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California Overhauls State Anti-Securities Fraud Statute

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On September 23, 2013, Governor Jerry Brown signed into law Senate Bill 538—which overhauls the anti-fraud provision of the California Securities Law of 1968, and will likely make it more difficult for would-be plaintiffs to maintain lawsuits for securities fraud.

Specifically, SB 538 revises California Corporations Code § 25401 to make it unlawful, in connection with the offer, sale, or purchase of a security, to: (a) employ a device, scheme, or artifice to defraud; (b) make an untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and (c) engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.[1]

In its historic form, the statute did not include clauses (a) and (c).[2] According to bill sponsor Senator Jerry Hill (San Mateo County), the changes were intended to bring California's anti-fraud provision in line with federal law.[3] And, indeed, the U.S. Securities and Exchange Commission's Rule 10b-5—an essential anti-securities fraud rule promulgated under Section 10(b) of the Securities Exchange Act of 1934—is fundamentally identical to the modified California statute.[4]

Interestingly, however, the original version of § 25401 was already based on federal law.[5] Section 12(a)(2) of the Securities Act of 1933 creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission[6]—virtually the same as clause (b), which more or less survived the recent rewrite of § 25401, with the exception that clause (b) also imposes liability on buyers and those who offer to buy.

To sue under Section 12(a)(2) and the previous version of § 25401, a plaintiff in a civil case would not have to allege that the defendant made a material misstatement or omission intentionally or negligently.[7] Similarly, a plaintiff would not have to allege that he or she relied on the misstatement or omission when determining whether to buy or sell a security, or that there was a causal connection between the material misstatement or omission and any damage suffered.[8]

Now that the California legislature has remodeled § 25401 based on Rule 10b-5, it stands to

reason that courts may interpret the new version in a way consistent with how the federal courts have interpreted Rule 10b-5. Unlike for Section 12(a)(2) claims, plaintiffs bringing a claim under Rule 10b-5 must allege scienter, reliance, and causation.[9] Accordingly, if the California courts import federal courts' Rule 10b-5 jurisprudence in their interpretation of the revamped § 25401, they may end up creating a new pleading hurdle for theoretically aggrieved investors (and their counsel)—and a ground for demurrer if plaintiffs do not plead what they must.

Additionally, to the extent that Rule 10b-5 has been interpreted by the federal courts to impose liability for insider trading,[10] the overhaul of § 25401 may have rendered somewhat redundant § 25402 of the California Corporations Code—which itself already prohibits insider trading. Thus, we can expect that plaintiffs who pursue insider trading causes of action under both the new § 25401 and the existing § 25402 will face motions to strike at least one of the causes of action as duplicative.

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[1] S.B. 538, 2013 Leg., Reg. Sess. (Cal. 2013); *see also* SB-538 The Corporate Securities Law of 1968, California Legislative Information (Oct. 2, 2013), http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201320140SB538.

[2] The Corporate Securities Law of 1968, Cal. Corp. Code § 25401 (amended 2013).

[3] S.B. 538 (stating that the bill intended to broaden anti-fraud provision); *see also* Bill Analysis: Assembly Committee on Banking and Finance, Assemb. 2013, Reg. Sess., at 2 (Cal. 2013), *available at* http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0501-0550/sb_538_cfa_20130607_121212_asm_comm.html ("[T]his bill . . . [e]nsures consistency with federal law by updating anti-fraud provisions in the Securities law. . . ."); Bill Analysis: Senate Banking & Financial Institutions Committee, S. 2013, Reg. Sess., at 1 (Cal. 2013), *available at* http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0501-0550/sb_538_cfa_20130401_115747_sen_comm.html.

[4] *Compare* 17 C.F.R. 240.10b-5 (2013) *with* Cal. Corp. Code § 25401 (2013).

[5] Marsh & Volk, Practice Under the California Securities Laws, § 14.03[1].

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

[7] Marsh & Volk, Practice Under the California Securities Laws, § 14.03[3][a]. Section 25501 of the California Corporations Code provided—and Section 12(a)(2) is generally consistent in providing—a defense to the action that proves that the plaintiff knew the facts concerning the untruth or omission; or that the defendant exercised reasonable care and did not know (or, if he or she had exercised reasonable care, would not have known) of the untruth or omission. *Id*.

[8] Marsh & Volk, Practice Under the California Securities Laws, § 14.03[7]; *see also* Cal. Corp. Code § 25501.

[9]*See, e.g., Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005); *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 172 (2d Cir. 2005); *Paracour Fin., Inc. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996) (en banc). Plaintiffs may also establish fraud on the market, which does not require that they prove that they directly relied upon the defendant's misrepresentations but only that they relied on the integrity of the price of the stock as established by the market. *Basic Inc. v. Levinson*, 485 U.S. 224, 243-44 (1988).

[10]*U.S. v. O'Hagan*, 521 U.S. 642, 647 (1997) (accepting misappropriation theory and holding that a person who misappropriates confidential information in breach of a fiduciary duty is liable for violating Rule 10b-5).

Authors

Michael Mugmon

PARTNER

Partner-in-Charge, San Francisco Office

michael.mugmon@wilmerhale.com

+1 628 235 1006

Chris Johnstone

SPECIAL COUNSEL

chris.johnstone@wilmerhale.com

+1 650 858 6147

Matthew D. Benedetto

PARTNER

Co-Chair, False Claims Act Practice

matthew.benedetto@wilmerhale.com

+1 213 443 5323