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COMMENTS

SECURITIES FRAUD UNDER THE BLUE SKY OF WASHINGTON

In the past, federal courts have been the primary forums for securities fraud litigation because they exercise exclusive jurisdiction over claims under the Securities Exchange Act of 1934,1 and have expansively interpreted the antifraud provisions of that Act.2 Recent devel-


When a securities fraud claim is brought under the 1934 Act, federal courts may extend pendent jurisdiction to additional claims arising under state securities laws and actions for common law fraud or negligent misrepresentation. See, e.g., Smith v. Manausa, 535 F.2d 353 (6th Cir. 1976); Kennedy v. Tallant, 3 BLUE SKY L. REP. (CCH) ¶ 71,311 (S.D. Ga. Oct. 22, 1976); Architectural League v. Bartos, 404 F. Supp. 304 (S.D.N.Y. 1975). But see Kerby v. Commodity Resources Inc., 395 F. Supp. 786 (D. Colo. 1975). The power of the federal courts to exercise pendent jurisdiction over claims for which there is no independent jurisdiction is discretionary. United Mine Workers v. Gibbs, 383 U.S. 715 (1966). However, if the nonfederal claim arises out of the same nucleus of operative fact or is an alternative theory upon which liability may be based, the court will usually consider it. The test is whether both federal and state claims would ordinarily be tried together and whether it is fair and convenient to both parties and to the court. United Mine Workers, 383 U.S. at 725-26.


Even securities and transactions which are exempt from the registration provisions of the 1933 Act, 15 U.S.C.A. §§ 77c, 77d (West 1971 & Supp. 1977), are covered by § 10(b) and rule 10b-5. E.g., Sohns v. Dahl, 392 F. Supp. 1208, 1218-19 (W.D. Va. 1975); accord, SEC v. Charles A. Morris & Assoc., 386 F. Supp. 1327, 1333 (W.D. Tenn. 1973) (although municipal bonds are exempt from registration, the anti-fraud provisions apply). Furthermore, in order for federal jurisdiction to attach, it is necessary only that the claim involve a transaction using "any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange." 15 U.S.C. § 78j (1970). Because almost all securities transactions do meet these criteria, actions will usually lie under § 10(b). Schoenbaum v. Firstbrook, 405 F.2d 200, 206 (2d Cir. 1968), rev'd in part on rehearing, 405 F.2d 215 (2d Cir.)
opments, however, suggest that state courts may provide a more attractive forum for plaintiffs seeking relief from securities fraud in Washington. Relevant considerations include recent United States Supreme Court decisions limiting the scope of civil liability under the 1934 Act;\(^3\) increasing congestion and delay in federal courts, recent amendments expanding the coverage of the civil liability provision of the Securities Act of Washington,\(^4\) and supplemental common law remedies available in state courts.\(^5\) This comment will discuss the often-overlooked alternative of bringing a private civil action for securities fraud in a state court under the antifraud provision of the Securi-

\(3\) Recent cases dealing with § 10(b) include Santa Fe Indus., Inc. v. Green, 97 S. Ct. 1292 (1977) (no cause of action is stated under § 10(b) absent an allegation of manipulation or deception), Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (scienter is a necessary element in an action under § 10(b)), and Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (only purchasers and sellers have standing to sue under § 10(b)). Recent cases dealing with § 14 include Piper v. Chris-Craft Indus., Inc., 97 S. Ct. 926 (1977) (no implied private right of action exists under § 14(c)), and TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976) (a fact is material if it would be considered important in deciding how to vote a proxy).


\(5\) Washington courts recognize both an action for common law fraud and an action for negligent misrepresentation. See Brown v. Underwriters at Lloyd's, 53 Wn. 2d 142, 153–54, 332 P.2d 228, 234–35 (1958) (negligent misrepresentation and common law fraud are two separate and distinct causes of action in Washington).
ties Act of Washington,\textsuperscript{6} or common law theories of fraud\textsuperscript{7} or negligent misrepresentation.\textsuperscript{8}

\textsuperscript{6} Wash. Rev. Code § 21.20.010 (1976), quoted at note 16 infra. The Washington Act contains two other antifraud provisions, which are beyond the scope of this comment. R.C.W. § 21.20.020, modeled after § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(1) to (2) (1970), creates liability for fraud and deceit on the part of investment advisors; R.C.W. § 21.20.350 makes it unlawful to file materially false or misleading documents with the state securities director. Because no provisions now exist under R.C.W. § 21.20.430 for civil liability as a result of violations of these sections, securities investors must bring a common law action for fraud or negligent misrepresentation or assert an implied cause of action under the statute. See generally 3 L. Loss, supra note 2, at 1661–69; 6 id. at 3808–16 (Supp. 1969).

Under § 410(h) of the Uniform Securities Act, upon which the Washington Act was modeled, private rights and remedies are specifically limited to those contained in the express civil liability provision. The purpose of this limitation is to prevent state courts from implying a private cause of action, as happened under § 10(b) of the 1934 Act. Uniform Securities Act § 410(h), Commissioners' Note. In adopting its version of the Uniform Securities Act, the Washington legislature, along with those of a number of other states, specifically omitted this provision of § 410(h), thereby declining to rule out implied causes of action under the Washington Act. 1–3 Blue Sky L. Rep. (CCH) (Alabama, Arkansas, Connecticut, Delaware, Hawaii, Idaho, Indiana, Kansas, Kentucky, Montana, Nebraska, New Mexico, Oregon, Virginia, & Wisconsin). See Note, Express and Implied Civil Liability Provisions in State Blue Sky Laws, 17 W. Res. L. Rev. 1173, 1193–94 (1966). See also Abrahamson v. Fleschner, [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,889 (2d Cir. Feb. 25, 1977) (an implied right of action exists under § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1970), and the absence of the words "in connection with a purchase or sale" indicates that a purchase or sale is not required); Note, Private Causes of Action Under Section 206 of the Investment Advisers Act, 74 Mich. L. Rev. 308 (1975).

Prior to the 1975 amendment creating an express cause of action for purchasers, see note 4 supra, the Washington Court of Appeals had held that a cause of action could be implied under R.C.W. § 21.20.010. Shermer v. Baker, 2 Wn. App. 845, 472 P.2d 589 (1970). In Ludwig v. Mutual Real Estate Investors, 18 Wn. App. 33, 567 P.2d 658 (1977), the court noted that its decision to permit an implied cause of action in Shermer "was a response to the legislature's failure to provide a statutory damage remedy against a purchaser of securities while providing such a cause of action against a seller." Id. at 42, 567 P.2d at 663 (emphasis in original). This indicates that the court may be willing to imply causes of action under R.C.W. §§ 21.20.020 & .350 for which there are presently no statutory damage remedies.

It should be noted that the legislature apparently failed to recognize the need to include these sections in its 1977 amendment to the civil liability provision. By deleting the words "fraud or misrepresentation" and substituting a specific reference only to R.C.W. § 21.20.010, it eliminated express civil liability for violations of R.C.W. §§ 21.20.020 & .350. See Wash. Rev. Code § 21.20.430(1)–(2) (Supp. 1977).


8. Cf. J & J Food Centers, Inc. v. Selig, 76 Wn. 2d 304, 456 P.2d 691 (1969) (false statements regarding a lease deposit and made to induce a sale constitute actionable negligence); Brown v. Underwriters at Lloyd's, 53 Wn. 2d 142, 332 P.2d 228 (1958) (false statements by a real estate broker, although not fraudulent, may be negligent and therefore actionable).

Actions for negligent misrepresentation in Washington have arisen mainly in connection with sales of real property; nevertheless, the analysis appears equally applicable
I. THE SECURITIES ACT OF WASHINGTON

Modeled after the Uniform Securities Act,9 the Washington Act is aimed at protecting investors and facilitating the smooth operation of local financial markets.10 Its provisions (1) prohibit fraud, or the misrepresentation or omission of a material fact;11 (2) require the licensing of brokers, dealers, and investment advisors;12 (3) provide for the registration of securities to be traded;13 and (4) create remedies for violations of the Act.14 In addition, the Washington Act contains a specific directive that it be construed so as "to make uniform the law of those states which enact it and to coordinate [its] interpretation and administration . . . with the related federal regulation."15

The general antifraud provision in the Washington Act, R.C.W. § 21.20.010,16 is modeled after SEC rule 10b-5,17 which was promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, with a focus on protecting investors from fraudulent practices.


11. Unlike the federal securities laws, whose purpose is to provide disclosure, state blue sky laws have served as a mechanism to rule on the merits of new offerings. See J. MOFSKY, supra note 9, at 15–17; Rooks, supra note 9, at 188. See generally Goodkind, Blue Sky Law: Is There Merit in the Merit Requirements?, 1976 WIS. L. REV. 79; Hueni, Application of Merit Requirements in State Securities Regulation, 15 WAYNE L. REV. 1417 (1969); Mofsky & Tollison, Demerit in Merit Regulation, 60 MARQ. L. REV. 367 (1977). For an example of one state's attempt to implement the merit approach by express statutory provision, see CAL. CORP. CODE § 25140 (West 1977).

1934. Unlike the federal statute, however, the Washington Act contains an additional section, R.C.W. § 21.20.430 creating express civil liability for violations of this antifraud provision.

A. Civil Liability

The civil liability provision in the Washington Act, R.C.W. § 21.20.430, designates the persons liable, the standards of care, and the measure of damages available under the Act. It provides for costs, interest, and attorneys' fees, and specifies a statute of limitations.

(1) To employ any device, scheme, or artifice to defraud;
(2) 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 are made, not misleading; or
(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

17. 17 C.F.R. § 240.10b-5 (1977). Pursuant to the power granted it by § 10(b), in 1942 the Securities and Exchange Commission promulgated rule 10b-5, which is substantially identical to R.C.W. § 21.20.010, quoted at note 16 supra, except for an interstate commerce requirement necessary for federal jurisdiction. The language of rule 10b-5 was patterned after § 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1970), the major difference being the inclusion of purchaser liability under § 10(b) and rule 10b-5.

18. 15 U.S.C. § 78j(b) (1970). This section makes it 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 security exchange—

(b) To use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


20. In addition to primary liability for purchasers, sellers, and offerors, id. § 21.20.430(1)-(2), third-party liability extends to all officers, directors, and controlling persons, as well as employees and other persons who materially aid in the transaction. Id. § 21.20.430(3).


In Turner v. Enders, 15 Wn. App. 875, 552 P.2d 694 (1976), two employees were defrauded in the purchase of a 40% interest in a mobile home sales business. Because they wished to retain their stock and sue for damages rather than rescission, they
similar to that applicable to actions for common law fraud. Prior to its amendment in 1977, this section contained no express reference to R.C.W. § 21.20.010, but imposed civil liability upon any person who offered, sold, or purchased a security "by means of fraud or misrepresentation." It was unclear under this language whether all violations of R.C.W. § 21.20.010 were covered by the phrase "fraud or misrepresentation" and thereby within the scope of R.C.W. § 21.20.430. This uncertainty has been clarified by the 1977 amendment, which provides that all violations of R.C.W. § 21.20.010 create civil liability under the Act.

B. Transactions Covered

An initial requirement for bringing a claim under the Washington brought an action for common law fraud rather than an action under the antifraud provision of the Washington Act. But see Chester v. McDaniel, 264 Or. 303, 504 P.2d 726 (1972) (Oregon Supreme Court permitted a claim for damages under a similar provision in the Oregon Securities Act).


24. This prior version of R.C.W. § 21.20.430 differed from the corresponding Uniform Securities Act civil liability provision, § 410(a), which states:

Any person who

(2) offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading (the buyer not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission,

is liable. . . .

Uniform Securities Act § 410(a) (emphasis added). The corresponding provision in the Washington Act as originally proposed was identical to § 410(a) until amended by the House before final passage when the words "fraud or misrepresentation" were substituted for the words quoted in italics above. 1959 House Journal 1038 (amending S.S.B. 52, 36th Legis., § 43). In the absence of legislative history, the purpose of this change is difficult to determine. The recent amendment to this section, striking the words "fraud or misrepresentation" and substituting a specific reference to R.C.W. § 21.20.010, should clarify the legislative intent. See note 4 supra. But see note 6 supra.

25. In Ludwig v. Mutual Real Estate Investors, 18 Wn. App. 33, 567 P.2d 658 (1977), a limited partner in a mutual real estate fund brought an action to recover her investment. The trial court found that the defendant, who was the principal owner of the corporate general partner, had violated R.C.W. § 21.20.010. On appeal, the court held that under the version of R.C.W. § 21.20.430 then in force, a violation of R.C.W. § 21.20.010 was not enough to establish civil liability. It was also necessary to show fraud or misrepresentation and an element of intent before civil liability would arise. 18 Wn. App. at 39–42, 567 P.2d at 661–62.
Act is that the challenged transaction involve a security.\textsuperscript{26} The Act contains a lengthy definition of "security,"\textsuperscript{27} modeled after the definitions in the Uniform Securities Act\textsuperscript{28} and in federal securities legislation.\textsuperscript{29} Included in these definitions are such terms as "notes," "stocks," "bonds," "debentures," and "investment contracts," only some of which have clear and unambiguous meanings. Courts have had by far the most difficulty determining what constitutes an investment contract, and the inclusion of investment contracts within the statutory definition of a security has led to substantial problems of interpretation.

Determining whether specific money-making ventures involve the sale of investment contracts has been a recurrent subject of administrative rulings and litigation in federal and state courts.\textsuperscript{30} The established \textit{Howey} test\textsuperscript{31} defines an investment contract as a security if money has been invested in a common enterprise with the expectation of profits to come solely from the efforts of others.\textsuperscript{32} In recent years, however, some federal and state courts have concluded that the broad protective purpose of securities legislation requires a more flexible standard.\textsuperscript{33} As a result, they have developed a "risk capital" ap-

\begin{footnotes}
\item[27] Id. § 21.20.005(12) (Supp. 1977).
\item[28] The Uniform Securities Act defines a security in language identical to R.C.W. § 21.20.005(12), except for the additional provision in the Washington Act to include out-of-state land sales. See \textit{Uniform Securities Act} § 40(1).
\item[31] \textit{SEC v. W.J. Howey Co.}, 328 U.S. 293 (1946).
\item[32] Id. at 298-99. For a discussion of the \textit{Howey} test and related cases, see 1 L. Loss, \textit{supra} note 2, at 483-511; 4 id. at 2500-57 (Supp. 1969).
\item[33] E.g., \textit{SEC v. Glenn W. Turner Ent., Inc.}, 474 F.2d 476, 482 (9th Cir.),
\end{footnotes}
proach,\textsuperscript{34} which relaxes two of the \textit{Howey} requirements—that profits be expected from the investment and that these profits derive \textit{solely} from the efforts of others.\textsuperscript{35} This new approach allows the investor to participate and requires merely that risk capital be supplied with a reasonable expectation of a valuable benefit, but without the right to exercise control over the enterprise.\textsuperscript{36}

The "risk capital" approach has been adopted as a modification of the \textit{Howey} test by the courts of neighboring states\textsuperscript{37} and by the Court of Appeals for the Ninth Circuit when interpreting federal securities

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  \item This approach was first used by the California Supreme Court in Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (sale of club memberships to raise capital for business venture held to be investment contracts).
  \item For example, both the sale of promotional memberships and pyramid sales schemes have been held to be investment contracts in spite of their failure to meet the \textit{Howey} test. See Silver Hills Country Club v. Sobieski, 55 Cal. 2d 811, 361 P.2d 906, 13 Cal. Rptr. 186 (1961) (promotional memberships); SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (pyramid sales scheme).
\end{itemize}
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legislation.\textsuperscript{38} Because the Washington Act contains a specific directive that it be construed in coordination with related state and federal legislation,\textsuperscript{39} it is likely that the "risk capital" approach will be adopted in Washington as well.\textsuperscript{40}

Once it has been determined that the disputed transaction involved a security, the Act does not require a special form of transaction or one in which only securities are involved.\textsuperscript{41} Purchases and sales need not be made through an impersonal market,\textsuperscript{42} and even if certain securities are exempt from the registration requirements of the Act, they are still covered by its antifraud provisions.\textsuperscript{43}

C. Standing

R.C.W. § 21.20.010 requires that the defendant's conduct occur

\textsuperscript{38} See, e.g., Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1256–57 & n.2 (9th Cir. 1976) (per curiam) (corporate note not a security because restrictions placed on corporation by bank minimized risk); SEC v. Glenn W. Turner Ent., Inc., 474 F.2d 476, 482 (9th Cir.), cert. denied, 414 U.S. 821 (1973) (profits need not come solely from the efforts of others). In a recent Supreme Court case, United Hous. Foundation, Inc. v. Forman, 421 U.S. 837 (1975), the Court left open the issue of the adoption of the "risk capital" approach under federal securities law. But see SEC Release No. 5211, [1971–1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,446 ("risk capital" approach applies in actions under federal securities acts).

\textsuperscript{39} WASH. REV. CODE § 21.20.900 (1976).

\textsuperscript{40} In fact, lower Washington courts have applied the "risk capital" approach. E.g., Lundquist v. American Campgrounds, Inc., 3 BLUE SKY L. REP. (CCH) ¶ 71,196 (King County Super. Ct., Oct. 30, 1973) (Judge Warren Chan applied "risk capital" approach in holding a pyramid sales scheme of campground memberships to be the sale of investment contracts in spite of plaintiff's participation in the scheme). But see State v. Williams, 17 Wn. App. 368, 371, 563 P.2d 1270, 1271–72 (1977), in which the court used the Howey test in holding that patent and royalty interests were securities. However, the need to use the "risk capital" approach did not arise and was not at issue in Williams.

\textsuperscript{41} Cf. Errion v. Connell, 236 F.2d 447 (9th Cir. 1956) (transaction involving exchange of stock for an interest in real property is covered by § 10(b)).

\textsuperscript{42} In Clausing v. DeHart, 83 Wn. 2d 70, 515 P.2d 982 (1973), the Washington Supreme Court held that "RCW 21.20.010 is applicable to 'face to face' negotiations outside the security markets between private individuals for the sale of the capital stock of a corporation." Id. at 73, 515 P.2d at 984.

\textsuperscript{43} Even though a transaction may involve a security, either the security or the transaction may be exempt from the registration requirements of the Washington Act under R.C.W. §§ 21.20.310 & .320. Nevertheless, the antifraud provision still applies. L. LOSS & E. COWETT, BLUE SKY LAW 25 (1958); UNIFORM SECURITIES ACT § 402(a), Commissioners Note. See Clausing v. DeHart, 83 Wn. 2d 70, 73 n.1, 515 P.2d 982, 984 n.1 (1973); cf. B & T Distrub., Inc. v. Riehle, 359 N.E.2d 622, 624 (Ind. App.) (Indiana law), rev'd on other grounds, 366 N.E.2d 178 (Ind. 1977); Chester v. McDaniel, 264 Or. 303, 504 P.2d 726, 728 (1972) (Oregon law). Three state securities acts specifically note that their fraud provisions apply whether or not a security is exempt from the registration provisions. ME. REV. STAT. tit. 32, § 881(1)(B) (West Supp. 1973); TENN. CODE ANN. § 48-1644(B) (Cum. Supp. 1976); TEX. REV. CIV. STAT. ANN. art. 581-33(A)(2) (Vernon 1964).
“in connection with” a purchase or sale in order to be actionable. This requirement is somewhat vague and has not been interpreted by a Washington court. The United States Supreme Court, however, interpreting similar wording in section 10(b) of the 1934 Act, has held that the words “in connection with” must be read flexibly.\textsuperscript{44} Thus, the defendant’s acts need not relate to the quality of the security,\textsuperscript{45} but may involve misrepresenting the value of the consideration offered in exchange for the security.\textsuperscript{46} The statutory directive to interpret the Washington Act in coordination with federal securities law\textsuperscript{47} supports a similar reading of R.C.W. § 21.20.010.

It is still necessary, however, for the plaintiff to be a purchaser or seller rather than a mere offeree in order to have standing to sue under R.C.W. § 21.20.010. In Blue Chip Stamps v. Manor Drug Stores,\textsuperscript{48} a case brought under section 10(b) and rule 10b-5, the United States Supreme Court considered a claim by offerees who were persuaded by an overly pessimistic prospectus not to purchase any shares. In affirming the dismissal of the complaint, the Court applied the rule initially formulated by the Court of Appeals for the Second Circuit in Birnbaum v. Newport Steel Corp.,\textsuperscript{49} and held that only actual purchasers and sellers may bring a claim for damages under section 10(b).\textsuperscript{50} Under the civil liability provision in the Washington Act, such a restriction on the class of plaintiffs is expressly stated,\textsuperscript{51} indicating that potential purchasers and sellers are not within the class of persons entitled to civil remedies under this section.\textsuperscript{52}

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  \item \textsuperscript{44} Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).
  \item \textsuperscript{45} See, e.g., Glickman v. Schweickart & Co., 242 F. Supp. 670, 674 (S.D.N.Y. 1965) (alleged misrepresentation relating to the financing of a securities purchase is actionable under § 10(b)).
  \item \textsuperscript{46} In Errion v. Connell, 236 F.2d 447 (9th Cir. 1956), defendant exchanged real property for securities. Even though the fraudulent act involved misrepresenting the value of the real property and not the securities, § 10(b) was held to apply.
  \item \textsuperscript{47} Wash. Rev. Code § 21.20.900 (1976).
  \item \textsuperscript{48} 421 U.S. 723 (1975).
  \item \textsuperscript{49} 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). The Birnbaum rule has been the subject of extensive commentary. See generally Boone & McGowan, Standing to Sue Under SEC Rule 10b-5, 49 Tex. L. Rev. 617 (1971); Lowenfels, The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5, 54 Va. L. Rev. 268 (1968); Whitaker, The Birnbaum Doctrine: An Assessment, 23 Ala. L. Rev. 543 (1971).
  \item \textsuperscript{50} 421 U.S. at 754–55.
  \item \textsuperscript{51} Wash. Rev. Code § 21.20.430(1)–(2) (Supp. 1977).
  \item \textsuperscript{52} Injured parties, who are not purchasers or sellers and therefore not covered by the provisions of R.C.W. § 21.20.430, may be able to assert an implied cause of action under R.C.W. § 21.20.020 (investment advisors) or R.C.W. § 21.20.350 (filing mis-
\end{itemize}
D. Causation

Claims brought under the antifraud and civil liability provisions of the Washington Act require a showing that the acts of the defendant in fact caused the loss the plaintiff has suffered.\(^5\) Under the civil liability provision, R.C.W. § 21.20.430, a purchaser is limited to a remedy of rescission and must tender the security in exchange for a return of the consideration paid.\(^5\) Similarly, a seller must tender the consideration received in exchange for a return of the security sold.\(^5\) Because the plaintiff's statutory remedy is rescission of the transaction, it is sufficient to establish transaction causation\(^6\) by showing that the misrepresentation or omission involved a material fact and that the plaintiff justifiably relied upon it to her detriment in deciding whether to purchase or sell.\(^5\)

I. Materiality

In Washington, a material fact has consistently been defined as "a fact to which a reasonable man would attach importance in determining his choice of action in the transaction in question."\(^8\) Because a leading documents). See note 6 supra. Because these sections do not contain the words "in connection with the offer, sale or purchase of any security," no purchase or sale is required.

\(^5\) Cf. 3 A. Bromberg, supra note 2, at § 8.7 (discussing rule 10b-5).

\(^5\) Wash. Rev. Code § 21.20.430(1) (Supp. 1977). In Garretson v. Red-Go, Inc., 9 Wn. App. 923, 516 P.2d 1039 (1973), an action was brought under R.C.W. § 21.20.430(1) for failure to register nonexempt securities. In permitting rescission, the court commented that "there is no liability for an illegal or fraudulent sale under this statute where the buyer chooses to retain the stock." 9 Wn. App. at 928, 516 P.2d at 1042.

\(^5\) Wash. Rev. Code § 21.20.430(2) (Supp. 1977). This subsection on seller's remedies was added by the 1975 amendment. Securities Act Amendments of 1975, ch. 84, § 24, 1975 Wash. Laws 371. Apparently inadvertently, the amendment failed to require that the seller return the consideration received in exchange for the security recovered. This oversight was corrected by the 1977 amendment.

\(^5\) This definition is in accord with federal case law. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). In Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), however, the Supreme Court broadened the materiality standard under § 10(b) to include facts which "a reasonable investor might have considered" important. Id. at 153–54 (emphasis added). In TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976), a case of securities fraud involving a proxy and brought under § 14(a) of the 1934 Act, the Court retreated from its holding in Affiliated Ute by stating that "[a]n omitted fact is material if there is a sub-

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prerequisite to materiality is the misrepresentation or omission of an existing fact, promises and opinions of the defendant concerning a future event generally are excluded from this definition. Materiality is an objective standard, based upon a reasonable investor's skills, and is not affected by the expertise of the plaintiff.

2. Reliance

Unlike the objective standard of materiality, reliance involves a subjective determination, and the standard will vary depending upon the expertise of the plaintiff. Decisions by federal courts under section 10(b) of the 1934 Act have indicated a limited relaxation of the reliance requirement. In Affiliated Ute Citizens v. United States, the Supreme Court held that in the case of a fraudulent omission, reliance could be presumed. In subsequent cases brought under section 10(b), relaxation of the reliance requirement has turned upon factual distinctions. Generally, if fraud or misrepresentation occurs in a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." Id. at 449 (emphasis added). Whether TSC signals a retreat from the Court's position in Affiliated Ute in § 10(b) cases remains unclear, but it appears likely given the similar interpretation of materiality in § 10(b) and § 14(a) actions.


60. Cf. 3 A. Bromberg, supra note 2, § 8.3, at 199 (discussing rule 10b-5). For a further discussion of materiality under § 10(b) and § 14(a), see Hewitt, Developing Concepts of Materiality and Disclosure, 32 Bus. Law. 887 (1977); 18 B. C. Indus. & Com. L. Rev. 349 (1977).


62. Some federal courts have held that it is an affirmative defense that the plaintiff's reliance was not reasonable and that he failed to exercise due diligence in investigating the transaction. E.g., Rochez Bros. v. Rhoades, 491 F.2d 402, 409-10 (3d Cir. 1974). Although the specific facts in each case will usually control the result, courts have generally held insiders and sophisticated investors to a higher standard of care than the general public. See Note, The Due Diligence Requirement for Plaintiffs Under Rule 10b-5, 1975 Duke L.J. 753, 762-70; Note, supra note 61, at 602-06; cf. S & F Supply Co. v. Hunter, 527 P.2d 217 (Utah 1974) (purchaser plaintiff, a stockbroker, not entitled to rescission when no false representations were made to him and he failed to exercise reasonable care based on his knowledge and experience). But cf. Washington Nat'l Corp. v. Thomas, 570 P.2d 1268, 1275 (Ariz. Ct. App. 1977) (contributory negligence not a defense as statute "imposes an affirmative duty not to mislead").


64. Id. at 154.

65. E.g., Blackie v. Barrack, 524 F.2d 891, 905-08 (9th Cir. 1975) (in a stock exchange transaction materiality is enough, reliance not required); Carras v. Burns, 516 F.2d 251, 257 (4th Cir. 1975) (rebuttable inference of reliance exists when a broker misrepresents a material fact); Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974),
face-to-face transaction, reliance is still required. If the complaint alleges nondisclosure in a marketplace transaction or in one involving a large group of investors, however, the problems of proof necessitate that reliance be presumed. In contrast, under the antifraud provision in the Washington Act it is still necessary to allege and prove actual reliance. In *Shermer v. Baker*, in which an unsophisticated seller was defrauded in a face-to-face transaction, the Washington Court of Appeals held that actual reliance must be shown. In *Clausing v. DeHart*, the Washington Supreme Court disregarded contractual recitals of reliance by the plaintiff and reinforced the requirement that actual reliance be established. Denying rescission, the court commented that the actual impact of a statement or omission is the primary concern when the equitable powers of the court are involved. The existence of a remedy of rescission under the Washington Act may explain the court's unwillingness to relax the reliance requirement; rescission is an equitable remedy which is not granted lightly by the courts. In the future, however, Washington courts may recognize presumed reliance when faced with cases involving the factual distinctions drawn by federal courts under section 10(b).

E. **Scienter**

Under the 1976 United States Supreme Court decision in *Ernst &
cert. denied, 422 U.S. 1007 (1975) (some degree of reliance or causation in fact is required); Jackson v. Bache & Co., 381 F. Supp. 71 (N.D. Cal. 1974) (when investor's contact with broker is "virtually non-existent," reliance is required); Hawk Indus., Inc. v. Bausch & Lomb, Inc., 59 F.R.D. 619, 624 (S.D.N.Y. 1973) (in class action, individual reliance on the part of each class member need not be shown, therefore class action appropriate).


68. Id. at 857–58, 472 P.2d at 597.

69. 83 Wn. 2d 70, 515 P.2d 982 (1973). The transaction involved the sale of stock in a nursing home which the seller had warranted was operated in accordance with all government rules and regulations. In upholding the trial court's finding that this warranty was not material, the Washington Supreme Court disregarded the formal recital of reliance stated in the sale contract. The court commented that "[t]he trial court properly looked to the actual effect of the omission rather than the formal declaration." Id. at 76, 515 P.2d at 985. But cf. Washington Nat'l Corp. v. Thomas, 570 P.2d 1268, 1275 (Ariz. Ct. App. 1977) (reliance not an element of a cause of action under the Arizona securities act).

Ernst v. Hochfelder, proof of scienter—"intent to deceive, manipulate, or defraud"—is now a necessary element in an action brought under section 10(b) and rule 10b-5. The issue in Hochfelder was whether an allegation of negligent conduct alone was sufficient to state a claim under section 10(b). The Court held that the statutory language of section 10(b) indicated that scienter was required. Although the Court conceded that the language of rule 10b-5 could be interpreted to encompass negligent as well as intentional conduct, it concluded that the scope of the rule "cannot exceed the power granted the Commission by Congress under § 10(b)."

Prior to Hochfelder, the Washington Court of Appeals, in Shermer v. Baker, had followed federal case law in the Ninth Circuit interpreting rule 10b-5 and held that scienter was not a necessary element in a civil action brought under R.C.W. § 21.20.010. Even though proof of scientist is now required under section 10(b) and rule 10b-5, it does not necessarily follow that it is also required under the Washington Act. Two federal appellate courts have observed that state anti-fraud provisions similar to Washington's differ from section 10(b) in that they require no showing of scientist whereas section 10(b) does.

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72. 425 U.S. at 193.


74. 425 U.S. at 190. The seventh, eighth, and ninth circuit courts had each held that negligence alone was sufficient. See, e.g., Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 290 U.S. 951 (1968); White v. Abrams, 495 F.2d 724 (9th Cir. 1974). The second and tenth circuits, on the other hand, had held that "scienter" was necessary. See, e.g., Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Clegg v. Conk, 507 F.2d 1351 (10th Cir. 1974), cert. denied, 422 U.S. 1007 (1975).

75. 425 U.S. at 214. The Court focused on the words "manipulative or deceptive device or contrivance" from § 10(b). See note 18 supra.

76. 425 U.S. at 214.

77. 2 Wn. App. at 856, 472 P.2d at 589. The Washington court relied on Royal Air Properties, Inc. v. Smith, 312 F.2d 210, 212 (9th Cir. 1962), and Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961).

78. Subsequent to Hochfelder, most lower federal courts have permitted actions to be brought under § 10(b) without requiring a showing of specific intent to defraud. See, e.g., McLean v. Alexander, 420 F. Supp. 1057, 1082 (D. Del. 1976) ("knowing misconduct"); Neill v. David A. Noyes & Co., 416 F. Supp. 78, 82 (N.D. Ill. 1976) ("some form of scientist beyond mere negligence").

79. Cole v. Alodex Corp., 533 F.2d 372 (8th Cir. 1976); Nickels v. Koehler Man-
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Although a landmark decision such as Hochfelder is ordinarily persuasive authority in state courts, a strong argument can be made for retaining the present Washington rule. Washington’s antifraud provision is patterned after rule 10b-5 and not section 10(b). It does not contain the language the Supreme Court relied upon in holding scienter a necessary element in a section 10(b) action. Consequently, the Court’s statutory analysis in Hochfelder ought not apply to an interpretation of R.C.W. § 21.20.010.

An analysis of the Washington antifraud provision indicates that all types of conduct, ranging from innocent to intentional, are covered. Separate criminal and civil liability provisions distinguish between the actionable standards of care, and the only specific reference to knowing or intentional conduct in the Washington Act is contained in the section imposing criminal liability. In State v. Hynds, a criminal action for violation of the antifraud provision, the Washington Supreme Court held that a wilful violation is required to establish criminal liability. The court went on to distinguish between civil and criminal liability and pointed out that, in criminal cases, “knowledge of the falsity of the representations and specific intent to defraud must be proven.”

In contrast, under R.C.W. § 21.20.430, the civil liability provision, purchasers, sellers, and offerors who violate R.C.W. § 21.20.010 are strictly liable to defrauded investors. The civil liability provision

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80. Compare the Washington antifraud provision, reproduced at note 16 supra, with § 10(b), reproduced at note 18 supra, and rule 10b-5, 17 C.F.R. § 240.10b-5 (1977).

81. See note 75 supra.


83. R.C.W. § 21.20.400 states: “Any person who wilfully violates any provision of this chapter . . . , or who wilfully violates any rule or order under this chapter . . . knowing the statement made to be false or misleading in any material respect, shall upon conviction be fined . . . or imprisoned . . . or both . . . .” Wash. Rev. Code § 21.20.400 (1976).

84. 84 Wn. 2d 657, 529 P.2d 829 (1974).

85. Id. at 663, 529 P.2d at 833.


contains no requirement of knowledge or intent to defraud. In addition, subsection (3) spells out a negligence standard for limited third-party liability. The absence of such a negligence standard for purchasers, sellers, and offerors is an additional indication of legislative intent to impose strict liability on those parties. Finally, because the Washington Act contains separate express provisions for criminal and civil liability—the former requiring knowing or intentional conduct and the latter with no such requirement—one might also infer a legislative intent to impose civil liability when no intent to defraud existed.

II. COMMON LAW ACTIONS

A defrauded purchaser or seller who is satisfied with rescission as a remedy should bring an action under the civil liability provision of the Washington Act. Under the Act, a plaintiff need establish only misrepresentation or omission of a material fact and justifiable reliance thereon. In addition, the statute provides for interest and attorneys’ fees. If rescission is an inadequate remedy, however, the defrauded plaintiff may seek more complete relief in a common law suit for damages, alleging either fraud or negligent misrepresentation. A claim of common law fraud requires a plaintiff to prove the elements of fraud by clear, cogent, and convincing evidence, while an action for negligent misrepresentation requires a plaintiff to establish the ex-

of R.C.W. § 21.20.010 does not require a specific intent to defraud. The making of an untrue statement is sufficient. \(\text{The making of an untrue statement is sufficient.}\) (emphasis added). In Ludwig v. Mutual Real Estate Investors, 18 Wn. App. 33, 567 P.2d 658 (1977), although the court denied recovery under the pre-amendment version of R.C.W. § 21.20.430, see note 25 supra, it did not question the trial court’s finding of a violation of R.C.W. § 21.20.010 in the absence of a showing of intent to defraud. Similarly, in an action under the New Mexico Securities Act, that state’s court noted: “The intent with which the defendant makes the statement is irrelevant under the terms of the statute. The statute requires only that the statement made be false and material, or that the omission be of a material fact necessary to make true the statement made.” Treider v. Doherty & Co., 86 N.M. 735, 527 P.2d 498, 500 (Ct. App. 1974).

88. No Washington cases have interpreted the scope of third-party liability under this section; however, it does not appear to extend to independent third parties, such as accountants, unless they “materially aid” in the transaction and cannot prove that they did not know, or should not have known of the facts producing liability. See notes 20 & 21 supra.

89. WASH. REV. CODE § 21.20.430 (Supp. 1977); See Part I supra.

90. For example, a plaintiff who may have suffered significant consequential damages as a result of a fraudulent transaction may wish to retain the security and sue for damages rather than settle for rescission.

istence of a duty to act and the defendant's failure to adhere to a standard of due care.

The principal reason for bringing a common law action for fraud or misrepresentation is to permit the plaintiff to affirm the transaction, retain the security or consideration received, and sue instead for monetary damages. The "benefit of the bargain" rule is the appropriate measure of damages in an action for negligent misrepresentation or common law fraud, and is computed as the difference between the value of the security as represented and its actual value at the time of sale. In addition, an injured party may recover consequential damages for the losses proximately caused by the defendant's acts. Under such circumstances, this recovery could be considerably greater than would be permitted in an action for rescission under R.C.W. § 21.20.430. It should be noted, however, that attorneys' fees are not usually recoverable in a common law action.

A. Common Law Fraud

It is a well-settled rule in Washington that the essential elements of a claim for fraud are (1) the representation of an existing fact, (2) its materiality, (3) its falsity, (4) the speaker's knowledge of its falsity or ignorance of its truth, (5) his intent that it should be acted upon by the person to whom it is made, (6) ignorance of its falsity on the part of the person to whom it is made, (7) the latter's reliance on the truth of the representation, (8) his right to rely on it, and (9) his consequent


damage. The absence or failure to plead and prove any one of these nine elements will be fatal to a plaintiff's claim.

While affirmative misrepresentations are clearly actionable, Washington courts have held that mere silence, in the absence of a duty to disclose, will not constitute fraud. In the past, a duty to disclose material facts has been found whenever a fiduciary relationship existed or whenever one party had superior knowledge which was unavailable to the other party who consequently relied on the fact that all material facts had honestly been disclosed. The modern trend, however, is to impose a duty to disclose material facts which are vital and material to the transaction. Furthermore, in cases of securities fraud, the Washington Court of Appeals has held that the antifraud provision of the Securities Act of Washington "creates a form of fiduciary relationship" and sets a "statutory standard of honesty and candor in direct dealings between individuals when the offer, sale or purchase of a security is involved." This statutory duty to disclose material facts in securities transactions, regardless of the expertise or knowledge of either party, also should provide an applicable standard of care in common law fraud actions.

The materiality and reliance requirements of common law fraud

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99. W. PROSSER, supra note 59, at § 106.


106. See W. PROSSER, supra note 59, at § 36; RESTATEMENT (SECOND) OF TORTS §§ 285, 286 (1965). This statutory duty should apply in actions for negligent misrepresentation as well. See text accompanying notes 118 & 119 infra.
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are similar to those under the antifraud provision of the Washington Act. The elements of knowledge on the part of the defendant and his related intent to defraud, however, are additional requirements, similar, but not identical, to the showing of scienter now required in actions under rule 10b-5 and section 10(b). If investors are defrauded while purchasing or selling securities in face-to-face transactions in which privity exists, the nine elements of common law fraud—especially intent to defraud and corresponding reliance—are not difficult to establish. If, however, securities are traded in an impersonal market in which buyers and sellers do not meet face to face, difficulties of proof are greatly enhanced.

B. Negligent Misrepresentation

An action for negligent misrepresentation is based upon negligence and not upon fraud, and arises when the defendant breaches a duty to exercise reasonable care in disclosing material facts relevant to a securities transaction. Although there are no Washington cases involving securities transactions in which an action for negligent misrepresentation has been maintained, in J & J Food Centers, Inc. v. Selig, a case involving the sale of real property, the Washington Su-
preme Court stated: "The elements of the action are false statements, made to induce a sale, which are relied on by the person asserting damages, and which that person may justifiably rely upon. As the measure of fault is negligence, the measure of justification is ordinary care."\(^{114}\)

An action for negligent misrepresentation requires no showing of intent to defraud or reckless behavior;\(^ {115}\) privity of contract need not exist;\(^ {116}\) and, once a duty to exercise due care is established, a negligence standard applies.\(^ {117}\) Because the Securities Act of Washington has been held to establish a statutory duty to act with honesty and candor in securities dealings,\(^ {118}\) an action for negligent misrepresentation should be appropriate when this duty has been breached.\(^ {119}\)

### III. CONCLUSION

Because most cases of securities fraud have been initiated in federal courts under section 10(b) and rule 10b-5, only a skeleton of case law exists under the antifraud and civil liability provisions of the Securities Act of Washington. With the recent developments in federal case law\(^ {120}\) and amendments to the civil liability provision in the Washington Act,\(^ {121}\) litigation in state courts has become an attractive alternative in spite of the uncertainty created by the lack of judicial interpretation of the Act.\(^ {122}\) Because a claim may be easier to estab-

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114. *Id.* at 311, 456 P.2d at 695.

115. *See*, *e.g.*, *id.* at 311, 456 P.2d at 695. *See generally* W. *Prosser*, *supra* note 59, § 107, at 706.

116. *See W. Prosser*, *supra* note 59, § 107, at 706–07 (commenting on the problem of limiting liability where human words "are capable of being repeated and passed on indefinitely").

117. Because this is an action for negligence, some courts have held that a defense of contributory negligence is available to the defendant on the grounds that the plaintiff was not justified in relying on the defendant's statements. *See W. Prosser*, *supra* note 59, § 107, at 716. In Washington, however, the defense of contributory negligence no longer is a bar to recovery. *See Wash. Rev. Code* § 4.22.010 (1976).


120. *See note 3 supra*.

121. *See note 4 supra*.

lish in state court under the Washington Act, plaintiffs in Washington no longer need go to federal court to seek relief under section 10(b). Furthermore, if a plaintiff wishes damages and not rescission, a claim for negligent misrepresentation or fraud should be no more difficult to establish than a claim under section 10(b).

In the past, civil actions brought under the antifraud and civil liability provisions of the Securities Act of Washington have involved only face-to-face transactions. In the future, more complex securities fraud litigation involving marketplace transactions can be expected to shift to state courts now that the scope of liability under section 10(b) has been limited. Although the Supreme Court's actions to limit the scope of liability under the 1934 Act may be viewed with alarm by some, the opportunity now exists for state courts to enter the field and make a significant contribution to investor protection under state law.

Sally H. Clarke

123. No appellate cases exist under the Washington Act involving a general fraud on the securities market. In every case under the Washington Act, either privity did exist between the plaintiff and defendant, e.g., Clausing v. DeHart, 83 Wn. 2d 70, 515 P.2d 982 (1973), or the defendant had made statements to the plaintiff to induce the purchase, e.g., Kaas v. Privette, 12 Wn. App. 142, 529 P.2d 23 (1974).