.); TEX. REV. CIV. STAT. ANN. art. 581-33F(2) (West, Westlaw through 2009 Reg. Sess.).

[110]Only liability for a named control person is status-based. *See* UNIF. SEC. ACT § 410(c) (amended 1958), 7C U.L.A. 888 (2006); UNIF. SEC. ACT § 509(g) (2002), 7C U.L.A. 165 (2006).

[111]Bristow v. Mourot, 260 S.W.3d 733, 735 (Ark. Ct. App. 2007) ("The question of whether a representative materially aids in the sale of a security is one of fact, the resolution of which depends, to some extent, on inferences drawn from the testimony."); *accord* Klein v. Oppenheimer & Co., 130 P.3d 569, 588 (Kan. 2006) (finding that a clearing firm materially participated in the violation based on services provided); Hogg v. Jerry, 773 S.W.2d 84, 87-88 (Ark. 1989) (proximate location, personal relationship, and degree of trust between the parties all contribute to a finding of material aid); Foster v. Jesup & Lamont Sec. Co., 482 So.2d 1201, 1207-08 (Ala. 1986) (indicating that the facts of the case justify a finding of material aid).

[112]*See, e.g.*, *Foster*, 482 So.2d at 1206-07 (finding the "materially aids" standard broader than the "substantial factor test" under then interpretation of Section 12 of the 1933 Act).

[113]Conn. Nat'l Bank v. Giacomi, 699 A.2d 101, 121-22 (Conn. 1997) ("[A]id 'is material if it has a natural tendency to influence, or was capable of influencing, the decision of the purchaser." (quoting Kungys v. United States, 485 U.S. 759, 770 (1988))); *Klein*, 130 P.3d at 584 ("State courts, a federal court anticipating state law, and arbitration panels interpreting the language of § 410 and statutes based on it have taken a rather broad view of activities that may constitute 'material aid.'"). Some pre-*Central Bank* cases, however, support the proposition that professional service can constitute material aid even under the stricter substantial assistance federal standard. *See, e.g.*, Powell v. H.E.F. P'ship, 835 F. Supp. 762, 769 (D. Vt. 1993) (denying law firm's motion to dismiss because firm provided substantial assistance in drafting materially misleading documents for purposes of aiding and abetting liability under Section 10(b) of the 1934 Act).

[114]Prince v. Brydon, 764 P.2d 1370, 1370-71 (Or. 1988) (attorney document preparation constitutes material aid); Towery v. Lucas, 876 P.2d 814, 819 (Or. Ct. App. 1994) (noting that "[e]very person" includes attorneys and that the courts have recognized no privilege for attorneys "who participate or materially aid in an unlawful sale of securities").

professional services.[115] Under these latter statutes, excepted professionals can still be liable but *only* if they otherwise participate in the transaction.[116] In some states, such as Texas, that impose liability upon "any person," the definition of "materially aids" is unclear because of inconsistent appellate opinions. Some Texas courts impose a narrow definition and require that the secondary defendant provide "substantial assistance" to the primary violator.[117] Professional gatekeeper liability is less likely under this standard.[118] Other Texas appellate panels, however, disagree and find no support in the Texas statute for a "substantial assistance" requirement.[119]

4. Defenses

Under all USA versions, secondary participants have the affirmative defense that they did not know, and in the exercise of reasonable care, could not have known of the fact underlying the violation.[120] Some states that extended the secondary defendants category to include "any person," have retained this general inverse negligence defense;[121] others, however, require

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[115]ARIZ. REV. STAT. ANN. § 44-2003(A) (West, Westlaw through 2011 1st Reg. Sess.) ("No person shall be deemed to have participated in any sale or purchase solely by reason of having acted in the ordinary course of that person's professional capacity in connection with that sale or purchase."); OHIO REV. CODE ANN. § 1707.431(A) (West, Westlaw through 2011 portion of the 2011-2012 Legis. Sess.) (exempting from liability "[a]ny attorney, accountant, or engineer whose performance is incidental to the practice of the person's profession").

[116]Bailey v. Trenam, 938 F. Supp. 825, 828 (S.D. Fla. 1996) (finding the standard legal services provision insufficient to incur liability under FLA. STAT. § 517.211); Perkowski v. Megas Corp., 563 N.E. 2d 378, 379-80 (Ohio Ct. App. 1990) (holding that receiving remuneration for finding purchasers is considered participation in the transaction); Gerlach v. Wergowski, 584 N.E.2d 1220, 1223 (Ohio Ct. App. 1989) (per curiam) (finding that an accountant's actions "exceeded the scope of any common law immunity attending the performance of his normal duties"); *see generally* Thomas E. Geyer, Michael P. Miglets & Keith A. Rowley, *Civil Liability and Remedies in Ohio Securities Transactions*, 70 U. CIN. L. REV. 939 (2002).

[117]*See, e.g.*, Navarro v. Grant Thornton, LLP, 316 S.W.3d 715, 720 (Tex. Ct. App. 2010) (material aids standard requires "substantial assistance," a standard that does not include failure to disclose material information in absence of an independent duty to investors).

[118]*Id.* at 729 (upholding summary judgment for an accounting firm that provided professional services because there was no evidence that the firm substantially assisted the primary violator).

[119]*See, e.g.*, Sterling Trust Co. v. Adderley, 119 S.W.3d 312, 320-21 n.39 (Tex. Ct. App. 2003) (finding no support in the Texas Securities Act for argument that the statute requires proof of "substantial assistance" to establish aider liability), *rev'd on other grounds*, 168 S.W.3d 835 (Tex. 2005).

[120]UNIF. SEC. ACT § (410)(a)(2) (amended 1958), 7C U.L.A. 888 (2006); UNIF. SEC. ACT § 509(b), (g) (2002), 7C U.L.A. 163-65 (2006).

[121]*E.g.*, OR. REV. STAT. §§ 59.115, 59.137 (West, Westlaw through Ch. 21 of the 2011 Reg. Sess.). Secondary liability premised on an affirmative defense of non-negligence is a more lenient burden for plaintiffs than traditional aiding and abetting standards, which require knowledge.

the plaintiff to prove that such other persons acted intentionally[122] or with scienter.[123]

IV. FEDERAL LIMITS ON BLUE SKY LAWS

A. *Preemption*

While many states maintain a robust forum providing injured investors with a means to redress securities fraud against both sellers and those who materially assist them, Congress has imposed some limits on state actions. In addition, states are ultimately constrained by the United States Constitution's Dormant Commerce Clause.

1. NSMIA

In 1996 Congress enacted NSMIA[124] to preempt state regulatory authority over defined "covered securities" including nationally listed securities and Rule 506 private placements.[125] NSMIA, however, expressly reserves to state regulators the ex-post power to investigate and prosecute fraud and nothing in NSMIA preempts private civil actions for securities fraud.[126] Indeed, NSMIA's legislative history expressly notes that the statute was not intended to impact any state statutory or common law claim for fraud.[127]

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[122]*E.g.*, CAL. CORP. CODE § 25401 (West, Westlaw through c. 1 of 2011 Reg. Sess.) (subjecting secondary defendants to liability if they act with intent to deceive). Courts have consistently held that under the California statute an allegation of recklessness does not suffice. *See* Orloff v. Allman, 819 F.2d 904, 907 (9th Cir. 1987) (finding that under Section 25504.1, liability for aiding and abetting under state law is restricted to intent to deceive or defraud); Bitter v. Borton, 2002 WL 557844, at *7 (Cal. Ct. App. Apr. 15, 2002) (dismissing claim under Section 25504.1 against law firm for failure to allege the opinion letter was issued "with the intent to deceive or defraud plaintiffs").

[123]*See, e.g.*, Sterling Trust Co. v. Adderley, 168 S.W.3d 835, 837 (Tex. 2005) (an aider must be a "person" who provides material aid to the primary violator with "'intent to . . . defraud or with reckless disregard for the truth or the law'" (quoting TEX. REV. CIV. STAT. ANN. art. 581-33(F)(2) (West, Westlaw through 2010 legislation))).

[124]National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3416 (1996) (codified as amended in scattered sections of 15 and 29 U.S.C.).

[125]Johnson, *supra* note 12 and accompanying text (examining legislative history of NSMIA).

[126]§ 102(a), 110 Stat. at 3419.

[127]H.R. REP. NO. 104-622, at 34 (1996) (Commerce Comm.), *reprinted in* 1996 U.S.C.C.A.N. 3877, 3897. The Commerce Committee stated it did not intend to "alter, limit, expand, or otherwise affect in any way any State statutory or common law with respect to fraud or deceit . . . in connection with securities or securities transactions" by enacting NSMIA. *Id.*

It is so clear that NSMIA does not preempt state civil antifraud liability that the issue is seldom raised in litigation. One exception, however, is *Houston v. Seward & Kissel, LLP*.[128] In *Houston*, the District Court for the Southern District of New York rejected an argument that NSMIA preempted a cause of action for secondary liability under Oregon blue sky law.[129] The defendant also asserted that the Oregon statute was invalid due to implied field and conflict preemption.[130] In rejecting these claims, the court noted that while Congress could have preempted the entire field of securities regulation, NSMIA instead expressly preserved state antifraud authority even for covered securities.[131] Moreover, given that NSMIA only preempted state registration and disclosure requirements for covered securities, there was no actual conflict between NSMIA and the Oregon antifraud statute.[132]

2. SLUSA and CAFA

State securities litigation, while not impacted by NSMIA, can rarely proceed as a class action. Two different federal statutes now prohibit state court adjudication for the vast majority of securities class actions. In 1998, Congress confronted allegations that civil plaintiffs were filing claims in state court to avoid pleading and other procedural hurdles imposed by the 1995 PSLRA.[133] Though the empirical evidence of a shift to state court was inconclusive,[134] Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA")[135] to restrict most securities fraud class actions to

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[128]2008 WL 818745 (S.D.N.Y. Mar. 27, 2008).

[129]*Id.* at *3-*4. The court noted the express NSMIA provision reserving antifraud authority to the states and held it applied equally to civil liability under state antifraud statutes. *Id.* at *4 ("A plain reading of the statute shows that NSMIA's preemption of state securities law is limited to precluding states from imposing disclosure requirements in prospectuses, traditional offering documents and sales literature relating to covered securities." (citing Zuri-Invest A.G. v. Natwest Fin., Inc., 177 F. Supp. 2d 189, 192 (S.D.N.Y. 2001))).

[130]*Id.* at *5.

[131]*Houston*, 2008 WL 818745, at *5.

[132]*Id.*

[133]H.R. REP. NO. 105-640, at 10 (1998); S. REP. NO. 105-182, at 3-6 (1998).

[134]*See generally* Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L.J. 141 (1999) (providing an in-depth analysis of the competing empirical studies); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets On California's Blue Sky Laws*, 54 BUS. LAW. 1, 4-9 (1998) (questioning whether any empirical data indicates a migration by plaintiffs to state court after PSLRA's passage); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 9, 42-46 (1998) (questioning the justification for SLUSA).

[135]Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3227 (codified in scattered sections of 15 U.S.C.).

federal court, where they would be subject to the jurisprudence of Rule 10b-5 and the procedural requirements of the PSLRA.[136] SLUSA precludes both state and federal courts from adjudicating certain class actions that are (1) based upon state statutory or common law;[137] and (2) allege a misrepresentation in connection with the purchase or sale of nationally traded securities.[138]

SLUSA applies to class actions or groups of lawsuits pending in the same court that raise common issues of law and fact and when combined seek damages on behalf of fifty or more persons.[139] Individual securities claims suits are not impacted by SLUSA[140] unless they are part of a series of

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[136]Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 82 (2006). "[Congress enacted SLUSA] [t]o stem this 'shif[t] from Federal to State courts' and 'prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the [Private Securities Litigation Reform Act of 1995.]'" *Id.* (quoting Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3227 (codified at 15 U.S.C. § 78(a))).

[137]Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3228 (codified in 15 U.S.C. § 77p). Initially, SLUSA would have prohibited all private actions in state court involving nationally traded securities. *See* Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Causes of Action*, 50 STAN L. REV. 273, 334 (1998) (arguing that a bill that precludes only class actions would allow plaintiffs to avoid the PSLRA's discovery stay by filing an individual action in state court).

[138]Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, 3230 (codified in 15 U.S.C. § 78bb(f)(1)(A) (2006)). SLUSA applies to "covered securities" which are defined in the statute as any security that is either listed on a national exchange or is "a security of the same issuer that is equal in seniority or that is a senior security to a security" that is listed on a national exchange. 15 U.S.C. §§ 77r(b)(1)(B)-(C). A senior security has "priority over any other class as to distribution of assets or payment of dividends." 15 U.S.C. § 77r(d)(4). Privately placed debt securities, however, are not "covered securities" under SLUSA. 15 U.S.C. § 78(bb)(5)(E).

[139]15 U.S.C. § 78bb(f)(5)(B)(ii). SLUSA contains exceptions, such as the "Delaware carve-out," which preserve any otherwise "covered class action . . . that is based upon the statutory or common law of the State in which the issuer is incorporated." 15 U.S.C. § 78bb(f)(3)(A)(i); *see also* Madden v. Cowen & Co., 576 F.3d 957, 970-76 (9th Cir. 2009) (defining the scope of the "Delaware carve-out"). This exception applies when claims involve communications directed to shareholders in connection with their voting rights, such as in merger and acquisition transactions. *See id.* at 971 & 971 n.7. SLUSA also contains an exception for suits brought by state entities. 15 U.S.C. § 78bb(f)(3)(B). The practical effect of this exception is that actions by state entities cannot be preempted as class actions under SLUSA's grouping provision. Even without this exception, however, individual state entities would only count as one investor for purposes of the fifty-investor preemption threshold. *See* Levine & Pritchard, *supra* note 134, at 30.

[140]*See* S. REP. NO. 105-182, at 7 (1998) (The Senate Banking, Housing, & Urban Affairs Comm. stated that it "does not intend for the bill to prevent plaintiffs from bringing bona fide individual actions simply because more than fifty persons commence the actions in the same state court against a single defendant."). Occasionally, federal courts operating under The All Writs Act, 28 U.S.C. § 1651(a), and the corresponding exception under the Anti-Injunction Act, 28 U.S.C. § 2283, have broadened the impact of SLUSA to include even individual actions if concurrent federal litigation is underway and the individual state suit unduly interferes with the jurisdiction of the district trial court. *See, e.g.*, Newby v. Enron Corp., 302 F.3d 295, 299-303 (5th Cir. 2002)

lawsuits that "proceed as a single action."[141] Courts can combine individual suits, even over the objection of the plaintiffs, if the plaintiffs have consolidated the actions for any purpose.[142] If the lawsuits, once combined, involve more than fifty plaintiffs, SLUSA preclusion applies. SLUSA creates federal removal jurisdiction over covered class actions,[143] relegating SLUSA interpretations primarily to the province of the federal courts as they consider remand petitions.[144]

SLUSA preclusion applies to state class action claims involving misrepresentations in securities transactions even if the state cause of action does not mirror Rule 10b-5.[145] Lower courts, for example, have held that SLUSA precludes state court class actions premised on state statutory or common law provisions that do not require scienter or reliance.[146] In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*,[147] the United States Supreme Court held that a class action based upon state law providing for liability for misrepresentations that cause investors to "hold" securities was "in connection with the purchase or sale of securities."[148] Therefore, the class

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(affirming district court's order enjoining a law firm from filing future state court actions without permission under the All Writs Act). *But see* Ret. Sys. of Ala. v. J.P. Morgan Chase & Co., 386 F.3d 419, 430-31 (2d Cir. 2004) (reversing trial court order to stay state court discovery issued pursuant to the All Writs Act where the only basis is avoiding delay).

[141]15 U.S.C. § 78bb(f)(5)(B)(ii)(II); *see also In re* Enron Corp. Sec., Deriv. & ERISA Litig., 535 F.3d 325, 342 (5th Cir. 2008) (holding that 172 out of 196 cases filed by a single law firm in the same court by virtue of direct filing or removal "proceed[ ] as a single action" under SLUSA, even though each case involved fewer than fifty plaintiffs).

[142]15 U.S.C. § 78bb(f)(5)(B)(ii)(II); *accord* Instituto De Prevision Militar v. Merrill Lynch, 546 F.3d 1340, 1347 (11th Cir. 2008) (actions can be involuntarily combined if plaintiffs have agreed to consolidation for discovery or any other purpose); *In re* Fed. Nat'l Mortg. Ass'n Sec., Deriv., and ERISA Litig., 503 F. Supp. 2d 25, 30-33 (D.D.C. 2007) (concluding that two lawsuits brought by plaintiffs who "opted out" of a class action were part of a "covered class action" after they were consolidated with the original class action lawsuit); Gordon Partners v. Blumenthal, 2007 WL 431864, at *18 (S.D.N.Y. Feb. 9, 2007) ("SLUSA does not require that the group of lawsuits be consolidated for trial, or for 'all' purposes . . . ."); *In re* WorldCom, Inc. Sec. Litig., 308 F. Supp. 2d 236, 246 (S.D.N.Y. 2004) (finding that cases consolidated for pretrial purposes qualified as a "group of lawsuits" under 15 U.S.C. § 78bb(f)(5)(B)(ii)).

[143]15 U.S.C. § 78bb(f)(2); Proctor v. Vishay Intertechnology Inc., 584 F.3d 1208, 1220 (9th Cir. 2009) (citing 15 U.S.C. §§ 78bb(f)(1)-(2)) (SLUSA creates a federal preclusion defense and alone creates federal removal jurisdiction if a claim is covered under the statute).

[144]Remand decisions are not appealable. Kircher v. Putnam Funds Trust, 547 U.S. 633, 635-36 (2006) (finding that SLUSA remand orders are not appealable in accordance with 28 U.S.C. § 1447(d)). Therefore, state courts may adjudicate the propriety of a federal court remand even if they are not often called upon to do so. *Id.* at 646.

[145]*See* Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Dabit, 547 U.S. 71, 71-72 (2006).

[146]Anderson v. Merrill Lynch Pierce Fenner & Smith, Inc., 521 F.3d 1278, 1287 (10th Cir. 2008) ("Plaintiffs did not have to allege scienter or reliance for SLUSA to apply."); *accord* Siepel v. Bank of Am., N.A., 526 F.3d 1122 (8th Cir. 2008).

[147]547 U.S. 71 (2006).

[148]*Id.* at 88-89.

action was subject to SLUSA, even though such claims could not have proceeded under Rule 10b-5 due to the purchaser-or-seller standing requirement of *Blue Chip Stamps*.[149] The Court noted that SLUSA should be interpreted broadly[150] to effectuate the congressional intent to limit abusive class actions.[151] In the wake of *Dabit*, courts have liberally construed the "in connection with" element of SLUSA and have looked at the substance of state complaints to prevent claimants from trying to elude preemption by "artful pleading."[152]

SLUSA does not apply to state securities fraud class actions resulting from the sale of non-covered securities such as privately placed debt securities or any securities issued by nonpublic companies that are not traded in national markets.[153] Defendants, however, may still remove these class actions to federal court under the 2005 Class Action Fairness Act ("CAFA").[154] CAFA confers original federal jurisdiction over any class action[155] with at least 100 claimants, minimal diversity, and an aggregate amount in controversy of at least $5 million.[156] CAFA contains exceptions

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[149]*Id.*; Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738 & 738 n.9 (1975) ("[Shareholders have the ability to] circumvent the *Birnbaum* limitation through bringing a derivative action on behalf of the corporate issuer if the latter is itself a purchaser or seller of securities.").

[150]*Dabit*, 547 U.S. at 85 ("[I]t is enough that the fraud alleged 'coincide' with a securities transaction—whether by the plaintiff or by someone else.").

[151]*Id.* at 82.

[152]Segal v. Fifth Third Bank, N.A., 581 F.3d 305, 310-11 (6th Cir. 2009); *accord* Levinson v. PSCC Servs., Inc., 2009 WL 5184363, at *12 (D. Conn. Dec. 23, 2009) ("Plaintiffs' claims of common law fraud, negligent misrepresentation, and aiding and abetting conversion and statutory theft are preempted by SLUSA because a misrepresentation or other fraudulent conduct is a necessary element of these causes of action."); City of Chattanooga v. Hartford Life Ins. Co., 2009 WL 5184706, at *3 (D. Conn. Dec. 22, 2009) (holding that a complaint for breach of fiduciary duty and unjust enrichment resulting from a misrepresentation is "in connection" with the purchase or sale of a security).

[153]*See* 15 U.S.C. §§ 78(bb)(5)(E), 77a-77d (2006).

[154]Class Action Fairness Act of 2005, Pub. L. No. 109-2, § 5, 119 Stat. 4, 12 (2005) (codified in 28 U.S.C. § 1453).

[155]28 U.S.C. § 1332(d)(11)(A)-(B) (2006) (defining the term "class action" to include mass actions, which are claims on behalf of more than 100 persons, even if not styled as class actions). *Cf.* Greenwich Fin. Servs. Distressed Mortg. Fund 3 LLC v. Countrywide Fin. Corp., 603 F.3d 23, 27-31 (2d Cir. 2010) (dismissing appeal on grounds that CAFA does not permit appellate review of remand orders); Anwar v. Fairfield Greenwich Ltd., 676 F. Supp. 2d 285, 294 (S.D.N.Y. 2009) (finding that a derivative suit on behalf of a fund with 700 shareholders is not a "mass action" subject to removal under CAFA).

[156]*See* 28 U.S.C. § 1332(d)(11)(A)-(B). CAFA provides that the "district courts shall have original jurisdiction of any civil action in which the matter in controversy exceeds the sum or value of $5,000,000, exclusive of interest and costs, and is a class action in which . . . any member of a class of plaintiffs is a citizen of a State different from any defendant." 28 U.S.C. § 1332(d)(2)-(2)(A). Under CAFA, a corporation is a citizen of the state of incorporation and the state where it

for class actions that involve covered securities under SLUSA,[157] for actions that concern corporate governance,[158] and for claims relating to the terms or ownership of the security itself.[159] Otherwise, state antifraud claims involving privately placed debt securities, such as mortgage-backed securities or private equity offerings such as non-traded limited partnership units or LLC interests, appear to fall squarely within CAFA and cannot generally proceed as a class action in state court if more than 100 plaintiffs are involved.[160] CAFA provides exclusive federal jurisdiction over designated class actions, including those based solely upon state law claims.[161] Unlike SLUSA, however, CAFA does not eliminate the class action as a means to adjudicate the state law claims; it merely provides that the litigation proceed in federal court.[162] Furthermore, CAFA preemption is not absolute; the statute requires the federal courts to decline jurisdiction when more than two-thirds of the class members, as well as the defendant, are from a single state.[163] In addition, courts have the discretion to decline

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maintains its principal place of business. 28 U.S.C. § 1332(c)(1). A corporation's principal place of business is its "nerve center," where "a corporation's officers direct, control, and coordinate the corporation's activities." Hertz Corp. v. Friend, 130 S. Ct. 1181, 1192 (2010).

[157]28 U.S.C. § 1332(d)(9)(A).

[158]*Id.* at § 1332(d)(9)(B).

[159]*Id.* at § 1332(d)(9)(C); *Greenwich Fin. Servs. Distressed Mortg. Fund 3 LLC*, 603 F.3d at 27-28 (remanding to state court after finding the class action fell within the CAFA exception on the meaning of terms of securities); Estate of Pew v. Cardarelli, 527 F.3d 25, 31-32 (2d Cir. 2008) (holding that the third CAFA exception was limited to disputes over the meaning of the terms of the security itself, such as the interest rate).

[160]There is a split among the circuits on the relationship between CAFA and section 22 of the 1933 Act, which provides concurrent jurisdiction in federal and state court for 1933 Act claims. Securities Act of 1933 § 22, 15 U.S.C. § 77v(a) (2006). *Compare* Luther v. Countrywide Home Loans Servicing LP, 533 F.3d 1031, 1034 (9th Cir. 2008) (holding that the action was not removable because Section 22 of the 1933 Act is more specific and trumps CAFA), *with* Katz v. Gerardi, 552 F.3d 558, 562-63 (7th Cir. 2009) (disagreeing with *Luther* and holding that securities class actions alleging 1933 Act claims are removable under CAFA unless they fall within a statutory exception), *and* N.J. Carpenters Vacation Fund v. HarborView Mortg. Loan Trust 2006-4, 581 F. Supp. 2d 581, 587-88 (S.D.N.Y. 2008) (finding the removal power under CAFA supersedes Section 22(a)).

[161]*See supra* notes 154-56 and accompanying text.

[162]*See supra* note 153-54 and accompanying text.

[163]28 U.S.C. § 1332(d)(4)(B) (2006); Lao v. Wickes Furniture Co., 455 F. Supp. 2d 1045, 1050 (C.D. Cal. 2006) ("Under the 'home state controversy' [exemption], district courts must decline jurisdiction where two-thirds or more of the class members and the 'primary' defendants are citizens of the state where the action was originally filed." (citing 28 U.S.C. § 1332(d)(4)(B))). District courts must also decline jurisdiction under the "local controversy" exception when: (1) more than two-thirds of the putative class members are from the forum state and at least one defendant is a citizen of the state, if the class seeks significant relief from that defendant, (2) the defendant's conduct constitutes a significant basis of the class claims, (3) the principal injuries occurred in the forum state, and (4) no similar class actions have been filed against any of the same defendants within a three year period. *Id.* at 1050-51 (citing 28 U.S.C. § 1332(d)(4)(A)).

jurisdiction when more than one-third but less than two-thirds of the plaintiffs reside in the same state as the defendant.[164]

The overall impact of congressional preemption is that most blue sky claims against secondary participants, in securities fraud cases involving public companies, are only viable in state court as individual actions or very small class actions with fewer than fifty class members. State securities fraud claims involving private, non-public, entities may be pursued in state court either as individual actions or class actions with fewer than 100 claimants. Larger class actions and traditional diversity cases involving private entities must generally proceed in federal court.[165] Given the privity requirement of most state antifraud civil liability statutes,[166] these congressional preemptive statutes should not unduly impede the ability of plaintiffs to proceed in state court, as large class actions would not be feasible in any event. Perhaps accidently, this procedural lineup insulates blue sky secondary liability claims from the common criticisms of federal securities class actions. Many scholars have argued that even meritorious federal securities class actions do not provide sufficient deterrence or compensatory benefits to justify their costs.[167] Indeed, many federal securities class actions involving secondary market transactions simply impose a wealth transfer upon public shareholders and result in a net loss to investors after transaction costs are considered.[168] Diversified investors are usually net losers under the current federal class action regime.[169] Most state statutes, however, provide for liability only in privity situations, and state lawsuits against secondary defendants largely avoid the wealth transfer problem in any event.[170]

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[164]28 U.S.C. § 1332(d)(3).

[165]*See supra* notes 139, 156 and accompanying text.

[166]*See supra* notes 59-65, 76 and accompanying text.

[167]*See, e.g.*, Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 SEC. REG. L.J. 181, 183-85 (2008) (summarizing critiques of class action securities litigation).

[168]*Id.*; *see also* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 698-700 (arguing that enterprise liability imposes the costs of fraud upon the innocent); John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1549-56 (2006) (arguing that the corporate entity and its insurer normally fund the settlement, with the concomitant cost ultimately falling on shareholders); INTERIM REPORT OF THE COMM. ON CAPITAL MARKETS REG., 78-79 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (finding that net recovery in securities class action litigation is circular).

[169]*See supra* note 168.

[170]*See generally* Coffee, *supra* note 168, at 1556-66 (arguing that claims against secondary defendants are mere wealth transfers).

B. *The Dormant Commerce Clause*

Defendants, particularly out-of-state defendants, have occasionally challenged state antifraud statutes that are more stringent than their federal counterparts under the United States Constitution's Dormant Commerce Clause. While the Commerce Clause expressly provides that "Congress shall have Power to . . . regulate Commerce . . . among the several States,"[171] the United States Supreme Court stated that there is also an "implicit" or "dormant" part of the clause that restricts state regulations that impact interstate commerce.[172] To assess state regulations under the Dormant Commerce Clause, the Supreme Court employs a two-tiered test.[173] Under the first tier, a state statute is *per se* invalid when it "directly regulates or discriminates against interstate commerce, or when its effect is to favor in-state economic interests over out-of-state interests . . . ."[174] If the state regulation is nondiscriminatory, "[t]he critical inquiry is whether the practical effect of the regulation is to control conduct beyond the boundaries of the State."[175] If, however, the state regulation only indirectly affects interstate commerce and regulates evenhandedly, courts will apply the second tier balancing test.[176] Under this tier, a court must determine whether the burden on interstate commerce imposed by the state regulation clearly exceeds the state's legitimate local interests.[177]

The few Dormant Commerce Clause challenges to state blue sky laws have focused on the extraterritorial effect of the statutes and the increased burden on interstate commerce. On the whole, these constitutional challenges have been unsuccessful. The Supreme Court, in a trilogy of cases collectively known as the "Blue Sky Cases," upheld the rights of the states to regulate securities despite Commerce Clause challenges.[178] The Court held

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[171]U.S. CONST. art. I, § 8, cl. 3.

[172]Healy v. Beer Inst., 491 U.S. 324, 326 n.1 (1989).

[173]*Id.* at 337 n.14

[174]Brown-Forman Distillers Corp. v. N.Y. State Liquor Auth., 476 U.S. 573, 579 (1986). *See also* Edgar v. MITE Corp., 457 U.S. 624, 640 (1982) (explaining the limits of the Dormant Commerce Clause).

[175]*Healy*, 491 U.S. at 336.

[176]*See* Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

[177]*Brown-Forman Distillers Corp.*, 476 U.S. at 579; *accord Pike*, 397 U.S. at 142 ("Where the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.").

[178]Caldwell v. Sioux Falls Stock Yards Co., 242 U.S. 559, 567-68 (1917) (upholding South Dakota blue sky laws); Hall v. Geiger-Jones Co., 242 U.S. 539, 539-49 (1917) (upholding Ohio blue sky laws); Merrick v. N.W. Halsey & Co., 242 U.S. 568, 590 (1917) (upholding Michigan blue sky laws).

that the state laws were constitutional because "[t]he provisions of the law[s] . . . apply to dispositions of securities *within* the State."[179] Further, the Court held that the state blue sky laws were merely "police regulation[s], [that] . . . affect[ed] interstate commerce . . . only incidentally."[180]

These Supreme Court precedents make it quite difficult for defendants to challenge state liability provisions on the basis that they regulate conduct wholly outside of the state.[181] For example, in *Houston v. Seward & Kissel, LLP*,[182] a New York law firm challenged the imposition of secondary liability under the Oregon blue sky laws on the grounds that the statute violated the Dormant Commerce Clause.[183] The defendant argued that the Oregon antifraud statute was unconstitutional because it regulated activity that occurred wholly beyond Oregon's borders—that is, the conduct of a New York law firm advising an Idaho client.[184] In rejecting the argument, the federal court for the Southern District of New York noted:

> [T]he Oregon Blue Sky laws are aimed at protecting Oregon residents from securities fraud and limited to the sale of securities in the state. The Plaintiff received the offering materials from Whittier at his home in Oregon, and made the purchase from there. It is this transaction that the Blue Sky laws address . . . .[185]

Therefore, the Court found that the Oregon statute regulated conduct within Oregon and did not violate the Commerce Clause on the basis of extraterritorial impact.[186]

In addition to a territorial requirement, to withstand a Commerce Clause challenge the state statute must further a legitimate state interest that does not unduly burden interstate commerce.[187] Every court to consider the

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[179] *Hall*, 242 U.S. at 557.

[180] *Id.* at 558; *see also* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69, 93 (1987) (rejecting out-of-state company's challenge to Indiana law conditioning an acquisition of corporate control of Indiana corporation on approval of a majority of the pre-existing disinterested shareholders by finding that the law regulated only in-state corporations).

[181] *See* A.S. Goldmen & Co. v. N.J. Bureau of Sec., 163 F.3d 780, 789 (3d Cir. 1999) ("[T]he overwhelming majority of courts that have considered dormant commerce clause challenges to blue sky laws [have upheld the statutes].").

[182] 2008 WL 818745 (S.D.N.Y. Mar. 27, 2008).

[183] *Id.* at *1.

[184] *Id.* at *5.

[185] *Id.*

[186] *Houston*, 2008 WL 818745, at *6.

[187] A.S. Goldmen & Co v. N.J. Bureau of Sec., 163 F.3d 780, 787 (3d Cir. 1999) (citing

issue has held that both the protection of state-resident investors[188] and the regulation of in-state issuers and dealers are legitimate state interests that do not unduly burden interstate commerce.[189] To date, no case has invalidated a remedial state securities statute providing civil liability for an antifraud violation.[190] In fact, noted securities commentators suggest that there no longer needs to be any substantial constitutional doubts about blue sky provisions.[191]

A State's imposition of civil liability in secondary market transactions, however, could press the constitutional limits of even remedial blue sky laws. Recently, the Oregon Public Employee Retirement System ("OPERS") trustees filed suit against AIG and Marsh & McLennan—two publically traded insurance companies—in state court under the Oregon securities laws.[192] Money managers hired by OPERS had purchased shares in each company on the secondary market and sought to recover losses on those investments alleging that the companies had made misrepresentations and

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Edgar v. MITE Corp., 457 U.S. 624, 644 (1982).

[188]In *Houston*, the court addressed the *Pike* balancing test by focusing on the nondiscriminatory impact of the statute. 2008 WL 818745, at *6. Finding no undue burden on interstate commerce, the court stated: "where the effect of the regulation is the same in and outside of the enacting state's territory, a Commerce Clause challenge will fail." *Id.* (citing USA Baseball v. City of New York, 509 F. Supp. 2d 285, 301-03 (S.D.N.Y. 2007)).

[189]Upton v. Trinidad Petroleum Corp., 468 F. Supp. 330, 336 (N.D. Ala. 1979) (finding no constitutional issues in state exemption from registration for sales of up to ten resident or non-resident purchasers), *aff'd on other grounds*, 652 F.2d 424, 427 (5th Cir. 1981); Oil Res., Inc. v. Fla. Dep't of Banking & Fin. Div. of Sec., 583 F. Supp. 1027, 1029-31 (S.D. Fla. 1984) (finding that the Florida statute regulating issuers and dealers in Florida did not violate the Commerce Clause), *aff'd. without op.*, 746 F.2d 814 (Table) (11th Cir. 1984); Enntex Oil & Gas Co. (of Nev.) v. State, 560 S.W.2d 494, 496-97 (Tex. App. 1977) (upholding Texas statute regulating sales by Texas issuer to out-of-state purchasers), *appeal dismissed*, 439 U.S. 961 (1978) (dismissing for lack of substantial federal question); Haberman v. Wash. Pub. Power Supply Sys., 744 P.2d 1032, 1054 (Wash. 1987) (rejecting a Commerce Clause challenge to the application of the Washington blue sky laws to a bond sale where the issuer, its members and directors, one respondent bond counsel, as well as the majority of the respondent participants were Washington residents); *cf.* Ariz. Corp. Comm'n v. Media Prods., Inc., 763 P.2d 527, 531-33 (Ariz. Ct. App. 1988) (holding that an Arizona statute requiring local registration of securities, even where the issuer was incorporated out-of-state and all purchasers were out-of-state residents, violated the Commerce Clause because it created an excessive burden on interstate commerce).

[190]Chrysler Capital Corp. v. Century Power Corp., 800 F. Supp. 1189, 1194 (S.D.N.Y. 1992) (holding that an Arizona antifraud statute does not violate the Commerce Clause and noting that the defendant "fails to cite any case in which a remedial anti-fraud statute was found to burden interstate commerce").

[191]*See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 39-40 (3d ed. 1989).

[192]*See* State v. Marsh & McLennan Cos., Inc., 250 P.3d 371, 372 (Or. Ct. App. 2011); State v. Am. Int'l Grp., Inc., No. 0802-03061 (Or. Multnomah Cnty. Cir. Ct. Apr. 30, 2009) (order denying AIG's motion to dismiss).

omissions in violation of Oregon securities antifraud statutes.[193] Among other defenses, AIG and Marsh & McLennan argued that the Oregon antifraud statute violated the Commerce Clause because it imposed an undue burden upon interstate commerce.[194] Two different judges in Multnomah County, Oregon heard the cases. Each judge reached different conclusions on the Commerce Clause issue. The court in *AIG* upheld the Oregon statute,[195] while the court in *Marsh & McLennan* ruled that that the statute violated the Commerce Clause.[196] The *AIG* litigation soon settled[197] and the *Marsh & McLennan* ruling was appealed to the Oregon Court of Appeals.[198]

The primary argument set forth in both cases concerned the increased burden the Oregon statute imposes on out-of-state public-company issuers.[199] The defendants argued that, if held valid, a more lenient state culpability standard would force public issuers to review disclosure documents with a level of precision not required under the federal system.[200] While this argument has failed in the context of preemption challenges,[201] a Commerce

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[193]*See Marsh & McLennan*, 250 P.3d at 372. In addition to facing liability in Oregon courts under Oregon blue sky laws, AIG and Marsh & McLennan both have been subjected to class action lawsuits in federal courts. *See In re* Am. Int'l Grp., Inc. 2008 Sec. Litig., 741 F. Supp. 2d 511, 517 (S.D.N.Y. 2010); *In re* Marsh & McLennan Cos., Inc. Sec. Litig., 501 F. Supp. 2d 452 (S.D.N.Y. 2006). The Marsh & McLennan claim was settled for $400,000,000 with an additional $60,000,000 awarded in attorney fees. *In re* Marsh & McLennan Cos., Inc. Sec. Litig., 2009 WL 5178546, at *1, *25 (S.D.N.Y. Dec. 23, 2009). The AIG class action was settled for an aggregate recovery of over $1,000,000,000. *See* Richard Cordray, Ohio Att'y Gen., *Cordray Secures Record Settlement with AIG: Total Case Expected to Recover Over $1 Billion for Shareholders* (July 16, 2010), http://www.ohioattorneygeneral.gov/Briefing-Room/Litigation-Pages/Securities-Litigation-Briefing-Documents/Cordray-Secures-Record-Settlement-with-AIG.

[194]*See Marsh & McLennan*, 250 P.3d at 374 (Marsh argued the Oregon statutes "were unconstitutional because they imposed more onerous duties on stock issuers than were imposed by federal and other states' securities laws").

[195]State v. Am. Int'l Grp., Inc., No. 0802-03061 (Or. Multnomah Cnty. Cir. Ct. Apr. 30, 2009) (order denying AIG's motion to dismiss).

[196]*Marsh & McLennan*, 250 P.3d at 372 ("[T]he trial court concluded that Oregon's statute was unconstitutional because it unduly interfered with Congress's power to regulate interstate commerce.").

[197]Kristian Foden-Vencil, *AIG Agrees to Pay Oregon $8 Million*, OREGON PUBLIC BROADCASTING (Feb. 25, 2010), news.opb.org/article/6798-aig-agrees-pay-oregon-8-million.

[198]*Marsh & McLennan*, 250 P.3d at 379-80 (finding the lower court did not err in granting defendant's motion for summary judgment because the state failed to present evidence that it actually relied on the securities law violations).

[199]*See, e.g.*, *id.* at 374.

[200]*See id.* at 374-75.

[201]*See* Wyeth v. Levine, 129 S. Ct. 1187, 1203-04 (2009) (holding that federal law does not preempt tort claim under state law alleging that an FDA-approved label for a drug did not contain an adequate warning); Altria Group, Inc. v. Good, 129 S. Ct. 538, 551 (2008) (holding that the Federal Cigarette Labeling and Advertising Act does not preempt a state law action on deceptive advertising).

Clause challenge could prove interesting. The *Marsh & McLennan* case itself is a case of first impression given the rather unique Oregon statute that combines civil liability for secondary market transactions with a culpability standard of negligence or perhaps even strict liability.[202] The Oregon Appellate Court, in a February 2011 opinion, directly avoided the constitutional issue,[203] but suggested that the lenient culpability standard in the Oregon statute might raise constitutional concerns.[204]

V. SECONDARY LIABILITY UNDER BLUE SKY LAWS: A WISE POLICY CHOICE?

States often justify their stringent secondary liability standards on the grounds that secondary participants in securities transactions, such as lawyers and accountants, should perform a gatekeeper role—a view supported by most academics.[205] Legislative and judicial pronouncements make clear that federal law has not expressly or implicitly preempted state antifraud remedies against secondary defendants.[206] Moreover, there has never been a successful commerce clause challenge to a securities antifraud civil liability statute.[207] Nonetheless, we must ask whether state imposition of secondary liability for securities fraud under state law is a wise policy choice? After all, this cause of action is currently unavailable under federal law,[208] and would, even if reinstated into the federal system, be subject to much different substantive and procedural standards.[209]

The continuing state role in the regulation and enforcement of securities regulations is often defended on grounds of federalism which at one level defines much of our political system. There is no shortage of scholarly work on the benefits and costs of federalism.[210] Perhaps the most

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[202]*See Marsh & McLennan*, 250 P.3d at 375-76.

[203]*Id.* at 376.

[204]*Id.* at 374 n.3. The Court, however, recast the issue as one of federal preemption rather than the Dormant Commerce Clause. *Id.*

[205]*See supra* note 2.

[206]*See supra* Part IV.A.

[207]*See supra* note 190 and accompanying text.

[208]*See supra* Part II & III.

[209]For example, the Dodd-Frank Act directs the GAO to study the impact of reinstating civil aiding and abetting liability under Rule 10b-5, but even this study was premised on a "knowledge" standard rather than the inverse negligence rule applicable under state law. *See* Dodd Frank Wall Street Reform & Consumer Prot. Act § 929Z, H.R. REP. NO. 111-517, 111th Cong. (2d Sess. 2010).

[210]*See, e.g.*, John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 710 n.6 (2009) ("Federalism is, of course, the opium of the law professors, which they can rarely avoid, even if there is nothing new to be said."). Federalism is championed as a system protecting individual rights by limiting national power. *See*

prevalent view of the benefits of our federalism system is that it provides flexibility to allow state experimentation and innovation. The United States Supreme Court[211] and numerous commentators[212] espouse this view. Critics, however, contend that costs of dual securities regulation, such as inconsistent or duplicative laws, may outweigh the perceived benefits of state innovation.[213]

State securities civil liability schemes, particularly those providing secondary liability, pose a complicated question about the appropriate role of federal versus state securities regulation and enforcement. On one hand, the state blue sky laws that impose secondary liability upon professionals and others may inform the debate on appropriate gatekeeper liability and therefore foster the goals of experimentation and innovation. Alternatively, such statutes may impose unwarranted costs due to inconsistent regulations and undue interference with interstate commerce.

Outside of class action preemption,[214] most of the debate and analysis involving federalism and securities regulation has revolved around the dual roles of the federal and state securities regulators rather than the different

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United States v. Lopez, 514 U.S. 549, 552 (1995) ("[A] healthy balance of power between the States and the Federal Government will reduce the risk of tyranny and abuse from either front." (citation omitted) (internal quotation marks omitted)); *see also* Robert P. Inman & Daniel L. Rubinfeld, *Rethinking Federalism*, 11 J. ECON. PERSP. 43, 44-53 (1997) (discussing the three principles of federalism); Michael W. McConnell, *Federalism: Evaluating the Founders' Design*, 54 U. CHI. L. REV. 1484, 1493, 1500 (1987) (book review) (arguing that decentralized decision-making allows for diversified citizen input into the political system and "state and local governments are better protectors of liberty"); A.C. Pritchard, *Constitutional Federalism, Individual Liberty, and the Securities Litigation Uniform Standards Act of 1998*, 78 WASH. U. L. Q. 435, 439 (2000) ("[S]tates are respected in our constitutional system because of the counter-balance that they provide to federal power.").

[211] *See, e.g.*, Gregory v. Ashcroft, 501 U.S. 452, 458 (1991) ("[Federalism] allows for more innovation and experimentation in government.").

[212] THOMAS R. DYE, AMERICAN FEDERALISM: COMPETITION AMONG GOVERNMENTS 20-21 (1990) (advocating that competitive federalism fosters innovation); DAVID OSBORNE, LABORATORIES OF DEMOCRACY 1-17 (1990) (explaining that state governments, formerly the enemies of change, have evolved into experimental laboratories promoting novel agendas in an effort to solve social and economic problems); *see* DANIEL J. ELAZAR, AMERICAN FEDERALISM: A VIEW FROM THE STATES 1-22 (1966) (providing a comprehensive analysis of state innovation); Daniel B. Rodriguez, *Turning Federalism Inside Out: Intrastate Aspects of Interstate Regulatory Competition*, 14 YALE L. & POL'Y REV. 149, 151 (1996) ("[O]ne of the essential values of federalism is that states may act differently.").

[213] Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 318-29 (1998) (disputing benefits of state competition and innovation for securities fraud class actions involving nationally traded securities); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2200-27 (2010) (questioning the multi-enforcer approach to deterring securities fraud).

[214] Scholars have generated ample commentary on the federalization of securities class actions under SLUSA and CAFA. *See supra* notes 135-70 and accompanying text.

state securities civil liability schemes.[215] NSMIA preemption resulted from the congressional decision that inconsistent state regulations unduly impeded the United States capital markets.[216] Perhaps lost in the rush for regulatory preemption was the concept that non-uniformity in liability schemes can have equally great importance.[217]

Issuers and their advisors who could face liability under state blue sky laws must adapt their *ex ante* behavior to conform to the state's liability schemes as well as its regulatory regime.[218] Therefore, it is important to assess whether the federalism rationale at all justifies state secondary liability rules that differ greatly from each other as well as from the federal system. If so, the courts should champion and protect state innovation.[219] If a state "gets it right," all can benefit from the better idea. If a state "gets it wrong," the adverse impact is largely limited to one state and upon realizing its error, the state can change its regulations.[220]

If the "experimental lab" metaphor is to go beyond rhetoric, someone must check the lab results and evaluate the impact of the varying state civil liability regimes upon secondary defendants.[221] Variations in state regimes can involve statutes and administrative regulations, appellate opinions, and trial court decisions and rulings. These can in turn impact state court filings, party disputes, and ultimately, the *ex ante* behavior of both primary and secondary participants in securities transactions.

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[215] *See, e.g.*, Stefania A. Di Trolio, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1302-14 (2004) (using public choice theory to support dual federal/state antifraud enforcement of securities laws).

[216] *See* Johnson, *supra* note 12, at 179-88 (analyzing the rationale underlying NSMIA preemption).

[217] Indeed, Congress specifically preserved the states' antifraud roles in the matter of regulation, enforcement, and civil liability. J. Liam Gruzs, *Responding to an Unforeseen Variation: Why Ohio Should Provide a Statutory Right of Rescission to All Defrauded Parties in a Stock-for-Stock Exchange*, 43 VAL. U. L. REV. 307, 320 (2008) (noting that under the NSMIA states have "considerable leeway in the construction of their antifraud provisions").

[218] *See* Pritchard, *supra* note 210, at 437 n.11 ("It should be obvious to even the casual observer that the threat of potential state litigation is likely to have an effect on the ex ante expectations of participants in the interstate securities markets.").

[219] In celebrating the potential role of the states, Justice Brandeis once stated, "[i]t is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country." New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting).

[220] In SLUSA, Congress pre-empted class actions based upon state blue sky laws that involve nationally traded securities, thus, significantly lessening the impact of the laws of any one state upon national markets. The stated rationale of SLUSA, however, had more to do with federal procedural protections for defendants than differing state liability schemes. *See supra* notes 135-52 and accompanying text.

[221] *But see* Rose, *supra* note 213, at 2222-24 (questioning whether it is possible to measure the impact of differing state enforcement regimes).

Legal scholars and lawmakers can compare state statutes and regulations with federal statutes and regulations, and they can draw some preliminary conclusions from the variations. Interestingly, while there are works describing the uniform securities acts and state variations,[222] very few scholarly articles attempt to examine the various state securities liability regimes to evaluate and compare their impact.[223] Rather, the few scholars who address state securities law tend to argue abstractly about the wisdom of overlapping regulatory systems.[224] Perhaps due to the complexities of a fifty-state system, others are content to leave the macro-analysis to the treatise writers and concentrate solely on a description of the laws of one state.[225]

State court judicial opinions could provide one glimpse of the impact of the varying state statutory schemes, but outside of Delaware, our ordinary view of the state courts is limited to published appellate opinions.[226] While

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[222]*See, e.g.*, LONG, *supra* note 47, § 12:1.

[223]*See, e.g.*, Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 BERKELEY BUS. L.J. 1, 32-41 (2005) (surveying and analyzing attorney liability under state blue sky law).

[224]Manning Gilbert Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 499 (1984) (arguing against federal preemption of state securities laws); Rutheford B. Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L. Q. 407, 408-09 (2000) (arguing that only complete federal preemption of state regulation can produce a "modern, fair, and efficient regulatory scheme for capital formation"); Reza Dibadj, *From Incongruity to Cooperative Federalism*, 40 U.S.F. L. REV. 845, 878 (2006) (arguing for a principle of "cooperative federalism," as opposed to dual or preemptive federalism, as a framework for securities regulation); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879, 911 (2006) ("[M]any federalism arguments are merely deregulatory arguments in disguise[,] . . . [but] because [they] are couched in federalism terms, they serve mainly to distract from important substantive debates on whether and how to best regulate American corporations."); Roberta S. Karmel, *Reconciling Federal and State Interests in Securities Regulation in the United States and Europe*, 28 BROOK. J. INT'L L. 495, 542-46 (2003) (discussing regulatory competition and concluding that national regulation better protects investors). For an earlier debate on the implications of federalism and the SEC, *compare* Alison Grey Anderson, *The Meaning of Federalism: Interpreting the Securities Exchange Act of 1934*, 70 VA. L. REV. 813, 853-56 (1984) (discussing the falsity behind a demarcation or balancing between discrete state and federal interests where corporate and securities law apply), *with* Edmund W. Kitch, *A Federal Vision of the Securities Laws*, 70 VA. L. REV. 857, 857 (1984) (arguing that the notions of federalism conflict with securities laws designed to protect individual interests).

[225]Richard G. Himelrick, *Arizona Securities Fraud Liability: Charting a Non-Federal Path*, 32 ARIZ. ST. L.J. 203 (2000); Jay H. Knight & Garett P. Baker, *Kentucky Blue Sky Law: A Practitioner's Guide to Kentucky's Registrations and Exemptions*, 34 N. KY. L. REV. 485 (2007); Ellen Minnig, *Auditor Liability Under Colorado Blue Sky Laws*, 29 COLO. LAW. 63 (Oct. 2000); Keith A. Rowley, *They Toil Not, Neither Do They Spin: Civil Liability Under the Oregon Securities Law*, 37 WILLAMETTE L. REV. 335 (2001); Keith A. Rowley, *Muddy Waters, Blue Skies: Civil Liability Under the Mississippi Securities Act*, 70 MISS. L. J. 683 (2000).

[226]The Delaware Court of Chancery, which has jurisdiction over business disputes including state securities matters, is one of the few state trial courts that maintain a searchable database.

useful interpreters of the state statutes, these appellate rulings do not present a cogent street view of the effect of a particular civil liability regime. Rulings or opinions from state trial courts would come closer to the mark, but unfortunately they are sporadic and exceedingly difficult to research with any assurance of obtaining reliable data. At present, most states do not maintain a database of trial court decisions, and few, if any, state trial courts routinely render opinions or track summary judgments or other interim procedural rulings.[227]

State court filings could provide a relevant indication of statutory impact. This data, however, is almost impossible to obtain because courts are often dispersed throughout a state, and state courts rarely centralize their statistics. In any event, few state courts track filings at all and rarely by subject matter.[228] Those state filings that are traced, such as state class actions, do not always produce consistent and reliable results.[229] For example, consider the conflicting studies on the volume of state securities class actions produced by parties supporting or opposing the 1998 SLUSA class action preemption bill.[230] Not surprisingly, there is even less information concerning disputes arising over statutory liability that settle without a judicial filing.

Finally, statutes also can influence *ex ante* behavior, even if no visible disputes result. For example, some commentators argue that imposing overly strict secondary civil liability will cause securities professionals to price their services beyond the reach of smaller, more risky issuers.[231] These issuers would likely forgo legal or accounting advice when selling securities, ultimately harming investors. Others, however, stress the gatekeeping

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Delaware State Court, *Court of Chancery Opinions and Orders*, http://courts.delaware.gov/opinions/List.aspx?ag=Court of Chancery.

[227]Very few state trial courts outside of Delaware, New York, and California consistently publish orders or opinions. New York, for example, publishes selected trial court opinions from its Supreme Court.

[228]Very few state trial courts maintain searchable electronic filing systems. Some state filings may be accessible with a search engine, such as Westlaw Docket Search, but the results are sporadic, the subject matter of the filings is ill-defined, and often necessitate a fee-paid "runner" to go to court and obtain the necessary documents.

[229]*See* Joseph A. Grundfest, *Securities Class Action Litigation in Q1 1998: A Report to NASDAQ from the Stanford Law School Securities Class Action Clearinghouse*, STAN. L. SCH. SEC. CLASS ACTION CLEARINGHOUSE (June 2, 1998), http://securities.stanford.edu/research/reports/19980602q1.html ("It is inordinately difficult to track state court filings and to provide precise figures for the volume of state court litigation.").

[230]*See supra* note 134.

[231]*See, e.g.*, Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1336 (2008).

function of professionals and applaud stricter statutory liability.[232] While both views have some intuitive appeal, lawmakers should at least attempt to assess the validity of each theory to evaluate whether a state should impose civil liability upon secondary defendants.

If state imposition of secondary liability produces costs in excess of benefits, one might expect to see this manifest itself in states that have the most aggressive securities civil liability statutes. The State of Oregon is a useful proxy for this analysis as it employs perhaps the most plaintiff-friendly blue sky laws in the country. Under the Oregon securities statutes, sellers are liable for misrepresentations to investors unless they can prove that they were *not* negligent.[233] The Oregon blue sky statutory scheme extends liability for securities fraud to *any person* who participates in or materially aids a securities transaction.[234] Moreover, the Oregon courts have promulgated a liberal judicial definition of "materially aids" to include professionals who assist in a securities transaction via standard professional services.[235] Under Oregon law, professionals and other secondary participants are liable to the same extent as the actual seller unless they maintain an affirmative defense of inverse negligence.[236] Finally, the Oregon statutes contain an express civil cause of action against issuers and secondary defendants for securities fraud in secondary market transactions.[237]

In Oregon, as in most states, trial court filings and opinions are not readily available, leaving reported appellate opinions as the sole searchable judicial database. Apart from reported judicial opinions, however, there is a unique resource available in Oregon providing a useful understanding of the impact of the state securities statutes. The Oregon State Bar Association maintains a mandatory malpractice-insurance program. All active members of the Oregon State Bar engaging in the private practice of law must purchase a minimum of $300,000 in insurance coverage from a sole provider, the Professional Liability Fund (PLF).[238] Since 1983, all Oregon

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[232]*See, e.g.*, *Report of the New York City Bar Ass'n Task Force on the Lawyer's Role in Corporate Governance–November 2006*, 62 BUS. LAW. 427, 455-61 (2007) (predicting expanded regulation and observing that lawyers are obligated to advise clients responsibly in recognition of the clients' duties to the investing public).

[233]OR. REV. STAT. § 59.115(1), (3) (West, Westlaw through Ch. 7 of 2011 Reg. Sess.).

[234]*See id.*

[235]Prince v. Brydon, 764 P.2d 1370, 1371-72 (Or. 1988) (holding that "material aid" in no way implies that knowledge is necessary, but rather it depends on the importance of one's personal contribution, such as typing, reproducing, and delivering documents).

[236]*See* OR. REV. STAT. § 59.115(3).

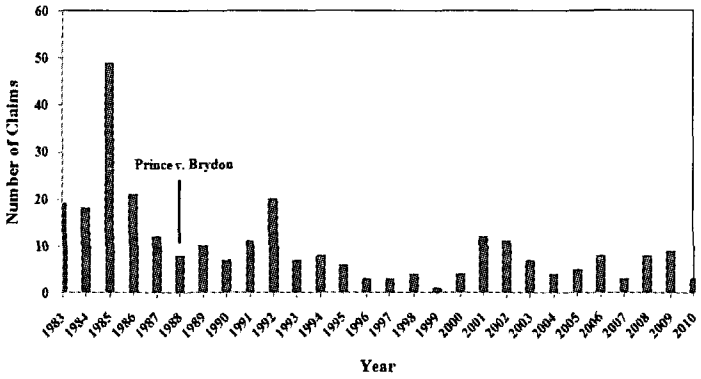
[237]OR. REV. STAT. § 59.137(1), (2).

[238]*See* OR. REV. STAT. § 9.080(2)(a). Pursuant to Section 9.080 of the Oregon Revised Statute, and with membership approval, the Oregon State Bar Board of Governors established the

private attorneys have maintained minimum insurance coverage that includes protection against claims based upon securities transactions.[239] Therefore, the PLF is the first line of defense for Oregon securities lawyers as any claim specifically involving securities matters is processed first by the PLF. The PLF claims process may be initiated not only when an attorney is named in litigation, but also when a covered attorney has concerns about potential errors in securities transactions.[240] Such concerns could stem from a number of sources, including: contact with a client, the client's lawyer, or a third party such as an investor. Securities related claims could include potential liability from errors resulting from compliance with both state and federal securities law, in addition to malpractice and secondary liability under the blue sky laws.

An interesting result followed the Oregon Supreme Court's decision in *Prince v. Brydon,* which held that attorneys performing traditional professional roles could "materially aid" a securities sale for purposes of the secondary liability provisions of the Oregon blue sky laws.[241] As the chart below shows, there was not a marked increase in PLF claims processed in the *Prince* aftermath.[242]

PLF Securities Claims by Year



Professional Liability Fund in 1977. Since July 1, 1978, all practicing Oregon lawyers have been required to carry primary malpractice coverage through the PLF. *Professional Liability Fund (PLF)*, OREGON STATE BAR (Jun. 9, 2011 8:23 PM), http://www.osbar.org/plf/plf.html.

[239]Before 1983, securities coverage was optional and available from the PLF only by means of a separate endorsement. Letter from Bruce Lee Schafer, Director of Claims, Oregon PLF to author (Apr. 2, 2010) (on file with author).

[240]*Id.*

[241]Prince v. Brydon, 764 P.2d 1370, 1371 (Or. 1988); OR. REV. STAT. § 59.115(3).

[242]Of more significance is the large number of claims from 1983-1986, perhaps stemming from the inclusion of all attorneys in securities coverage in 1983.

The latest available PLF statistics show that from 2001 to 2010 (a time period spanning two economic downturns), sixty-one securities related claims were processed, equivalent to less than 1% of the total claims.[243] The PLF paid a total of $3,217,612 on securities related claims, representing approximately 2.6% of the value of all claims paid in the ten-year period.[244] These statistics indicate that the imposition of secondary liability upon attorneys engaged in Oregon securities transactions did not result in a marked increase in overall liability claims.[245] Indeed, the trend remains fairly constant throughout the PLF reporting years, without the expected rise following the *Prince* decision.[246]

These PLF statistics are both over-inclusive and under-inclusive when used to assess claims for secondary liability under Oregon's blue sky law. The "claims" are over-inclusive in that they can represent mere inquiries or concerns rather than actual liability.[247] Also, the PLF statistics may be over-inclusive, in that they include malpractice claims apart from potential secondary liability. Nonetheless, while the correlation between malpractice claims and secondary liability claims is not perfect, they significantly overlap. If a client-issuer is solvent and must pay a securities claim, the client may file a malpractice claim against her attorney. Alternatively, if a client is insolvent, and cannot pay the investors, secondary liability claims are more likely.

Conversely, the PLF statistics are under-inclusive in that they do not reflect secondary liability claims against out-of-state attorneys or non-attorney defendants, such as accountants.[248] Accurate statistics on claims

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[243]*See* Ira R. Zarov, *PLF 2010 Annual Report*, OREGON STATE BAR PROFESSIONAL LIABILITY FUND, 5, http://osbplf.org/docs/plans/2010%20PLF%20AnnualReport.pdf (last visited Jun. 17, 2011).

[244]Of the $3,217,612, $1,403,480 represented the indemnity payment and $1,658,901 represented expenses. The indemnity payment corresponds to 2% of all PLF payments while the expenses signify 3% of PLF payments for expenses. Ira R. Zarov, *PLF 2010 Annual Report*, OREGON STATE BAR PROFESSIONAL LIABILITY FUND, 5, http://osbplf.org/docs/plans/2010%20PLF%20AnnualReport.pdf (last visited Jun. 17, 2011).

[245]The PLF statistics do not reflect the total dollar value of claims as it only requires minimum insurance protection for Oregon attorneys. Attorneys may procure excess coverage through any number of insurance carriers. Therefore, in a particular case, the actual dollar amount of paid securities claims could be much higher. *See, e.g.*, Jeff Manning, *Portland Law Firm Agrees to Settlement in Sunwest Case*, THE OREGONIAN, Oct. 22, 2009, *available at* http://www.oregonlive.com/business/index.ssf/2009/10/portland_law_firm_agrees_to_30.html (describing a $30,000,000 securities fraud and malpractice claims settlement as one of the largest ever by an Oregon law firm).

[246]The PLF statistics indicate a sharp peak in 1985, two years following mandatory securities coverage and a smaller unexplained peak in 1992.

[247]*See* Letter from Bruce Lee Schafer to author, *supra* note 239.

[248]*See* Pls.' Compl. for Or. Sec. Law Damages, Agee's Wyndmoor, LLC v. Thompson &

under Oregon blue sky laws against these defendants are not readily available. Fortunately, the plaintiffs' bar in Oregon, which generally brings such cases, is relatively small and well integrated. When asked to recall any securities claims brought in the past ten years against secondary defendants other than Oregon lawyers (and thus not included within the PLF statistics), the plaintiffs' lawyers reported only a handful of cases.

While the Oregon secondary liability securities statute has not apparently engendered a slew of securities claims, there remains the question of whether even the potential imposition of liability for professionals who materially aid securities transactions in Oregon has caused issuers to forgo professional services due to increased costs. Oregon attorneys do not report any noticeable increase in securities offerings without professional involvement; to the contrary, one noted positive trend is that attorneys not conversant in securities law are advised to refer potential issuers to those with experience.[249] This development portends well for the gatekeeper role that attorneys can play to protect investors—a role made even more important given the anemic pre-sale authority now exercised by state and federal regulators.[250]

The PLF statistics, together with substantial anecdotal evidence, suggest that Oregon's strict secondary liability regime has not produced significant adverse impacts upon issuers or secondary defendants, including professionals. Neither the number nor dollar amount of claims has substantially increased since the Oregon Supreme Court held that the provision of professional services falls within the statutory definition of

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Knight, LLP, 2009 WL 1635372 (Multnomah Cnty. Cir. Ct. May 6, 2009) (Trial Pleading) (filed against accounting firm involved in the failed Sunwest venture); Brad Broberg, *Securities Fraud Victims Target Perpetrators' Advisers*, PORTLAND BUS. J., June 6, 2010, *available at* http://www.bizjournals.com/portland/stories/2010/06/07/focus2.html (noting the 2008 $30,000,000 Oregon jury verdict against Arthur Andersen).

[249]The following email exchange occurred on the Oregon State Bar Business Law Section list-serve in June of 2010: Email entitled "Newbie Advice?" "Listmates, Is anyone willing to chat on the phone with me for a few minutes regarding the best way to structure an investment group and how to avoid some common pitfalls? PC will be leasing and developing certain real properties using investors' money. Thanks!" Email from [new lawyer], to Business Law Section Members (June 24, 2010, 1:12PM PDT) (on file with author). This request produced 8 responses strongly encouraging "newbie" to refer the matter to experienced securities counsel. The following are representative responses: "Usually I would advise new attorneys to try different areas of the law to gain experience but securities law is an area filled with pitfalls and malpractice traps for the inexperienced. Be careful. Associate experienced counsel or refer out." Email from [experienced attorney], to Business Law Section Members (June 24, 2010, 3:31PM PDT) (on file with author). "Please do not walk, but run away from this one and refer the PC to an existing attorney who handles security issues . . . you do not - I repeat, 'do not' - want to be a target under the blue sky laws." Email from [experienced attorney], to Business Law Section Members (June 24, 2010, 1:25PM PDT) (on file with author).

[250]*See* Johnson, *supra* note 12, at 179-80.

"materially aids."[251] While Oregon securities professionals would undoubtedly prefer that their services fall outside the statutory definitions,[252] the system has not produced the dire consequences feared in other states that have eliminated gatekeeper liability. Instead, at least for lawyers, the potential statutory liability seems to have the salutatory impact of channeling securities cases to attorneys with expertise who can act as effective gatekeepers.[253]

The fortuitous combination in Oregon of the country's most aggressive secondary liability regime and a mandatory single source malpractice insurance program provides evidence to assess the costs and benefits of the imposition of secondary liability for securities fraud under state law. The Oregon experience suggests that the potential benefits for investor protection outweigh costs associated with increased secondary liability. Other states may consider following Oregon's lead in imposing gatekeeper liability in an effort to better protect investors without fear of dire consequences. At the very least, the available evidence counsels that Congress should continue to respect the traditional state role in policing securities fraud.

VI. CONCLUSION

There has been a pointed tendency for Congress to preempt state blue sky laws that conflict with the federal system, especially when dealing with publicly traded companies. With the exception of the class action arena, state securities civil liability regimes have largely survived. This Article concludes that the state civil liability statutes should continue to coexist with the federal regulatory system. Outside of Section 11 of the 1933 Act governing registered public offerings, federal law does not provide any private remedy against gatekeeper defendants in cases of securities fraud; therefore, it is entirely appropriate that state law operate in this arena. Even Oregon's aggressive civil liability regime has not produced adverse consequences of great importance in the state, and certainly not on the national stage. The integration of the generally privity-based blue sky laws with the federal class action preemption acts has perhaps achieved an ideal balance, even if by accident. Individual investors or small groups of investors remain free to bring claims under blue sky antifraud statutes

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[251] *See supra* note 241-42 and accompanying text.

[252] *See* Broberg, *supra* note 248 (noting examples of professional discontent with the aiding and abetting provisions of the Oregon securities laws).

[253] While information involving attorneys roles may not be directly correlated to other professionals, at least antidotal evidence suggests a similar trend.

against both sellers and secondary defendants, including professionals. There also remains a limited space for smaller state court class actions against secondary defendants.[254] Larger class actions against public issuers appropriately remain the sole province of the federal securities law, where stricter procedural hurdles exist to combat potential abuses on cases where the incentives for abuse are most compelling. Indeed, perceived class action abuses are the primary driver keeping civil aiding and abetting liability out of the federal system.

Civil liability for securities fraud is an important component of antifraud efforts given the limited resources of federal and state regulatory agencies. Nothing underscores the limits of these governmental resources more clearly than the anemic regulatory efforts that preceded the catastrophic events leading to the recent economic crisis. Gatekeepers, such as professionals involved in securities offerings, can play an important role in deterring their clients' wrongs. In particular, professional advisors in private offerings provide the only line of defense between promoters and investors, many of whom are vulnerable retail investors. While it seems unlikely that Congress will, in the foreseeable future, reinstate civil aiding and abetting liability into the federal system, Congress should at least resist efforts to further restrict states' attempts to deter securities fraud and compensate victims.

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[254] *See* Jennifer J. Johnson, *Securities Class Actions in State Court*, U. CIN. L. REV. (forthcoming 2011) (detailing space available for securities class actions in state court in light of federal preemption and providing empirical study).