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No. 75779-2-I

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION I

FEDERAL HOME LOAN BANK OF SEATTLE,

Appellant,

v.

CREDIT SUISSE SECURITIES (USA) LLC, f/k/a CREDIT SUISSE FIRST BOSTON LLC, CREDIT SUISSE FIRST BOSTON MORTGAGE SECURITIES CORP., and CREDIT SUISSE MANAGEMENT LLC, f/k/a CREDIT SUISSE FIRST BOSTON MANAGEMENT LLC,

Respondents.

RESPONDENTS' BRIEF

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Respondents Credit Suisse Securities (USA) LLC, Credit Suisse First Boston Mortgage Securities Corp. and Credit Suisse Management LLC (collectively, "Credit Suisse"), respectfully submit this brief in opposition to Appellant Federal Home Loan Bank of Seattle's ("FHLB Seattle") Opening Brief, dated January 12, 2017.

INTRODUCTION

The trial court granted summary judgment against FHLB Seattle's claims under the Washington State Securities Act ("WSSA") on the ground that FHLB Seattle is unable as a matter of law to prove that it relied on the statements that it alleges are false or misleading. FHLB Seattle makes no argument on appeal that its purported showing of reliance is sufficient—indeed, Credit Suisse conclusively demonstrated that it is not. Instead, FHLB Seattle asks this Court to strike reliance as an element of the WSSA altogether, upending 50 years of unbroken precedent and overruling the Washington Legislature's clear intent. FHLB Seattle's request should be denied.

First, the Washington Supreme Court has held that claims under the WSSA require a showing of reliance. Its decisions are binding here. FHLB Seattle's protestation that this precedent—and the Court of Appeals' decisions following it—should be disregarded as "dicta" is belied by the Supreme Court's own decisions and by the appeal records in those cases.

Second, the Washington Legislature's enactment of, and subsequent amendments to, the WSSA demonstrate its intent for reliance to be an element of the statute. The Legislature enacted the WSSA's substantive standard for liability (RCW 21.20.010) using the same language as Federal Rule 10b-5, a cause of action that has required proof of reliance since before the WSSA became law. The Legislature has also amended the WSSA numerous times since its enactment in the face of uniform case law requiring a showing of reliance. None of those amendments indicated any intent to exclude reliance as an element of the statute.

Third, Washington's courts have without exception held that a showing of reliance is required under the WSSA. The out-of-state decisions that FHLB Seattle cites relate to the Federal Securities Act and versions of the Uniform Securities Act enacted by other states and have no place dictating this state's law where the Legislature's intent is clear and the courts have uniformly required that reliance be shown.

This Court should affirm the trial court's summary judgment decision and deny FHLB Seattle's appeal.

STATEMENT OF THE CASE

The trial court granted summary judgment against FHLB Seattle and dismissed this action against Credit Suisse on the ground that FHLB Seattle cannot prove that it relied on the allegedly false or misleading statements that form the basis of its WSSA claims, the only claims that it pleaded. (CP 8-109, 2640, 3311-12.)

In its complaint, FHLB Seattle alleged that certain prospectus supplements that Credit Suisse filed with the U.S. Securities and Exchange Commission (the "SEC") relating to residential mortgage-backed securities ("RMBS") certificates that FHLB Seattle purchased from Credit Suisse contained false or misleading statements. (CP 8-109.) FHLB Seattle alleged that its securities traders relied on the alleged misstatements in the prospectus supplements in purchasing the RMBS certificates at issue, and filed this action against Credit Suisse under Section 21.20.010 and Section 21.20.430 of the WSSA seeking rescission of its RMBS purchases.[1] (CP 53, 86-87, 108-09.)

Discovery in this action revealed that FHLB Seattle did not and could not have relied on the challenged prospectus supplements. FHLB Seattle's trading records show that it purchased one RMBS certificate at issue on May 30, 2007, and the second on September 30, 2005 before 2:00 p.m. (CP 3268-69; SCP 9852, 10364.) Time stamps on the SEC's website establish that the prospectus supplements that correspond to those certificates were first available on the Internet on June 1, 2007 and September 30, 2005 at approximately 5:00 p.m., respectively—*after* FHLB Seattle purchased the certificates. (CP 3268-69, 3276, 3281.)

[1] FHLB Seattle originally asserted claims with respect to purchases of four certificates from three RMBS. (CP 8, 53, 87.) On August 10, 2016, FHLB Seattle voluntarily dismissed with prejudice its claims with respect to two of those certificates, ARMT 2005-6A 1A31, purchased on July 29, 2005, and ARMT 2005-10 6A21, purchased on November 15, 2005. (CP 4388.) The only certificates remaining at issue in this action are ARMT 2005-10 6A21 and ARMT 2007-2 2A1. (CP 4388, 4391-92.)

Credit Suisse moved for summary judgment on the two certificates on the ground that FHLB Seattle could not prove reliance on the challenged prospectus supplements because the undisputed evidence establishes that FHLB Seattle had never received them, and could not have reviewed them, before purchasing the certificates at issue. (CP 2637-38.) In its opposition, FHLB Seattle did not claim, as it had at the beginning of this case (CP 9, 55, 88), that its traders read and relied on the challenged prospectus supplements. Nor did FHLB Seattle claim, as it had after discovery revealed that its traders could not recall receiving the prospectus supplements, that it was the "habit" of its traders to receive and rely on prospectus supplements. (CP 3011-12.) Instead, FHLB Seattle claimed only that its traders relied on the challenged prospectus supplements as per their ordinary practice of reviewing such materials on the Internet prior to acquiring securities, but FHLB Seattle offered no evidence that the prospectus supplements for the two certificates were available on the Internet prior to its purchases.[2] (CP 3085; SCP 10461.) In fact, the uncontroverted evidence clearly established that those prospectus supplements were not available prior to the purchases at issue, as described above.

[2] FHLB Seattle attaches as Appendix A to its Opening Brief statements quoted from a number of RMBS offering documents. The vast majority of statements relate to securities not at issue in this lawsuit. FHLB Seattle makes no argument on appeal that relates to those securities.

On May 4, 2016, the trial court granted Credit Suisse's motion. (CP 3311-12.) In a subsequent order denying FHLB Seattle's motion to reconsider the ruling, the trial court explained:

> "FHLBS failed to establish that it reasonably relied on the misstatements it alleged were contained in the prospectus supplements for those deals. The undisputed evidence demonstrated that FHLBS had not reviewed the prospectus supplements before settling its trades and therefore FHLBS could not have reasonably relied upon the purported misstatements therein." (SCP 10461.)

On this appeal, FHLB Seattle has dropped altogether the pretense that it relied on the prospectus supplements that it alleges contain false or misleading statements. Instead, FHLB Seattle's only assignment of error on appeal is that this Court should change the law and exclude reliance as an element under the WSSA. (Seattle Br. 5.) All other issues from the trial court's proceedings are waived.[3] *See* RAP 10.3(g) ("The appellate court will only review a claimed error which is included in an

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[3] On May 16, 2016, FHLB Seattle asked the trial court to reconsider its decision on an entirely new theory of "predictive reliance" based upon information that its traders had seen in connection with RMBS not at issue here or in preliminary sales materials that they may (or may not) have reviewed. (CP 3328-34.) The trial court rejected the theory on both procedural and substantive grounds. (SCP 10461-62.) Because FHLB Seattle had not previously raised or pleaded so-called "predictive reliance", the trial court held that the theory was improperly raised, stating that "[a]t every stage of this litigation, FHLBS has argued that it relied upon the prospectus supplements" and that FHLB Seattle "had the opportunity to present [its 'predictive reliance'] argument at summary judgment" and "chose not to do so". (SCP 10461.) On the merits, the trial court found that FHLB Seattle's theory was "unsupported by its complaint or the record" and that "an amendment of FHLBS's complaint would be futile because reliance on preliminary materials is unreasonable and insufficient to support FHLBS's claims". (SCP 10461-62.) FHLB Seattle failed to assign error to the trial court's order denying reconsideration.

assignment of error or clearly disclosed in the associated issue pertaining thereto."); *see also State v. Sims*, 171 Wn.2d 436, 441, 256 P.3d 426 (2011) ("an appellant is deemed to have waived any issues that are not raised as assignments of error and argued by brief").

ARGUMENT AND AUTHORITY

The trial court correctly held that reliance is a required element of liability under the WSSA. There is no basis to exclude the element where binding Washington precedent requires that reliance be shown and Washington's Legislature clearly intends that the showing be made. The Court should affirm the trial court's grant of summary judgment.

I. THE WASHINGTON SUPREME COURT HAS HELD THAT RELIANCE IS AN ELEMENT OF THE WSSA.

The Washington Supreme Court unambiguously has held that reliance is an element of the WSSA. In *Hines v. Data Line Systems, Inc.*, 114 Wn.2d 127, 787 P.2d 8 (1990), it held that plaintiffs proceeding under the WSSA must show that they "relied on the misrepresentations in connection with the sale of the securities".[4] *Id.* at 134. FHLB Seattle does not argue that *Hines* is distinguishable from the case at bar and instead contends only that it should be disregarded as non-binding dicta. (Seattle Br. 5.) That contention has no merit.

[4] The Court of Appeals has further held that such reliance must be reasonable. *See Stewart v. Estate of Steiner*, 122 Wn. App. 258, 265-66, 93 P.3d 919 (2004).

Once the Supreme Court "has decided an issue of state law, that interpretation is binding on all lower courts until it is overruled by" the Supreme Court. *State v. Gore*, 101 Wn.2d 481, 487, 681 P.2d 227 (1984); *Godefroy v. Reilly*, 146 Wash. 257, 259, 262 P. 639 (1928) ("When [the Supreme Court] has once decided a question of law, that decision, when the question arises again, is not only binding on all inferior courts in this state, but it is binding on this court until that case is overruled.").

The Supreme Court's *Hines* decision is an authoritative pronouncement of the WSSA's elements. In *Hines*, corporate investors claimed losses arising from the defendants' failure to disclose the declining medical condition of the company's CEO. 114 Wn.2d at 130. On appeal, the parties "disagree[d] upon the level of causation required to establish a claim under the WSSA". (Reply Brief for Appellants at 18, *Hines v. Data Line Sys., Inc.*, 114 Wn.2d 127 (No. 20506-4-I) (attached as Appendix I).) The investors argued that the WSSA required only a showing of "transaction causation", *i.e.*, reliance (Brief for Appellants at 58-65, *Hines v. Data Line Sys., Inc.*, 114 Wn.2d 127 (No. 20506-4-I) (attached as Appendix II)),[5] while the defendants in that case argued that proof of both reliance *and* loss causation was required (Brief for Respondents at 31-34, *Hines v. Data Line Sys., Inc.*, 114 Wn.2d 127

[5] Reliance is often referred to as "transaction causation". *See, e.g.*, *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341-42, 125 S. Ct. 1627, 161 L.Ed.2d 577 (2005).

(No. 20506-4-I) (attached as Appendix III)). Framing the question as whether "the investors must establish that defendants' misrepresentations were the proximate reason for their investments' decline in value", the Supreme Court held that investors "need only show that the misrepresentations were material and that [the investors] relied on the misrepresentations in connection with the sale of the securities". *Hines*, 114 Wn.2d at 134; *see also id.* at 135 ("an investor who is *wrongfully induced* to purchase a security may recover his investment without any requirement of showing a decline in the value of the stock" (emphasis added)). Applying this standard to the facts, the Supreme Court held that the undisputed findings of fact from the court below "substantiate that each investor relied on [the challenged] statements". *Id.* at 134.

FHLB Seattle's characterization of *Hines*'s discussion of reliance as "no[t] relevant to the issues before" the Washington Supreme Court is baseless. (*See* Seattle Br. 27.) The *Hines* decision itself and the record on appeal indicate that the Supreme Court was faced with the question of what elements must be proved to prevail on a claim under the WSSA and that the Supreme Court's interpretation was not superfluously made in passing. Indeed, in a subsequent decision, the Washington Supreme Court reiterated that reliance is an element of the WSSA. In *Go2Net, Inc. v. Freeyellow.com, Inc.*, the jury found, among other things, that the seller of a yellow pages corporation had made a materially false or misleading statement related to the corporation's ownership and that the plaintiff "had *relied on the misrepresentation or omission* in its decision to acquire" the securities at issue. 158 Wn.2d 247, 251, 143 P.3d 590 (2006) (emphasis added). On those facts, the Supreme Court held that "the jury's findings on the verdict form established [the defendant's] violation of the" WSSA. *Id.* Like its mischaracterization of *Hines*, FHLB Seattle's suggestion that *Go2Net* "said nothing about any requirement to prove reliance" is simply wrong. (Seattle Br. 23.)

Undeterred by the Supreme Court's unambiguous case law, FHLB Seattle contends that the trial court here "erred in grafting the reliance requirement" on the WSSA because the Court of Appeals decision that it cited, *Stewart*, 122 Wn. App. 258, relied on *Hines* in holding that proof of reliance is required under the WSSA.[6] (Seattle Br. 3-5.) This contention has no merit. *Stewart* adopted an eight-factor test for determining whether an investor's reliance on an alleged misstatement is "reasonable", and itself is a cited authority for the proposition that proof of reliance is required by the WSSA. *Stewart*, 122 Wn. App. at 274; *see FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc.*, 175 Wn. App. 840, 868 n.67, 309 P.3d 555, *aff'd in part, rev'd in part and remanded*, 180 Wn.2d 954, 331 P.3d 29 (2014) (citing

[6] FHLB Seattle curiously states that *Stewart* incorrectly "relied on" the Court of Appeals' decision in *Guarino v. Interactive Objects, Inc.*, 122 Wn. App. 95, 86 P.3d 1175 (2004), as authority for the WSSA's reliance element. (Seattle Br. 3.) *Stewart*, however, made no reference to *Guarino*. Both *Stewart* and *Guarino* cited the Supreme Court's *Hines* decision as authority for the WSSA's reliance element. *See Stewart*, 122 Wn. App. at 264 n.7; *Guarino*, 122 Wn. App. at 109. Neither panel (both from Division I) suggested that *Hines*'s discussion of reliance might be dicta.

Stewart in holding that reasonable reliance is required). The Court of Appeals' citation to binding Supreme Court precedent is no error, even if FHLB Seattle finds that precedent inconvenient here. *See Gore*, 101 Wn.2d at 487 (noting that a decision by the Washington Supreme Court on an "issue of state law . . . is binding on all lower courts until it is overruled by" the Washington Supreme Court).

Even if one accepts the (erroneous) characterization of *Hines* as dicta, the decisions of the Court of Appeals that unambiguously hold that reliance is required under the WSSA are entitled to respect under the doctrine of stare decisis under the very decision that FHLB Seattle cites. (Seattle Br. 4 n.3 (citing *Grisby v. Herzog*, 190 Wn. App. 786, 807, 362 P.3d 763 (2015) ("The various panels of the Court of Appeals strive not to be in conflict with each other because, like all courts, we respect the doctrine of stare decisis.")).) In *Grisby*, the Court of Appeals was faced with conflicting decisions of the Court of Appeals on the requirements of due process and chose to honor the case that accurately interpreted binding U.S. Supreme Court precedent on the issue, predicting that the Washington Supreme Court would do the same. *Id.* at 811. Here, Washington's precedent is uniform.

II. THE WASHINGTON LEGISLATURE INTENDED RELIANCE TO BE AN ELEMENT OF THE WSSA BY ADOPTING FEDERAL RULE 10b-5, WHICH REQUIRES PROOF OF RELIANCE.

There can be no dispute that Washington intends reliance to be an element under the WSSA. RCW 21.20.010, the WSSA's substantive liability provision, was modeled nearly verbatim to Federal Rule 10b-5, which at the time the WSSA was enacted required (and today still requires) a showing of reliance. Since that time, Washington courts have been unanimous in holding that reliance is required, and the Legislature has never sought to exclude reliance from the WSSA, notwithstanding having subsequently amended the statute on more than one occasion.

A. The WSSA's Liability Provision and Rule 10b-5 Are Nearly Verbatim.

Washington enacted the WSSA and RCW 21.20.010 in 1959 using nearly identical language to Federal Rule 10b-5, promulgated by the SEC under the Federal Securities Exchange Act of 1934. *See* 17 C.F.R. 240.10b-5. The two provisions are identical except that RCW 21.20.010 omits Rule 10b-5's requirement that the challenged securities transaction occur in interstate commerce. Rule 10b-5 states:

> "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.

Section 21.20.010 of the WSSA states:

> "It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (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." RCW 21.20.010.

Washington courts routinely have recognized that RCW 21.20.010 was based on Rule 10b-5 and that they are intended to be parallel. The Court of Appeals has commented that "[i]t seems inconceivable to us that the legislature, in 1959, could have intended that RCW 21.20.010 created for intrastate commerce something different from what rule 10b-5 created for interstate commerce". *Shermer v. Baker*, 2 Wn. App. 845, 849-50, 472 P.2d 589 (1970); *see Guarino*, 122 Wn. App. at 110 ("The related federal regulations [to RCW 21.20.010] are Section 10(b) [and] Rule 10b-5."); *Clausing v. DeHart*, 83 Wn.2d 70, 72, 515 P.2d 982 (1973) (stating that "[t]he Securities Act of Washington, RCW 21.20, is patterned after and restates in substantial part the language of the federal Securities Exchange Act of 1934").

At the time RCW 21.20.010 was enacted, it was well-established (and remains established today) that Rule 10b-5 plaintiffs must prove reliance on an allegedly false or misleading statement. *See, e.g.*, *Reed v. Riddle Airlines*, 266 F.2d 314, 319 (5th Cir. 1959); *Mills v. Sarjem Corp.*, 133 F. Supp. 753, 767 (D.N.J. 1955); *Speed v. Transamerica Corp.*, 5 F.R.D. 56, 60 (D. Del. 1945); *see also Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2418 n.1, 189 L.Ed.2d 339 (2014) ("a private plaintiff must prove . . . reliance upon the misrepresentation or omission" (citation omitted)). Against this backdrop, there can be no dispute that Washington intended that RCW 21.20.010, similar to Rule 10b-5, would require a showing of reliance. *See, e.g.*, *Broughton Lumber Co. v. BNSF Ry. Co.*, 174 Wn.2d 619, 632-33, 278 P.3d 173 (2012) (interpreting statutory language based on the legislature's contemporaneous understanding of terms used).

Despite this clear history contradicting its position, FHLB Seattle argues that this Court nonetheless should now exclude reliance as an element of the WSSA because (i) the Washington Supreme Court has struck two other elements (scienter and loss causation) from the WSSA that previously overlapped with Rule 10b-5 (Seattle Br. 22-23), (ii) the WSSA does not include the term "reliance" (*id.* at 27), and (iii) Washington enacted into the WSSA's remedy provision some portions of Section 12(a)(2) of the Federal Securities Act and

Section 410(a) of the Uniform Securities Act, which, some courts hold, provide a reliance-free cause of action (*id.* at 13-21). None of these contentions has any merit.

First, FHLB Seattle's argument that the Washington Supreme Court struck two elements that were previously common to Rule 10b-5 and RCW 21.20.010 says nothing about reliance under either statute. On the contrary, the fact that Washington courts have expressly struck those two elements—but confirmed time and again that reliance is an element of the WSSA—directly undermines FHLB Seattle's argument. As to scienter, the Washington Supreme Court's holding in *Kittilson v. Ford*, 93 Wn.2d 223, 608 P.2d 264 (1980), that scienter is not an element under the WSSA resulted from a 1977 amendment to the WSSA by the Legislature that struck the terms "fraud" and "misrepresentation" from the statute.[7] *See id.* at 226. And the absence of a loss causation requirement

[7] In its 1976 *Ernst & Ernst v. Hochfelder* decision, the U.S. Supreme Court held that Rule 10b-5 requires a showing of scienter on the ground that its enabling statute, Section 10(b) of the Securities Exchange Act of 1934, contained the words "manipulative or deceptive", which the U.S. Supreme Court reasoned to "strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct". 425 U.S. 185, 197, 96 S. Ct. 1375, 47 L.Ed.2d 668 (1976). One year after *Hochfelder* was decided, the Washington Legislature struck analogous "fraud" and "misrepresentation" language from the WSSA. *See* Laws of 1977, Ex. Sess., ch. 172, § 4 ("Any person, who offers or sells a security in violation of any provisions of RCW 21.20.010 or 21.20.140 through 21.20.230, is liable . . . ."). Following Washington's 1977 amendment, *Kittilson* held that scienter is not an element under the WSSA, reasoning that *Ernst & Ernst v. Hochfelder* is "inapplicable to our Securities Act" because "the 'manipulative or deceptive' language of section 10(b) of the 1934 act is not included in the Washington act, . . . in contrast to the federal scheme, the language of Rule 10b-5 is not derivative but is the statute in Washington, [and] . . . no legislative history similar or analogous to Congressional legislative history exists in Washington". 93 Wn.2d at 226.

is not based on any differences between the language of RCW 21.20.010 and Rule 10b-5 but instead stems from the fact that the WSSA defines rescission and rescissory damages as the statutory remedy, *see* RCW 21.20.430, while out-of-pocket damages are generally the remedy for a cause of action under Rule 10b-5, *see Ludlow v. BP, P.L.C.*, 800 F.3d 674, 682 (5th Cir. 2015), *cert. denied*, 136 S. Ct. 1824, 194 L.Ed.2d 829 (2016). The *Hines* decision holding that proof of loss causation is not required does not indicate any intent to exclude reliance as an element of the WSSA. To the contrary, *Hines* expressly held that proof of reliance is required, 114 Wn.2d at 134, and *Kittilson* reaffirmed the elements of liability as set forth in the Court of Appeals' *Shermer* decision, which held that proof of reliance is required, *Kittilson*, 93 Wn.2d at 227 ("[t]he interpretation of RCW 21.20.010 first announced in *Shermer* is the better rule"); *Shermer*, 2 Wn. App. at 858 ("It is sufficient that the plaintiff *relied upon* the misrepresentation or omission of a material fact" (emphasis added)).

Second, FHLB Seattle's argument that the term "reliance" appears nowhere in the WSSA is unconvincing. The progenitor of RCW 21.20.010, Rule 10b-5, also does not include the word reliance, but both provisions have for decades been held to require proof of reliance. *Shermer*, 2 Wn. App. at 858; *Halliburton*, 134 S. Ct. at 2418 n.1. And as described below in Section II.C., the Washington Legislature never has sought to exclude reliance as an element, thus ratifying it as part of the statute.

Third, any speculation that the Legislature intended to exclude reliance on the ground that portions of RCW 21.20.010's enabling and remedy provision, RCW 21.20.430, are "based . . . on section 12(a)(2) of the 1933 [Federal Securities] Act and the Uniform Securities Act, both of which provide for strict liability" (Seattle Br. 20), is baseless. RCW 21.20.430 creates a private right of action for violations of RCW 21.20.010 and defines rescission as the successful plaintiff's remedy. It is true that RCW 21.20.430 contains *some* language in common with Section 12(a)(2) of the Securities Act and Section 410(a)(2) of the Uniform Securities Act. However, Washington never enacted the *liability* portions of those provisions that some jurisdictions have held give rise to the reliance-free cause of action that FHLB Seattle asks this Court to create. Instead, Washington adopted only the portions of those provisions that relate to rescission, and chose not to enact the liability standards. In their place, Washington cross-referenced RCW 21.20.010 as the liability standard giving rise to a claim for rescission under the WSSA. *See* RCW 21.20.430(1) ("Any person, who offers or sells a security in violation of any provisions of RCW 21.20.010 . . . is liable to the person buying the security from him or her, who may sue either at law or in equity to recover the consideration paid for the security, together with interest . . . upon tender of the security, or for damages if he or she no longer owns the security."). That liability standard, as described above, was copied from Federal Rule 10b-5 and the Securities Exchange Act of 1934—not the 1933 Securities Act—and requires reliance as an element.

FHLB Seattle's argument that Washington intended to create a different cause of action based on statutory text that it never enacted is meritless.

FHLB Seattle seeks support for its position by observing that some decisions applying the WSSA have noted parallels between RCW 21.20.430 and Section 12 of the Securities Act and Section 410 of the Uniform Act. (*See* Seattle Br. 20 n.15.) While there are parallels in the remedies, none of the cases holds that RCW 21.20.430 gives rise to reliance-free liability under the WSSA.[8] As to reliance, FHLB Seattle cannot cite a single case holding that the WSSA does not require the element. Instead, it simply asks the Court to ignore all the cases confirming that reliance is an element of the WSSA.

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[8] Many of the cases that FHLB Seattle cites regarding similarities between RCW 21.20.430 and the Federal Securities Act also state that RCW 21.20.010 is patterned on the Securities Exchange Act of 1934 or expressly state that reliance is an element of the WSSA. *See Kinney v. Cook*, 159 Wn.2d 837, 843, 154 P.3d 206 (2007) (noting that RCW 21.20.010 is "patterned after and restates in substantial part the language of the federal Securities Exchange Act of 1934"); *Go2Net*, 158 Wn.2d at 251 (stating that the jury found that "Go2Net had relied on the misrepresentation or omission in its decision to acquire FreeYellow"); *Clausing*, 83 Wn.2d at 72 (stating that "[t]he Securities Act of Washington, RCW 21.20, is patterned after and restates in substantial part the language of the Federal Securities Exchange Act of 1934"). Others address only the definition of "sale" or "seller" of securities under RCW 21.20.430, which is not at issue in this appeal. *See Cellular Eng'g, Ltd. v. O'Neill*, 118 Wn.2d 16, 19, 820 P.2d 941 (1991) (deciding whether the activities constituted a "sale and offer for sale of securities" under the WSSA); *Hoffer v. State*, 113 Wn.2d 148, 152, 776 P.2d 963 (1989) (holding that the Court would "retain the 'substantial contributive factor' test in interpreting the term 'seller' in RCW 21.20.430(1)"); *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wn.2d 107, 744 P.2d 1032 (1987) (discussing the definition of "seller" under RCW 21.20.430).

B. Courts Are Unanimous That Proof of Reliance Is Required Under the WSSA.

Reliance has been uniformly applied and litigated under the WSSA for nearly 50 years at every level of Washington's courts and in every circumstance of securities litigation, pleading through appeal. Regardless of the procedural posture, Washington's courts have, without exception, held that a showing of reliance is required under the WSSA. FHLB Seattle has not offered a single case stating otherwise, and the out-of-state authorities that it cites have no place against Washington's unbroken precedent.

1. Washington Case Law Is Unanimous That Reliance Is an Element Under the WSSA.

The first reported civil case to apply the WSSA held that reliance is an element of liability under RCW 21.20.010. *Shermer*, 2 Wn. App. at 858. In *Shermer*, shareholders in a telephone company sold their stock back to the company through its managing director, who represented that he would not subsequently sell his interest in the company. *Id.* at 846-47. Despite the representation, the managing director sold his stake for a substantially higher price than the shareholders received. *Id.* The shareholders filed suit, claiming damages under the WSSA. *Id.* At trial, a jury found the managing director liable based on finding, among other things, that the shareholders "relied on the truth of the representation, or on the non-existence of the fact not disclosed, and had a right to so rely". *Id.* at 856 n.6. The Court of Appeals affirmed the trial court's judgment and, in the context of holding that scienter is not an element of the WSSA, explained that "[i]t is sufficient that the plaintiff *relied upon* the misrepresentation or omission of a material fact". *Id.* at 858 (emphasis added).

Since *Shermer*, the WSSA's reliance element has been litigated and applied (multiple times) at each stage of securities litigation:

- Pleading Standard: *Futureselect*, 175 Wn. App. at 869-70 (holding that Washington's "liberal notice-pleading standard" applies to alleging reasonable reliance under the WSSA);

- Liability Standard: *Stewart*, 122 Wn. App. at 274 (adopting a multi-factor test for determining whether reliance on an alleged misrepresentation is reasonable); *Helenius v. Chelius*, 131 Wn. App. 421, 443-44, 120 P.3d 954 (2005) (holding that a contract's "integration clause" does not preclude reasonable reliance under the WSSA on statements outside the contract); *Moore v. Thornwater Co. LP*, No. C01-1944C, 2006 WL 1423535, at *8 (W.D. Wash. May 23, 2006) (holding that reliance on alleged misstatements disclaimed by a contract's "non-reliance" clause was reasonable under the WSSA);

- Evidentiary Presumptions: *Guarino*, 122 Wn. App. at 109 (holding that reliance may be presumed under the WSSA "when the defendant omits to disclose a material fact"); and

- Class Certification: *In re Intermec Corp. Sec. Litig.*, No. C90-7832, 1991 WL 207370, at *3 (W.D. Wash. June 17, 1991) (certifying a class of investors asserting claims under the WSSA where the subject securities were traded in an efficient market such that a presumption of reliance applied and individualized proof of reliance was not required); *In re Metro. Sec. Litig.*, No. CV-04-25-FVS, 2009 WL 36776, at *4-5 (W.D. Wash. Jan. 6, 2009) (declining to certify a putative class of investors where individualized proof of reliance was required in the absence of a presumption of reliance).

FHLB Seattle's position would upend this unbroken chain of authority and should be rejected.

2. The Out-of-State Authorities Cited by FHLB Seattle Are Neither Binding Nor Persuasive.

FHLB Seattle's citation to decisions from other states interpreting their own blue sky laws, some of which do not require reliance and others that do, is neither binding nor persuasive here. (*See* Seattle Br. 24-26.) "[T]he Washington Supreme Court is the final arbiter of the meaning of Washington statutory law", *In re Petersen*, 138 Wn.2d 70, 80-81, 980 P.2d 1204 (1999), and has held that a showing of reliance is required under the WSSA. *Hines*, 114 Wn.2d at 134.

As an initial matter, FHLB Seattle miscasts the state of the law in other jurisdictions. FHLB Seattle acknowledges that two states require a showing of reliance under their securities statutes (Seattle Br. 26), but makes no mention that decisions regarding state securities statutes from at least five additional states (Georgia, Kansas, Maryland, Minnesota and Mississippi) also require a showing of reliance,[9] and

[9] *See Keogler v. Krasnoff*, 268 Ga. App. 250, 253, 601 S.E.2d 788 (Ga. Ct. App. 2004) (holding that, when interpreting Georgia's OCGA § 10-5-12(a),"we look to the similar elements a plaintiff must allege under section 10(b) of the Securities Act of 1934: 1) a misstatement or omission . . . 4) on which plaintiff relied" (internal quotations and citations omitted)); *Jayhawk Capital Mgmt., LLC v. LSB Indus., Inc.*, No. 08-2561-EFM, 2012 WL 4210462, at *8 (D. Kan. Sept. 19, 2012) (stating that reliance is an element of Rule 10b-5 and that plaintiff "must prove these same elements to prevail on his claim under Kan. Stat. Ann. § 17-12a501"); *Sherwood Brands, Inc. v. Levie*, No. Civ. RDB 03-1544, 2006 WL 827371, at *20 (D. Md. Mar. 24, 2006) (dismissing complaint alleging violations of Maryland Securities Act where plaintiff failed to show, *inter alia*, any "basis for her to have reasonably relied on the[] alleged misrepresentations"); *Merry v. Prestige Capital Mkts.*, 944 F. Supp. 2d 702, 709 (D. Minn. 2013) ("[A] plaintiff asserting liability under Minn. Stat. § 80A.68(2) must allege . . . (4) reliance upon the misrepresentation or omission."); *Geisenberger v. John Hancock Distribs., Inc.*, 774 F. Supp. 1045, 1051 (S.D. Miss. 1991) ("The Court finds that both Miss. Code Ann. § 75-71-717(a)(2) and []§ 75-71-501 contain an implicit requirement of reasonable reliance consistent with federal Rule 10b-5.").

likewise makes no mention that cases from six of the 21 states that it cites as not requiring reliance (Arizona, Colorado, Illinois, Indiana, Ohio and Oregon) have held the contrary, *i.e.*, require a showing of reliance.[10] Nor does FHLB Seattle mention that the Pennsylvania decisions that it cites as purportedly "reliance free" (under certain statutory subsections) hold that Pennsylvania's equivalent to RCW 21.20.010 does require reliance.[11]

[10] *Compare* Seattle Br. 25, *with Jankovich v. Bowen*, 844 F. Supp. 743, 749 (S.D. Fla. 1994) ("interpret[ing] the [Arizona] statute as embodying a reliance requirement"); *Hosier v. Citigroup Glob. Mkts., Inc.*, 835 F. Supp. 2d 1098, 1107 (D. Colo. 2011) (noting that reliance is an element of a claim under Colo. Rev. Stat. Ann. § 11-51-501); *JJR, LLC v. Turner*, 58 N.E.3d 788, 802 (Ill. App. Ct. 2016) (claims in Illinois under 815 Ill. Comp. Stat. Ann. 5/12(F) and 5/12(G) "require that the plaintiffs prove reliance on the alleged false and misleading statements"); *Perry v. Eastman Kodak Co.*, No. IP 87-1023-C, 1991 WL 629728, at *3, *7 (S.D. Ind. Apr. 22, 1991) ("Reliance is an element of a Rule 10b-5 cause of action . . . . Violations of [Indiana] Section 23-2-1-12 carry the same reliance, causation and duty to disclose requirements as its federal counterpart, Rule 10b-5."); *In re Nat'l Century Fin. Enters., Inc., Inv. Litig.*, 905 F. Supp. 2d 814, 829 (S.D. Ohio 2012), *aff'd sub nom. Pharos Capital Partners, L.P. v. Deloitte & Touche*, 535 F. App'x 522 (6th Cir. 2013) ("[T]he court finds that justifiable reliance is an element of a[n] [Ohio] § 1707.41(A) claim."); *and State v. Marsh & McLennan Cos., Inc.*, 353 Or. 1, 14, 292 P.3d 525 (Or. 2012) ("[A] purchaser of securities on the open market must establish some form of reliance on misrepresentations made by the defendant in order to establish a claim for damages under [Oregon's] ORS 59.137.").

[11] Unlike the WSSA, Pennsylvania's state securities statute contains separate liability provisions analogous to both Rule 10b-5 and Section 12(a)(2). *See* 70 Pa. Stat. and Cons. Stat. Ann. §§ 1-401 (West 1973), 1-501 (West 1998). Though Pennsylvania's provision analogous to Section 12(a)(2), which was never enacted in Washington, does not require a showing of reliance, *Kronenberg v. Katz*, 872 A.2d 568, 597 (Del. Ch. 2004) (applying Pennsylvania law), the cases that FHLB Seattle cites hold that the Pennsylvania provision that is analogous to Rule 10b-5 (and RCW 21.20.010) does require a showing of reliance, *Gilliland v. Hergert*, No. 2:05-cv-01059, 2008 WL 2682587, at *7 (W.D. Pa. July 1, 2008) (holding that the RCW 21.20.010 equivalent has the same elements of a Rule 10b-5 claim); *Fulton Fin. Advisors v. NatCity Invs., Inc.*, No. 09-4855, 2013 WL 5635977, at *10 (E.D. Pa. Oct. 15, 2013) (holding that the RCW 21.20.010 equivalent "must satisfy the familiar elements of a 10b-5 claim").

FHLB Seattle's purported state survey also glosses over the fact that many of the "reliance free" jurisdictions that it cites adopted causes of action analogous to Section 12(a)(2) of the Federal Securities Act, which does not require a showing of reliance and that were never enacted by Washington.[12]

The WSSA is distinct from the blue sky laws enacted in many other states. *See Go2Net*, 126 Wn. App. at 776-77 (noting that the Uniform Act has been "wholly or substantially enacted in the great majority of states" and recognizing that this "does not mean [Washington] courts must imitate" other courts in interpreting the WSSA). Specifically, states that do not require a showing of reliance under their blue sky laws all provide a due diligence defense for underwriters.[13] The defense permits underwriters to show that they exercised reasonable care and did not know (or that had they exercised reasonable care, would not have known) of an alleged untruth or omission. *See, e.g.*, Cal. Corp. Code

[12] *Compare* Conn. Gen. Stat. Ann. § 36b-29(a)(2) (West 2010) (containing language substantially similar to 12(a)(2) of the Federal Securities Act), Ky. Rev. Stat. Ann. § 292.480 (West 2010) (same), Mass. Gen. Laws Ann. ch. 110A § 410(2) (West 1991) (same), Mo. Ann. Stat. § 409.5-509 (West 2003) (same), Neb. Rev. Stat. Ann. § 8-1118(1) (West 2013) (same), N.J. Stat. Ann. § 49:3-71 (West 1997) (same), *and* Va. Code Ann. § 13.1-522(A) (West 1997) (same), *with* RCW 21.20.010 (language materially identical to Rule 10b-5), RCW 21.20.430 (omitting language analogous to § 12(a)(2)), *and Shermer*, 2 Wn. App. at 850 (observing that the WSSA is materially identical to Rule 10b-5 and holding that reliance is required).

[13] 12A Long et al., *Blue Sky Law* § 12:5, State-by-State Charts for State Securities Acts: Civil Liability—State Securities Acts (2016) (observing that all states that do not have a reliance requirement provide for a due diligence defense).

§ 25501 (West 1969). The availability of the due diligence defense in the absence of a reliance requirement protects underwriters who, despite taking reasonable care to ensure that information in the offering documents was accurate, nonetheless sold securities using statements allegedly containing material misstatements or omissions. The WSSA has no such due diligence defense for underwriters. Were the Court now to eliminate the element of reliance, the WSSA would create absolute liability for classes of defendants that take no leading role in issuing challenged securities. There is nothing to suggest the Washington Legislature intended such an extreme result.

C. The WSSA's Post-Enactment History Demonstrates the Legislature's Intent to Maintain Reliance as an Element.

To the extent that Washington Supreme Court precedent and the WSSA's mirror-image enactment to Rule 10b-5 do not end the inquiry (and they should), the Legislature's acceptance of nearly 50 years of unbroken authority interpreting the WSSA as requiring reliance certainly does. Following the Court of Appeals' 1970 *Shermer* decision, the WSSA has been amended numerous times. No amendment has excluded or cast any doubt on the WSSA's reliance requirement.

Washington's Legislature is "presume[d] [to be] aware of judicial interpretations of its enactments and . . . its failure to amend a statute following a judicial decision interpreting that statute [indicates] legislative acquiescence in that decision". *City of Fed. Way v. Koenig*, 167 Wn.2d 341, 348, 217 P.3d 1172 (2009) (concluding that legislative silence for 23 years constituted legislative acquiescence); *see also 1000 Friends of Wash. v. McFarland*, 159 Wn.2d 165, 181, 149 P.3d 616 (2006) ("If the legislature does not register its disapproval of a court opinion, at some point that silence itself is evidence of legislative approval."). Here, the Legislature has had no hesitation changing the WSSA when necessary, but has been silent for nearly 50 years on reliance—twice the length of time at issue in *Koenig*—further demonstrating that the courts have it exactly right in holding that reliance is an element under the WSSA.

The WSSA has been amended nine times since it was enacted.[14] For example, in 1975, the Legislature amended the WSSA to include an express right of action against purchasers of securities, which *Shermer* had implied under the statute, to fill "an obvious and unexplainable gap in the coverage of the express remedies provision".[15] *Wade v. Skipper's, Inc.*, 915 F.2d 1324, 1332 (9th Cir. 1990). Prior to the 1975 amendment, the WSSA's "enabling" provision (RCW 21.20.430) provided an express cause of action only against sellers of securities.

[14] Laws of 1998, ch. 15, § 20; Laws of 1986, ch. 304, § 1; Laws of 1985, ch. 171, § 1; Laws of 1981, ch. 272, § 9; Laws of 1979, Ex. Sess., ch. 68, § 30; Laws of 1977, Ex. Sess., ch. 172, § 4; Laws of 1975, 1st Ex. Sess., ch. 84, § 24; Laws of 1974, Ex. Sess., ch. 77, § 11; Laws of 1967, ch. 199, § 2.

[15] *See* Laws of 1975, 1st Ex. Sess., ch. 84, § 24 ("Any person who buys a security by means of fraud or misrepresentation is liable to the person selling the security to him, who may sue either at law or in equity . . . ."); *see also Ludwig v. Mut. Real Estate Inv'rs*, 18 Wn. App. 33, 42-43, 567 P.2d 658 (1977), *overruled on other grounds by Kittilson*, 93 Wn.2d at 225.

Compare RCW 21.20.430(1), *with* RCW 21.20.430(2). While monitoring developments in the case law, the Legislature has never indicated any intent to strike reliance as an element of the WSSA. *See, e.g., Wade*, 915 F.2d at 1332 (observing that the WSSA's 1975 and 1977 amendments "demonstrate [the Washington Legislature's] willingness and ability to correct its own omissions").

The Legislature also has given no indication that RCW 21.20.010 should serve as insurance against investor loss. On this point, the U.S. Supreme Court stated in regards to Rule 10b-5 that "allowing recovery in the face of affirmative evidence of nonreliance—would effectively convert Rule 10b-5 into a scheme of investor's insurance. There is no support in the Securities Exchange Act, the Rule, or our cases for such a result". *Dura*, 544 U.S. at 345 (internal quotation marks omitted). As stated above, RCW 21.20.010 is nearly verbatim to Rule 10b-5, and the same logic applies. FHLB Seattle's suggestion to the contrary (Seattle Br. 27), is simply wrong. Indeed, the Washington Supreme Court decision that FHLB Seattle cites in claiming that reliance should be excluded from the WSSA "to protect investors" (*id.* at 27 (citing *FutureSelect*, 180 Wn.2d at 970-71)), found no incompatibility between requiring a showing of reliance and investor protection. In *FutureSelect*, the Supreme Court affirmed a Court of Appeals decision that held that reasonable reliance must be alleged to withstand a motion to dismiss. *See FutureSelect*, 175 Wn. App. at 867-68 ("To establish a claim under the WSSA, an investor must prove that (1) the seller made material misrepresentations or omissions about the security and (2) the investor relied on those misrepresentations or omissions.").

CONCLUSION

For the foregoing reasons, this Court should affirm the judgment of the court below dismissing FHLB Seattle's claims against Credit Suisse.

Dated: March 3, 2017

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that on this day she caused a copy of this document to be served via email to the last known address of all counsel of record.

I certify under penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

Dated this 3rd day of March 2017, at Seattle, Washington.

Suzanne M. Powers, Legal Assistant

20506-4-I

NO. 20506-4-I

COURT OF APPEALS, DIVISION I,
OF THE STATE OF WASHINGTON

GREGORY HINES, et al.,

Appellants,

v.

DONALD E. BARNARD, BRUNO E. BOIN, and

PERKINS COIE,

Respondents.

REPLY BRIEF OF APPELLANTS
(RE BARNARD AND BOIN)

FILED
COURT OF APPEALS DIV. #1
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I. INTRODUCTION

Appellants (hereafter "Investors") will use this Reply Brief to identify and discuss those areas of the Brief of Respondents Barnard and Boin to which Investors take particular exception. For convenience of the court, Investors' comments will follow the organization of Respondents' brief. Investors will make every effort to limit the contents of this brief to a reply to the brief of Barnard and Boin, and will not reargue areas adequately briefed in Investors' opening brief.

II. FACTS

On pages 5 through 7 of their brief, Barnard and Boin down-play their participation in matters pertaining to the offering of the subject securities. In essence, they argue that their participation was limited to attendance at board meetings where important decisions appear to have been passively and anonymously ratified. Two points must be made here. First, this characterization of the participation of Barnard and Boin is not supported by the record. Pages 46 and 47 of the Brief of Appellants cite ample references to the record below indicating the active participation of Barnard and Boin in the full decision-making and offering process. Second, and equally important, even if Barnard and Boin had not actively participated, this would be no defense: as directors of the issuing corporation they had a statutory duty both under the Washington Business Corporation Act ("WBCA") and under the Washington State Securities Act ("WSSA") to participate.

On page 8 Barnard and Boin assert that Peterson was back at work in June and "within a month of the operation, was fully recovered." A similar representation is made on page 21. Once again, this is factually incorrect and legally immaterial. Factually, the record establishes that Peterson was not back at work full time or at full speed for quite some time (CP 372-373; CP 384-386). Nor was he "fully recovered" -- he had two remaining brain aneurysms which he described as "a time bomb in my head." (CP 148-150). Moreover, facts pertaining to the <u>initial</u> aneurysm and brain surgery were material items subject to disclosure even if it was true that Peterson <u>appeared</u> to be recovering well.

On page 10 Barnard and Boin list the dates that plaintiffs "purchased their interest in Dataline." The schedule omits one Investor and does not include the dates on which Investors finalized their investment decisions by tendering a check to the broker retained by Data Line. The complete information is as follows:

Name	Amount Purchased	Date of Purchase	Date of Certificate
William Vieser (d/b/a Circle 5 Associates IV)	$50,000	6/25/82	7/15/82
Richard Swan (D.S. Food Sales Co., Inc.)	50,000	7/9/82	7/15/82
Robert Arnold	50,000	7/13/82	7/15/82
Vance Mylroie	50,000	8/4/82	8/11/82
Gregory Hines	25,000	10/4/82	10/14/82
Gregory Hines (H&H Distributors Pension Fund)	50,000	10/4/82	10/14/82
Arne Midtskog	10,000	11/10/82	8/11/82[1]
Andrew Mathisen	50,000	11/11/82	12/1/82
Michael Schwartz	50,000	11/29/82	1/11/83
Total	$385,000		

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1 Although Midtskog made his investment on November 10, 1982, in a decision made by the broker, his investment was recorded as part of an investment made by an investment partnership effective August 11, 1982. Although this does not appear to have been improper, it was done without his knowledge, and the August 11th issuance date on the certificates cannot be attributed to his decision, which was not made until November 10.

On page 11 Barnard and Boin state that Peterson did not decide whether to undergo the second aneurysm operation until sometime in late October, 1982. By this they would have the court believe that since the decision to undergo surgery had not been made, there was nothing to disclose. Although the <u>second surgery</u> may have been speculative prior to October 15, 1982, the <u>existence of the remaining aneurysms</u> was a fact which was known by Peterson and his physicians, easily discoverable by Barnard and Boin, and a highly material item which could have and should have been disclosed.

Also on page 11 Barnard and Boin quote from a letter by Peterson's surgeon written after the second surgery indicating the doctor's opinion that the chances of Peterson having subsequent complications were "very small." The fact that complications did arise resulting in the complete disability of Peterson should be sufficient to indicate that the chances -- though considered by a surgeon to be statistically very small -- would be considered by the reasonable investor to be sufficiently significant to require disclosure.

Finally, on page 12 Barnard and Boin assert that "Dr. Ojemann ultimately concluded that Peterson's health problems were related to depression, not to the aneurysm operations." This is a mischaracterization of Ojemann's testimony. As discussed on page 13 of the Brief of Appellants, although Ojemann concluded that Peterson's health problems were related to the depression, he acknowledged that the depression could in turn have been attributed either to the aneurysms or the surgeries.

III. LAW

A. Control Personal Liability.

On pages 12 through 19 of their brief, Barnard and Boin argue that they can only be liable for securities violations if they qualify as control persons of Data Line as defined by applicable federal laws and case decisions. From here they argue that the trial court properly concluded that neither Barnard nor Boin could be found to be control persons of Data Line. This argument fails for three reasons, each of which will discussed separately below.

1. Direct Liability Under RCW 21.20.430(1).

Shortly after Investors filed their opening brief, the Washington Supreme Court decided Haberman v. WPPSS, 109 Wn.2d 107, ____ P.2d _____ (1987). The Haberman decision expanded the definition of a seller of securities to include those whose participation in the sale was a substantial factor in causing the transaction to take place. As the court noted:

> We conclude that the substantial factor - proximate cause definition of seller prevailing in the federal circuits provides the best guidance for our analysis of seller liability under RCW 21.20.430(1). We note that our conclusion is in accord with the views expressed in the official comments to the recently revised Uniform Securities Act of 1985. Although not adopted in Washington, new Section 605(a) of the Uniform Securities Act contains the language of old Section 410 upon which RCW 21.20.430(1) was based. The official comments to Section 605(a) state that under this definition, 'liability may be imposed on a person in addition to the immediate seller if the person's participation was a substantial contributive factor in the violation.' [Citation deleted]. We believe that this approach best promotes the legislative purpose behind the WSSA, while harmonizing our statutory scheme with federal and other state decisions. We also believe this definition is in harmony with similar developments in general tort law.

Haberman at 130.

The level of participation of Barnard and Boin in the private placement preparation and sales process creates a question of fact as to whether they might be deemed substantial participants directly liable under RCW 21.20.430(1).

2. Per Se Liability Under RCW 21.20.430(3).

Nowhere in their brief to Barnard and Boin confront the uncontested abundance of case law from other jurisdiction precisely on point concluding that directors of a corporation are per se liable for securities violations of the issuer irrespective of control person status and irrespective of culpable conduct. On pages 39 through 41 of Investors' opening brief, five such cases are cited and discussed. In each decision state courts held directors per se liable under blue sky laws substantially identical to the operative provisions of § 21.20.430(3). Barnard and Boin do not in any way refute or even address these cases, and the assertion on page 12 of their brief that Investors' "reading of the Washington State Securities Act is not supported by . . . cases construing other similar state statutes" is simply not true.

Barnard and Boin cite two cases in opposition to the per se liability reading of § 21.20.430(3). The first case is Burgess v. Premier Corporation, 727 F.2d 826 (9th Cir. 1984). As discussed on pages 42 to 43 of Investors' opening brief, for reasons which we cannot know the Burgess court did not address the per se liability argument, and the Burgess decision cannot be cited to negate the express per se liability of directors created by § 21.20.430(3). Respondents' novel claim that Burgess creates different standards of culpability for direct sellers as opposed to outside directors is not supported by statute, case law or logic.

The second case cited is Harman v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974). Barnard and Boin do not point out that Harman was not a securities case, but rather a derivative action against a former director and majority stockholder charged with breach of his fiduciary duty to the company, its creditors and its stockholders. It applied Kansas corporations law, not the securities laws. The Harman case is of no guiding or precedential value.

In summary, Respondents' brief raises no authority to seriously refute the clear language of

§ 21.20.430(3) making directors _per se_ liable regardless of control person status and regardless of culpable participation.

3. Control Personal Status.

The main thrust of Barnard and Boin's argument is that they were not, as a matter of law, control persons of Data Line. Respondents cite two Ninth Circuit cases interpreting federal law which hold an outside director liable as a control person only if (1) he had actual power or influence over the alleged controlled person (in this case, either Data Line or its officers), and (2) he was a culpable participant in the alleged illegal activity. _Buhler_ v. _Audio Leasing Corp._, 807 F.2d 833 (9th Cir. 1987) and _Orloff_ v. _Allman_, 819 F.2d 904 (9th Cir. 1987). Although this court is not bound to adopt the interpretation of federal courts, sufficient questions of fact exist as to whether or not Barnard and Boin satisfied the two-part _Buhler_ test even if it is adopted as the law of Washington.

The court noted in _Buhler_ that "whether a defendant has power or influence over an allegedly controlled person is a question of fact." _Buhler_ at 835. The references to the record set forth on pages 46 to 47 of Investors' opening brief are sufficient for summary judgment purposes to establish that both Barnard and Boin had at least real influence over the private placement preparation and sales activities of Data Line, the legal effect of which can not be negated by a delegation of their power to the officers.

Barnard and Boin do not appear to contest the factual questions surrounding the first element. Rather, they address the second element and assert that there are "no facts upon which an inference can be made that Barnard and Boin culpably participated in any concealment of material facts from potential investors." (p. 19) However, the facts show at least a deliberate decision to avoid knowledge and the appearance of active participation by delegating their important duties to the officers. Under still-evolving Ninth Circuit law, Barnard and Boin may satisfy the second element of the Buhler test by culpably failing to act to prevent the misconduct.

Although initially invoked as a method to impose liability on broker-dealers for failing to supervise their sales agents, two Ninth Circuit cases and one Fifth Circuit case have recognized the applicability of the doctrine to non-broker dealers under circumstances where a particular defendant had a duty to supervise. Kersh v. General Counsel of Assemblies of God, 804 F.2d 546 (9th Cir. 1986); G.A. Thompson & Co., Inc. v. Partridge, 636 F.2d 945 (5th Cir. 1981); Zweig v. Hearst Corporation, 521 F.2d 1129 (9th Cir. 1975). The court in Zweig set out five factors to be considered in determining whether a duty to supervise should be imposed on persons other than broker-dealers: (a) whether the controlling person derives direct financial gain from the activity of the controlled person; (b) the extent to which the controlled person is tempted to act unlawfully because of the controlling person's policies; (c) the extent to which statutory or regulatory law or the defendant's own policies require supervision; (d) the relationship between the plaintiff and the controlling person; and (e) some public policy need to impose such a requirement. See Zweig, 521 F.2d at 1135 and Kersh, 804 F.2d at 550.

In the present case, analysis of the listed criteria support application of the doctrine to Barnard and Boin: on the one hand, as major shareholders in Data Line they stood to gain financially from a large infusion of capital into the corporation; on the other hand, the WSSA was promulgated to protect the investing public, who are in a position of inferior knowledge and inferior access to knowledge vis-a-vis corporate directors. Moreover, both the public policy embodied by the WSSA and the clear direction of § 21.20.430(3) support imposing a duty on directors to exercise the supervisory control given to them. At the very least, Barnard and Boin delegated their control and buried their heads in the sand. This culpable failure to act satisfies the participation prong of the Buhler test.

B. Washington Business Corporation Act.

On page 20 of their brief Barnard and Boin quote Miller v. King County, 59 Wn.2d 601, 605, 369 P.2d 304 (1962) for the proposition that "the rules of statutory construction require that statutes be interpreted to give meaning and effect to each, if possible." Investors could not agree more. However, Respondents would have this court render the provisions of RCW 21.20.430(3) meaningless in deference to RCW 23A.08.343. This court should comply with the mandate of Miller and give both statutes meaning and effect, which in the present case is not only possible but quite easy.

Section 23A.08.343 should be given its plain meaning to protect directors against mismanagement claims by shareholders if they exercise good business judgment in corporate matters. In those few and well circumscribed instances in which a corporation issues stock, § 21.20.430(3) should be given its plain meaning to control the conduct of directors for the benefit of the investing public. There is simply no reason to have an identical standard of care apply to two dramatically differently and easily distinguishable situations. A director of reasonable intelligence should be able to understand a statutory mandate that he or she owes a higher duty of care in decisions pertaining to sales of stock than he or she does in managing the day-to-day affairs of the corporation.

This precise issue was confronted by the Oregon Court of Appeals in Everets v. Holtman, 667 P.2d 1028, 1033 (Ore. App. 1983). The court reviewed the language of the Oregon Corporation Code, which is similar to RCW 23A.08.343, and concluded that compliance sheltered a director from liability to the corporation but not from investors with a securities claim. Barnard and Boin offer no compelling reason why a similar interpretation should not be adopted by the courts of Washington.

C. Duty to Investigate.

Simply put, Respondents ask this Court to read the affirmative defense language of RCW 21.20.430(3) as a passive, good faith, lack of knowledge defense. There is absolutely no logical, statutory or case support for such a reading. By its clear words the statute requires affirmative action on the part of a director who would use it as a shield, i.e., directors are liable unless they:

> did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

Investors are prepared to admit for purposes of this appeal that Bernard and Boin did not know of Peterson's remaining aneurysms.[2] However, they have made no showing whatsoever that in the exercise of reasonable care they could not have known

2 Of course, they both knew about Peterson's first aneurysm and operation yet chose not to require disclosure concerning this. As set out in their opening brief, Investors contend that this in itself constituted a material omission for which Barnard and Boin are liable.

of Peterson's ongoing health problems. The simple and undisputed fact is that they could easily have known, but chose not to make the least inquiry.

In support of their request to interpret the affirmative investigation language of § 21.20.430(3) to require only passive good faith, Respondents rely by analogy on Section 15 of the Securities Act of 1933 and Section 20(a) of the Securities Exchange Act of 1934. Notwithstanding recitations in the Uniform Securities Act concerning the historical origins of the affirmative defense language contained in § 21.20.430(3), a simple reading of the Section 15 and Section 20(a) language shows that they are distinctly and dramatically different from the language in § 21.20.430(3). Section 15 provides a defense if the defendant has no "reasonable grounds to believe in the existence of" the liability producing facts. Section 20(a) provides a defense if the defendant "acted in good faith." Both of these provisions allow a defense based upon passive ignorance. Section 21.20.430(3) clearly predicates the defense upon <u>action</u> -- the defense is not available unless the liability producing facts <u>could</u> <u>not</u> <u>have</u> <u>been</u> <u>discovered</u> in the exercise of reasonable care.

Barnard and Boin cite only one state case interpreting language similar to the WSSA. Hamilton Bank & Trust Co. v. Holliday, 464 F. Supp. 429 (N.D. Ga. 1979). In order to fairly evaluate the precedential value of Hamilton, the Court should be aware of certain facts not discussed in Respondents' Brief. Defendants in Hamilton were outside directors of HBI, a company which owned HFI as a wholly owned subsidiary. They were not directors of HFI. The only directors of HFI were the inside directors of HBI. The securities violations which were the subject of the suit were conducted by HFI. As a matter of fact, the court found that the outside directors of HBI did not participate, aid, abet or assist in the securities fraud participated by the inside directors on behalf of HFI, and did not learn about the transaction until afterwards. As to whether the outside directors' failure to learn of the fraud was unreasonable, the court concluded:

> It is important to note that in the context of HBI's overall loan reduction goal of $200,000,000, HFI's sale of loan participations totaling $1,800,000 to Plaintiff . . . was not a transaction which the Outside Directors of HBI could reasonably be expected to have investigated. HFI loans amounted to

> only $13,566,824 and constituted only two percent of HBI system's loans.

Hamilton at 1242.

Reasonable investigation by the outside directors of HBI would not have uncovered the unlawful conduct. Barnard and Boin, on the other hand, could have learned of Peterson's ongoing health problems by simply inquiring of Peterson or his physician, or by adequately supervising those to whom they purportedly delegated their responsibilities as directors.

On pages 28-31 of their brief Respondents discuss Lanza v. Drexel & Co., 479 F.2d 1277, 1280 (2d Cir. 1973). Investors are satisfied to stand on the discussion of Lanza contained on pages 41-42 and 49-52 of the opening brief.

D. Materiality.

On page 31 of their brief Bernard and Boin admit that Investors have raised material issues of fact regarding the materiality of Peterson's second brain aneurysms and craniotomy. As far as this admission goes, Investors agree and commend Respondents for their candor. The Court should not lose sight of the fact that Investors also contend that the initial aneurysm and craniotomy were material facts which should have been disclosed. These were known to Barnard and Boin well in advance of the first closing, and should have been the subject of a supplement to the Private Placement Memorandum.

E. Causation.

On page 31 of their brief Barnard and Boin admit that Investors have raised material issues of fact regarding the element of causation. Respondents go on to invite the Court to comment upon the element of causation for guidance on remand. Investors welcome the guidance of this Court as well.

The parties disagree upon the level of causation required to establish a claim under the WSSA. Specifically, Investors contend that they need only show "transaction causation," i.e., that the omission was a substantial contributive factor in their decision to purchase the stock. Respondents contend that Investors must also show "loss causation," i.e., that the omission was a substantial contributive factor to the decline in the value of the stock. Investors feel that they adequately briefed this argument on pages 58-65 of their opening brief. They will take this opportunity to address several new cases raised on pages 32-34 of Respondents' brief.

On page 32 Barnard and Boin cite Alna Capital Associates v. Wagner, 758 F.2d 562, 565 (11th Cir. 1985) for the proposition that "other states also hold that a plaintiff must establish causation to prevail." However, it is clear from reading Alna and the cases it discusses that the causation element referred to is that of transaction causation and not loss causation. Similarly, Respondents on page 33 refer to DuPont v. Brady, giving an incorrect cite. The correct cite is: [1986 Transfer Binder] Blue Sky Rep. (CCH) ¶ 72,457 (S.D.N.Y. 1986). As with Alna, DuPont discusses "proximate damage" in terms of reliance and transaction causation. Neither of these cases support Respondents' contention that other Uniform Securities Act states require loss causation. Indeed, New York is not even a Uniform Securities Act state.

F. Negligent Misrepresentation.

Nowhere does the Brief of Respondents address the negligent misrepresentation issue raised by Investors. This is appropriate, as reversal on the dismissal of Investors' negligent misrepresentation claim against Barnard and Boin seems a foregone conclusion in light of Haberman v. WPPSS, supra. At pages 161-64 of the decision, the Haberman court adopted the rational discussed on pages 34-38 of Investors' opening brief. Specifically, the court accepted Restatement (Second) of Torts § 552(1), (2) (1977), the text of which is set out on page 28 of Investors' opening brief. Haberman expressly recognizes that an injured investor may state a claim for negligent misrepresentation against participants in a securities issuance based upon information supplied only indirectly by those participants.

In the instant case, Barnard and Boin as directors of Data Line were ultimately responsible for seeing that the information contained in the Private Placement Memorandum was accurate and complete. There is at the very least a question of fact in Investors' favor as to whether Barnard and Boin were negligent in their duty to see that the information supplied to potential investors was accurate and complete.

IV. CONCLUSION

Barnard and Boin repeatedly ask this Court to construe the Washington State Securities Act narrowly to comport with federal statutes which often are not even remotely similar in language. The Court should recall the Washington Supreme Court's recent pronouncement on this very point:

> We note that while the purpose of federal securities laws is to maintain the integrity of the secondary securities markets and to enforce disclosure, the WSSA is intended to protect investors [citations deleted]. To this end, this Court has construed the WSSA broadly. Haberman, supra, at 125-126.

Respectfully submitted this 18th day of January, 1988.

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NO. 20506-4-I

COURT OF APPEALS, DIVISION I,
OF THE STATE OF WASHINGTON

GREGORY HINES, et al.,

Appellants,

v.

DONALD E. BARNARD, BRUNO E. BOIN, and

PERKINS COIE,

Respondents.

BRIEF OF APPELLANTS

W. Wesselhoeft
Phil Miller
Dennis J. Dunphy
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I. PROCEDURAL NOTE

This is an appeal from two cases which were consolidated for discovery and trial in the court below. The Hines case was brought by seven plaintiffs. The Swan case was brought by Swan alone. Both cases involve identical allegations against identical defendants. Respondent Perkins Coie was dismissed from the consolidated cases on May 4, 1987 after its motion for summary judgment. Respondents Barnard and Boin were dismissed from the consolidated cases on May 7, 1987 after their motions for summary judgment. Separate appeals were filed by Appellants approximately one week apart. By order of this Court dated June 8, 1987, the two appeals were consolidated. Although the underlying facts are the same as to all Respondents, the legal issues involved in this appeal are largely different as between Perkins Coie on the one hand and Barnard and Boin on the other.

II. ASSIGNMENTS OF ERROR

By separate orders, Honorable Anthony Wartnik dismissed Appellants' claims under the Washington State Securities Act and for negligent misrepresentation against Respondents Perkins Coie and Respondents Barnard and Boin. Neither order contained findings of fact or conclusions of law, nor did either order specify the basis for granting the summary judgments. As such, the issues on this appeal become whether the orders may be upheld upon any ground. The specific issues pertinent to review are as follows:

A. Perkins Coie

Applicability of Washington State Securities Act

1. As a matter of law, can an injured investor state a cause of action against outside counsel for an issuing company pursuant to RCW 21.20.010 and/or RCW 21.20.430(3)?

Materiality

2. Did Perkins Coie establish, as a matter of law, that the health condition of the chief executive officer of the issuing company was not a material fact subject to disclosure?

Negligent Misrepresentation

3. As a matter of law, may injured investors state a cause of action for negligent misrepresentation against outside counsel for an issuing company?

4. Did Perkins Coie establish, as a matter of law, that it was not negligent toward Appellants

in failing to disclose, or insist upon disclosure by the issuing company or its directors, of the health condition of the chief executive officer?

B. Barnard and Boin

Materiality

5. Did Barnard and Boin establish, as a matter of law, that the health condition of the chief executive officer of the issuing company was not a material fact subject to disclosure?

Control Person Liability

6. Are outside directors of an issuing company subject to liability under RCW 21.20.010 and/or RCW 21.20.430(3) only if they are controlling persons of the issuing company?

7. Did Barnard and Boin establish, as a matter of law, that they were not controlling persons of the issuing company at the time of the offering?

Reliance Defense

8. May outside directors rely on officers, inside directors and/or independent counsel to make factual investigations and legal determinations as to what facts are material and therefore subject to disclosure in offering materials?

9. If the law recognizes a "defense of reliance," did Barnard and Boin establish, as a matter of law, that they are entitled to the protection of the defense?

Causation

10. Must an injured investor prove that the specific fact or facts omitted from the offering materials directly caused the security to become worthless?

11. Did Barnard and Boin establish, as a matter of law, that the health condition of the chief executive officer of the issuing company was not a substantial contributing factor to the failure of the company?

Negligent Misrepresentation

12. May injured investors state a cause of action for negligent misrepresentation against outside directors of an issuing company?

13. Did Barnard and Boin establish, as a matter of law, that they were not negligent toward Appellants in failing to disclose, or insist upon disclosure by the issuing company or its directors, of the health condition of the chief executive officer?

III. STATEMENT OF THE CASE

Appellants, who will be hereafter referred to as "Investors," are eight individual purchasers of stock in a now defunct company known as Data Line Systems, Inc. ("Data Line" or the "Company"), pursuant to a private placement of securities. Respondents Barnard and Boin are individuals who served as outside directors (i.e., they were not officers) of Data Line prior to and during the offering. Respondent Perkins Coie is a private law partnership which was retained as outside counsel by Data Line to give advice and assistance to Data Line in connection with the offering.

Also named as defendants in the actions below, although not parties to this appeal, were Data Line, three individuals who were officers and directors of Data Line (and their spouses), two individuals who were also outside directors of Data Line (and their spouses), the underwriter, Evans Llewellyn Securities, Inc., and its principals, Andrew Evans and Ann Llewellyn.

Data Line was founded in June, 1980 by former employees of Key Tronic Corporation, Dale Peterson and Gary Morgan. (CP 339-342) The Company was formed primarily to market an optical character recognition ("OCR") slot reader combined with a computer terminal for automating the processing of transactions by bank tellers. Although systems such as this were to some extent already in production by several other manufacturers, Data Line was convinced that its product represented a marked improvement in several respects. (CP 343-344)

Senior management of Data Line from its inception throughout the period of the stock offering in question consisted of Dale L. Peterson, director, president and chief executive officer; Gary B. Morgan, chairman of the board and executive vice president; and John T. Mason, director and secretary/treasurer.

Prior to the formation of Data Line, Peterson had been associated with Burroughs Corporation and later held positions of senior responsibility in Key Tronic Corporation in Spokane. At the time of the stock offering he was 47 years old and a capable executive with excellent marketing skills and an ability to attract lender and venture capital. (CP 340-341)

In addition to the three officers/directors named above, there were four other directors at the time of the stock offering. These included Lewis

Zirkle, Robert Cline and Respondents Barnard and Boin. Barnard and Boin purchased a significant interest in the Company -- 11% of the common stock each -- and were voted to the board of directors at the first annual meeting in June of 1980. (CP 339-342; CP 345-346; CP 392-393)

During the first one and one-half years of its existence, the Company was primarily engaged in designing its products. By early 1982, the board of directors had determined that the Company would need substantial outside financing in order to be successful. After reviewing various alternatives, the board authorized its officers to enter into an agreement with Evans Llewellyn Securities, Inc. for the sale of stock pursuant to a private placement memorandum. (CP 351-352) A business plan was prepared and given limited circulation to potential investors, including some of the Appellants. It described Peterson's health as "excellent." (CP 395)

On June 10, 1982, Data Line and Evans Llewellyn caused a private placement memorandum (the "PPM") to be circulated offering for sale to investors meeting certain suitability standards a minimum of 30,000 and a maximum of 70,000 shares of common stock in Data Line at a price of $25.00 per share. Under the terms of the PPM each investor was to make a minimum purchase of 2,000 shares for $50,000.00. The offering was to be terminated and investors' funds returned with interest if Data Line did not receive and accept subscriptions for at least 30,000 shares within a limited time period. The PPM, provided to each Investor before the actual purchase of stock, included the following disclosure:

> (9) Dependence Upon Key Personnel. The performance of the Company depends upon the active participation of its officers, including Dale L. Peterson, its President and Chief Executive Officer, and Gary B. Morgan, its Chairman of the Board, Executive Vice-President and Chief Operating Officer, and a small group of other technical and management personnel. The loss of any of these qualified personnel could have a material adverse effect upon the Company.

(Emphasis added.) (CP 357-358)

The PPM was published on June 10, 1982. Four days earlier, on June 6, 1982, Dale Peterson was hospitalized in Spokane and on June 7 diagnosed as having multiple aneurysms located in the blood vessels supplying his brain. (CP 359) Peterson was flown to the University Hospital in Seattle, where on June 10, 1982 -- the very day on which the PPM was circulated -- George Ojemann, M.D. opened his skull and closed off the aneurysm that had bled. (CP 360-362) Dr. Ojemann could not undertake to perform corrective surgery on the remaining aneurysm as it was located in the opposite hemisphere of Peterson's brain.

All of the directors were advised of Peterson's hospitalization and condition prior to his transfer to Seattle for surgery. (CP 366-367) Perkins Coie was advised of Peterson's condition at approximately the same time. (CP 366-367) Shortly after the surgery, Perkins Coie recommended in writing that information regarding Peterson's health problem be disclosed to investors prior to closing of the stock sales. Attorney Stuart Landefeld of Perkins Coie documented this decision in a letter as follows:

> Gary [Morgan] and I have discussed the possibility of Dale writing a letter to all investors on his health in thirty days, or before the closing. This would both provide full information and reassure investors. Let's plan on it.

(CP 370-371)

In spite of the fact that the June surgery was apparently successful, the existence of the remaining aneurysm presented a continuing problem. Following the surgery, and before his discharge on

June 16, Peterson was advised by Ojemann that he should have a second surgery to repair the remaining aneurysm, and that this surgery should take place within six months. (CP 363-365) Without that corrective surgery there could be another sudden bleeding episode which in turn would create a serious risk of death. For the otherwise normal person the risk of this occurring without corrective surgery would be at the cumulative rate of 2% per year. However, Peterson's remaining uncorrected aneurysm was larger than most in size. In addition, he suffered from high blood pressure. This combination of factors significantly increased his risk of another aneurysm explosion up to the time of the second surgery. There was a likelihood that the second surgery would correct the remaining aneurysm in the sense that it would prevent future bleeding. However, with any surgery on an aneurysm buried deeply in the brain there is a distinct risk that the patient's cognitive function will be adversely affected to some degree. (CP 363-365; CP 374-375; CP 376-378; CP 379-380)

Peterson and his wife knew of the doctors' concern and of the need for the future surgery. It does not appear that either Perkins Coie, Barnard or Boin actually knew of the existence of the remaining aneurysm, the need for future surgery, or the risks involved therewith. However, it is undisputed that neither Perkins Coie, Barnard nor Boin ever checked with Dr. Ojemann or any other treating physician with respect to the progress which Peterson was making. Nor is it disputed that none of the individuals expressly inquired of Peterson as to his exact condition. Rather, all chose merely to observe Peterson and draw lay conclusions from his appearance and behavior.

The eight Appellants subscribed for a total of $385,000.00 of stock in Data Line, which stock was issued pursuant to closings occurring between July 15, 1982 and January 11, 1983. (CP 11)

In mid-October of 1982, Peterson went to California to seek a second medical opinion. A review of an angiogram at that time disclosed the presence of two remaining aneurysms. A doctor there concurred in the advice given by Ojemann. He quoted Peterson describing himself as having a "time bomb in my head." (CP 148-150)

Peterson underwent a second surgery by Dr. Ojemann on December 7, 1982. The two aneurysms which were addressed in this process were located near the base of the right hemisphere of Peterson's brain. Almost immediately afterwards it became apparent that Peterson was not making a satisfactory recovery. By February of 1983 Peterson was experiencing mental problems including a severe depression. The board of directors became concerned and forced him to tender his resignation as chief executive officer. He did so on March 28, 1983. Later that year he took a medical leave of absence and never returned to Data Line.

Although Respondents argued below that (a) Peterson's depression was not caused by either the aneurysms or the surgery and (b) Peterson's retirement from the Company had nothing to do with its demise, the record in this case clearly supports a contrary finding on both points. Psychiatrist John E. Hamm, an expert consultant retained by Investors, presented an affidavit to the court which concluded that Peterson suffered from (1) organic mental disorder, post-intracranial aneurysm operations and (2) depression secondary to the diagnosis and surgical treatment of intracranial aneurysms. (CP 308-309, ¶ 6) Dr. Hamm concluded that there was a significant causal relationship between the aneurysms and the depression. (CP 308-309, ¶ 6)

Respondents below mischaracterized the testimony of Peterson's neurosurgeon, Dr. Ojemann, as concluding that Peterson's health problems were related to depression, not to his aneurysm operations. What Dr. Ojemann actually stated was his opinion that Peterson did not sustain frontal lobe damage during the surgery. He went on to say, however:

> What the precipitating factors were for [the depression] I am not totally sure.
>
> . . .
>
> The stress of the operation might have contributed . . . . (CP 387-388)

Nor did Respondents prove as a matter of law that Peterson's retirement was not a contributing factor to Data Line's failure. On June 6, 1983 -- one year after the offering -- Data Line wrote a letter to its shareholders stating:

> [H]owever, we did not meet our projected sales for 1982 nor did we meet our revenue projections. Additionally, we did not meet our expected gross margin percentages.
>
> We can identify the reasons for this poor showing, based upon the following facts:
>
> 1. Dale Peterson, president and CEO, had a brain aneurysm and operations in June and

> December which constrained his participation.
>
> . . .

(CP 384-386)

A draft prospectus approved by Barnard, Boin and the other directors in connection with a failed capitalization effort in 1983 states:

> During the _second_ _half_ _of_ _1982_* the efforts of the Company to change its orientation from research and development to marketing and sales _were_ _hampered_ _by_ _the_ _serious_ _illness_ of its then President. This _disabling_ _illness_ _persisted_ _throughout_ _the_ _period_ and eventually _required_ that he take a medical leave of absence. _See_ "Management Remuneration". Also during this period the need for additional working capital became critical and diverted significant executive time and effort from the sales and development of the Company's product line. _Both_ _of_ _these_ _factors_ _adversely_ _affected_ _the_ _Company's_ _results_, particularly since it had increased its level expenses in anticipation of additional sales.

(Emphasis added) (CP 372-373)

In July of 1984 the corporate stockholders voted to wind up the affairs of Data Line. Stock purchased under the PPM is worthless.

IV. ARGUMENT - PERKINS COIE

A. Investors May State A Cause Of Action Against Perkins Coie As Outside Counsel To The Issuer Pursuant To RCW 21.20.010 And/Or 21.20.430(3).

Perkins Coie's argument against attorney lia-

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* Note that the depression did not begin until 1983.

bility under the Washington State Securities Act (WSSA) is that the language of the WSSA must be literally construed to impose liability only upon those who fall within very narrow definitions of certain identified persons; since nowhere do the statutes expressly make attorneys liable for participating in the issuance of misleading offering materials, Investors have no cause of action against Perkins Coie.

This fits in quite nicely with an argument advanced by Barnard and Boin which would lead to the conclusion that, even admitting that a crucially material fact was omitted from the offering materials, no one is liable to Investors. The argument goes like this:

> The Washington Business Corporation Act specifically allows directors to delegate their duties and rely on the opinions of qualified experts, including attorneys. (RCW 23A.08.343). The Data Line directors delegated decisions regarding materiality to Perkins Coie, and relied on the ultimate recommendation of Perkins Coie not to disclose Peterson's health problems. Since the directors relied on Perkins Coie, it wouldn't be fair to hold them liable for the result. From Perkins Coie's standpoint, since attorneys are not expressly named in the WSSA, it would not be fair to hold Perkins Coie liable.

Investors do not believe that our Legislature intended such an absurd result, and do not feel that either the pertinent statutes or relevant case law dictate such an absurd result.

The WSSA is codified in RCW 21.20.005, et seq. The basic anti-fraud prohibition is contained in RCW 21.20.010, and provides in pertinent part as follows

> Unlawful offers, sales, purchases. It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> . . .
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make statements made, in the light of the circumstances under which they are made, not misleading. . . .

Washington's civil liabilities section is contained in RCW 21.20.430 and reads, in pertinent part, as follows:

> (1) Any person, who offers or sells a security in violation of 21.20.010 . . . is liable to the person buying the security from him or her, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at eight percent per annum from the date of payment, costs, and reasonable attorneys' fees . . .
>
> . . .
>
> (3) Every person who directly or indirectly controls a seller or buyer liable under subsection (1) . . . . above, every partner, officer, director or person who occupies a similar status or performs a similar function of such seller or buyer, every employee of such a seller or buyer who

> materially aids in the transaction, and every broker-dealer, sales person, [or other authorized seller] who materially aids in the transaction is also liable jointly and severally with and to the same extent as the seller or buyer, unless such person sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

RCW 21.20.430(1) expressly makes the actual issuer of the securities liable. RCW 21.20.430(3) expressly makes every partner, officer and director of the issuer liable, subject to a due diligence defense. In addition to the obvious participants expressly named, the statute should be interpreted to include unaffiliated professionals such as accountants and attorneys who are substantial contributors to the primary violation. The statutes in question leave four basic openings from which to derive independent professional liability under appropriate facts. These are as follows:

(1) Control person liability under RCW 21.20.430(3);

(2) Liability of persons performing a function similar to an officer or director under RCW 21.20.430(3);

(3) Employee liability under RCW 21.20.430(3); and

(4) An implied private right of action for aiding and abetting under RCW 21.20.010, or an "extended privity" argument under RCW 21.20.430(1).

1. <u>Perkins Coie Indirectly Controlled Data Line As To the Pertinent Non-Disclosure</u>.

Subsection (3) of RCW 21.20.430 expressly identifies several classes of individuals who are secondarily liable for securities violations. Included in this list is:

> every person who directly or indirectly controls a seller or buyer liable under [§ 21.20.430(1)].

Perkins Coie would have this Court believe that "control" means a voting majority of the shareholders and directors. In fact, "control" in this context means only the <u>power</u> <u>to</u> <u>influence</u> <u>the</u> <u>pertinent</u> <u>decision</u>. While no Washington case law defines the sweeping phrase "directly or indirectly controls" contained in the statute, case law and administrative interpretations in other jurisdictions construing comparable statutes shed light on these issues. The cases clearly define these terms broadly enough to encompass persons in positions comparable to that of Perkins Coie.

For example, the "control" language of the WSSA is similar to the broad language contained in Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o. In regulations implementing the federal securities laws, the SEC chose a broad, open-ended definition of "control":

> The term "control" . . . means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the person, whether through the ownership of voting securities, by contract, or otherwise.

17 CFR § 230.405 (1984).

Consistent with the SEC's approach, courts have interpreted Section 15 control person liability to extend to any person or entity that has the power to influence the seller of a security. Pennaluna & Co. v. SEC, 410 F.2d 861 (9th Cir. 1969), cert. denied, 396 U.S. 1007 (1970). Accord, Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968) (control person liability requires "only some indirect means of discipline or influence short of actual direction"); G.A. Thompson v. Partridge, 636 F.2d 945

(5th Cir. 1981); McFarland v. Memorex Corp., 581 F. Supp. 878 (N.D. Cal. 1984).

It is undeniable that Perkins Coie had the power to influence the Data Line directors in their decisions as to which matters were to be deemed material for purposes of disclosure. Indeed, this is one of the express purposes for which Perkins Coie was employed. Director Morgan testified in his deposition that Data Line followed Perkins Coie's advice not to disclose Peterson's health problems. (CP 444-446) In response to questioning by the directors, Perkins Coie affirmatively advised that no additional disclosure was necessary as to Peterson's health problems. (CP 444-446; CP 381-383) Andy Evans, of underwriter Evans Llewellyn, testified at his deposition that this was his company's first underwriting, and that the officers and directors of Data Line as well as his own company were heavily relying on the attorneys' advice as to what should be disclosed. (CP 474-475) Perkins Coie gave an express opinion that no material facts were omitted from the offering materials. Perkins Coie did not establish as a matter of law that it had no "indirect means of influence" regarding the decision to disclose or conceal.

2. Perkins Coie Performed a Function Similar To That of a Director In Regard to the Non-Disclosed Information.

Subsection (3) of § 21.20.430 also imposes secondary liability on:

> [E]very partner, officer, director or person who occupies a similar status or performs a similar function of [a seller or buyer liable under § 21.20.430(1)]. . . .

Nowhere is the inequity of Perkins Coie's argument more evident than in its denial of liability under this section of the WSSA. It is the primary responsibility of directors, on behalf of a corporate entity, to make the numerous important decisions involved in a public offering of securities. One of the most important of these decisions involves the determination as to what facts are material and therefore required to be disclosed to potential investors. This is one of the primary "functions" of a director. Rightly or wrongly, Barnard, Boin and the other directors expressly attempted to delegate this critical director function to Perkins Coie. There is no logical reason why director liability should not be extended to Perkins Coie in such circumstances.

Failure to extend liability in a case such as this could lead to the creation of an unintended major loophole to liability. Section 23A.08.343 of the Washington Business Corporation Act expressly allows directors to delegate certain duties and rely upon the opinions of qualified experts, including attorneys and accountants. Although this section was intended to enhance the business judgment rule defense available to directors in an action brought <u>by shareholders</u>, there is nothing on the face of the statute to prevent it from implying a new defense to liability under the securities laws, i.e., delegation of the function <u>and any resultant liability</u> to outside experts. However, outside experts will argue, as does Perkins Coie here, that they are not liable under the securities laws because they are not expressly named in RCW 21.20.430(1) or (3).

If both propositions are accepted by the courts, injured investors will be without a remedy. This patently inequitable dilemma can be resolved in either of two ways: courts can refuse to apply the Business Corporation Act delegation defense in securities litigation; or the courts can interpret the "function of a director" language in RCW

21.20.430(3) to have liability stay with whoever performs the actual function of the director. While either solution would be generally acceptable, consistent resolution is critical. The courts of this state cannot allow directors of an issuer to delegate responsibility for materiality disclosure decisions to outside counsel without giving injured investors a direct cause of action against outside counsel.

3. Perkins Coie was an Employee of Data Line.

Perkins Coie was retained (and presumably well paid) to give advice such as it gave regarding the materiality of Peterson's health problems. In Ackerman, Jablonski, Porterfield & DeTure v. Alhadeff [Blue Sky Law Reporter (CCH) ¶ 72,390 (W.D. Wash. 1986)], on a motion to dismiss, the court addressed the issue of whether an independent professional retained by the seller/issuer of securities may be an "employee" within the meaning of the statute. The court held that the accounting firm of Arthur Anderson & Company, which was retained by the issuer/seller to prepare audited financial statements, "could be considered an employee of the seller of the securities who materially aided the sales transactions." Id. at 71,768. Investors request this Court to interpret the "employee" liability language of Section 430(3) to include outside experts such as Perkins Coie specifically retained to aid in the offering process.

4. "Participant Liability" Beyond Those Literally Named in the Statutes is Recognized in Washington

Perkins Coie argues that RCW 21.20.430(1) requires strict privity between the seller and the purchaser of securities. Since Perkins Coie was not the actual seller of any of the securities, it claims that it cannot be liable under RCW 21.20.430(1). Such a strict and literal reading of the statute runs counter to the principles of interpretation established by the Washington Supreme Court as set forth in McClellan v. Sundholm, 89 Wn.2d 527, 533, 574 P.2d 371, 374 (1978):

> We note also that securities legislation is remedial in nature and has as its purpose broad protection of the public. Thus it is appropriate to construe the statute broadly in order to maximize the protection offered . . . .

Such a narrow reading of the WSSA would also run contrary to its legislative history. Prior to 1977, the civil liability provision of the WSSA,

§ 21.20.430, did not incorporate the prohibitions of § 21.20.010, which had been held to imply a broad private right of action. See Shermer v. Baker, 2 Wn. App. 845, 472 P.2d 589 (1970). In 1977, the Legislature amended the WSSA to broaden the express cause of action contained in § 21.20.430(1) and encompass the prohibitions set forth in § 21.20.010. These prohibitions include conduct that goes far beyond concepts of fraud or misrepresentation by persons in direct privity; § 21.20.010 outlaws all acts done "in connection with the offer, sale or purchase of any security directly or indirectly . . . ." (Emphasis added). An interpretation of § 21.20.430(1) that only sellers who engage in face-to-face transactions with purchasers are liable under the WSSA is plainly inconsistent with the intended incorporation of the broad prohibitions of § 21.20.010 into the express civil liability provisions of the WSSA.

Two Washington Court of Appeals cases expressly accept a "substantial participation" test for purposes of the WSSA. Both hold that "participants" in a transaction are liable under the WSSA even if they did not pass title of the security to the purchaser. In Golberg v. Sanglier, 27 Wn.

App. 179, 616 P.2d 1239 (1980), rev'd on other grounds, 96 Wn.2d 874, 639 P.2d 1347 (1981), the court held:

> Participant liability for a violation of RCW 21.20.010 may result from the rendition of assistance in perpetration of the violation even though the participant is not an actual party to the sale.

Id at 193 (Emphasis added).

Similarly in Kaas v. Privette, 12 Wn. App. 142, 529 P.2d 23 (1974), the court stated:

> Each party who joins in misrepresenting material facts to a prospective purchaser is required to return the defrauded purchaser to his former position when the grounds for rescission are proven. [Citations deleted]. Every participant in a fraud and each one who assists another in the perpetration of the fraud is liable to the injured party.

Id., at 151 (Emphasis added).

While both Goldberg and Kaas concern liability under § 21.20.010 and do not expressly address the provisions of § 21.20.430, the latter section only adds an express remedy to that which had previously been implied under RCW 21.20.010. Burgess v. Premier Corp., 727 F.2d 826, 839 (9th Cir. 1984)). See also Rainier National Bank v. Schnurr [1982-84 transfer binder], Blue Sky Law Reporter (CCH) ¶ 71,760 (Wash. Sup. Ct. 1981) (bank is security seller though it did not pass title).

Decisions of the federal courts construing § 12(2) of the Securities Act of 1933, which contains a parallel provision to the WSSA civil liabilities section, also make it clear that the notion of "seller" comprehends those who assist in the sales process. The Second, Fifth, Sixth and Ninth Circuits, for example, all accept the "substantial participation" test in Section 12(2) cases. E.g., Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969); Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 692 (5th Cir. 1971); Lewis v. Walston & Co., 487 F.2d 617 (5th Cir. 1973); Davis v. Avco Financial Services, Inc., 739 F.2d 1057, 1065-68 (6th Cir. 1984), cert. denied, 105 S. Ct. 1359 (1985); Admiralty Fund v. Jones, 677 F.2d 1289, 1294 (9th Cir. 1982); SEC v. Murphy, 626 F.2d 633, 650 (9th Cir. 1980).

Alternatively, if this Court concludes that RCW 21.20.010 and 21.20.430(1) require a showing of privity, there is no reason to apply a definition of privity different than normal tort or contract privity. Section 552 of the Restatement (Second) of Torts states in pertinent part:

> <u>Information negligently supplied for the guidance of others</u>.
>
> (1) One who, in the course of his business, profession or employment . . . supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to loss suffered
>
> (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
>
> (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Attorneys must realize that any information and advice they provide to issuers for use in connection with a securities offering will be passed on to a defined group of individuals -- potential investors -- to be relied upon by them in making their investment decision. Washington courts have held professionals imparting information which they know would be relied upon by others to a high standard of care. <u>See</u>, <u>e.g.</u>, <u>Rogers</u> v. <u>Toppenish</u>, 23 Wn. App. 554, 557, 596 P.2d 1096, 1098 (1979).

The courts of other states have also extended the liability of professionals to foreseeable recipients of information without strict privity. _See, e.g._, _Roberts v. Ball, Hunt, Hart, Brown & Baerwitz_, 57 Cal. App. 3d 104, 110, 128 Cal. Rptr. 901, 905-906 (1976) (the court applied a foreseeability-based balancing test in holding an attorney liable to third parties who relied upon his negligently prepared legal opinion). _See also_, _International Mortgage_ v. _John P. Butler Accountancy Corp._, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986); _Bradford Securities Processing Services, Inc._ v. _Plaza Bank & Trust_, 653 P.2d 188 (Okla. 1982).

Investors do not believe that Perkins Coie's assertions regarding strict construction of § 21.20.430(1) adequately address or accurately reflect the state of the law on this subject, and believe that primary liability for "participants" goes well beyond the literal seller of the security.

B. <u>Perkins Coie Did Not Establish, As A Matter Of Law, That Peterson's Health Condition Was Not A Material Fact Subject To Disclosure</u>.

Admittedly, if the trial court found that facts concerning Peterson's health were not material, then that finding alone would completely dispose of Investors' securities claims and probably Investors' negligent misrepresentation claims as well. However, it is impossible for the trial court to have found, as a matter of law, that facts concerning Peterson's health were not material. If anything, it is clear as a matter of law from the evidence presented that such facts were material. The only affidavit directly addressing the question of materiality is that of MacMillan Pringle (CP 303-306), an investment advisor consulted by Investors, which affidavit was uncontested. Mr. Pringle concluded that Peterson's health condition was a fact that a reasonable investor would consider material to his or her investment decision. The facts completely support this conclusion. Pertinent facts include:

(a) That on June 6, 1982, Dale Peterson was hospitalized and on June 7 diagnosed as having multiple brain aneurysms in the blood vessels to the brain, one of which had bled (CP 359);

(b) That on June 10, Peterson underwent "urgent" intracranial surgery to repair the aneurysm which had bled (CP 360-362; CP 374-375);

(c) That even after the surgery an untreated treated aneurysm remained (CP 363-365); and

(d) That Peterson's physician recommended that he undergo a second craniotomy within six months to repair the untreated aneurysm. (CP 363-365)

Amazingly, Perkins Coie, Barnard and Boin all contend that no reasonable mind could find that an investor would consider Peterson's health problems material facts to be weighed in his or her investment decision. Their logic can be summarized as follows:

> As of the date of the PPM, Peterson appeared to be recovering well from the initial brain surgery. Although facts concerning significant complications might have been material, there is nothing material about a typical recovery from brain surgery. Since the second brain surgery was six months away, potential complications from the second surgery would be speculative as opposed to material. Finally, since his retirement was caused by depression and not by bursting

> aneurysms, nothing concerning aneurysms disclosed in the PPM could possibly have been material in any event.

Not only is this sleight-of-hand logic factually unsupportable, but it misstates the legal standard applied to Investors' security claim.

Respondents asserted that Peterson's doctor had given him a clean bill of health after the first operation and that ". . . any failure to disclose an operation from which a full recovery had been made is not material." (CP 14-15). From this faulty premise they argue that no reasonable investor could attach importance to a past operation from which there was a complete recovery. This argument fails for a number of reasons. First, Dr. Ojemann had not given Peterson a clean bill of health following his first surgery. Peterson's condition post-surgery was that he would have to undergo a period of recovery from the first surgical procedure, that he carried at least one untreated aneurysm with a danger of rupture, and that he should undergo a second brain surgery within six months. (CP 363-365). Respondents also argue that, at least as of the first two closings, the aneurysms had not affected Peterson's health. This, however, is premised upon a false assumption as to the element of causation, which is discussed in more detail in Section V.E. below. It is sufficient for purposes here to note that there is no requirement that Peterson's <u>disability</u> actually occurred prior to the time the stock was sold.

Just as Respondents did not prove as a matter of law that Peterson's health problems were not significant, they did not prove as a matter of law that Peterson's active participation in Data Line was not crucial. As set forth in the statement of facts above, Data Line made three clear and express admissions on these points:

(1) Peterson was described in the PPM as a key man whose loss "could have a material adverse effect upon the Company" (CP 357-358);

(2) A June 1983 letter from Data Line to its shareholders attributed the Company's poor performance in 1982 to the constraints on Peterson's participation caused by his "brain aneurysm and operations" (CP 384-386); and

(3) A subsequent draft prospectus attributed the Company's poor performance in 1982 to Peterson's "serious" and "disabling illness." (CP 372-373)

It is undeniable that any fact concerning a serious health problem of Peterson would have been material to a reasonable investor. If this is not adequately established by common sense, it is more than adequately documented in the Affidavit of MacMillan Pringle. A grant of summary judgment to Perkins Coie (and to Barnard and Boin as well) cannot be supported by a finding that the facts concerning Peterson's health were not material.

C. <u>Investors May State A Cause Of Action For Negligent Misrepresentation Against Perkins Coie As Outside Counsel For Data Line</u>.

<u>Perkins Coie Did Not Establish, As A Matter Of Law, That It Was Not Negligent Toward Investors In Failing To Disclose, Or Insist Upon Disclosure By Data Line Or Its Directors, Of Peterson s Health Condition</u>.

The court below also granted Perkins Coie summary judgment of dismissal as to Investors' claims against Perkins Coie for negligent misrepresentation. While the order was not specific, the ruling could be justified only upon finding that (a) as a matter of law, Investors may not state a claim for negligent misrepresentation directly against Perkins Coie, or (b) although Investors could state such a claim, Perkins Coie disproved it as a matter of law. Neither of these contentions can be supported upon review by this Court.

There is ample support for the proposition that Perkins Coie owed a duty of care to Investors, who were part of a foreseeable group of prospective stock purchasers and among the intended recipients of the information provided to Data Line by Perkins Coie.

The Washington courts, adopting the criteria of § 552 of the Restatement (Second) of Torts, have imposed liability on those who supply false information knowing that the information will be given to someone else who will rely on it. The text of § 552 is set forth on p. 28 above, and will not be repeated here.

In Wilbur v. Western Properties, 22 Wn. App. 458, 463-64, 589 P.2d 1273, 1277 (1979), following the principles of the Restatement, the court found a city and county liable for the injuries of plaintiff for misrepresentations made to plaintiff's architect and engineer. The court took no notice of the fact that the misinformation had reached the plaintiff indirectly. In Transamerica Title Ins. Co. v. Johnson, 103 Wn.2d 409, 417, 693 P.2d 697,

affirmative

701 (1985), the Washington Supreme Court reaffirmed the use of Restatement § 552 to analyze negligent misrepresentation. Recovery in Transamerica was denied because plaintiff did not rely on the defendant's misrepresentation. However, in the context of a securities action, reliance will be presumed as to the omission of a fact which is deemed material, i.e., plaintiff need not prove in the negative that he relied on the absence of the omitted fact. E.g., Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 92 (2d Cir. 1981).

affirmative

but higher standard: scienter

It is also worthy of note that the courts of Washington and other states have held professionals imparting information which they know would be relied upon by others to a high standard of care without a finding of strict privity. See Rogers v. Toppenish, 23 Wn. App. 554, 557, 596 P.2d 1096, 1098 (1979); International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (4th Dist. 1986); Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal.App. 3d 104, 110, 128 Cal. Rptr. 901, 905-06 (2nd Dist. 1976); Bradford Securities Processing Services, Inc. v. Plaza Bank & Trust, 653 P.2d 188 (Okla. 1982).

(?)

These principles of extended liability apply quite appropriately in the instant case. Perkins Coie, by failing to insist on disclosure of the facts concerning Peterson's health problems, effectively supplied false information to Investors -- an obviously foreseeable group of information recipients who would inevitably be relying upon the accuracy and completeness of the information provided to them. Needless to say, Perkins Coie's self-serving disclaimer that no one other than the underwriter was entitled to rely on the "opinion" is no defense.

MR - distinguish

Nor can the summary judgment be upheld by finding that Investors' negligent misrepresentation claim failed as a matter of law. It is uncontested that Perkins Coie was aware of the first aneurysm and operation. There are no facts to support a finding that Perkins Coie could not have made simple inquiry of Peterson's physicians. There are no facts to support a contention that Investors were not foreseeable recipients and users of the facts which were the subject of Perkins Coie's opinion on disclosure. Perkins Coie cannot demonstrate as a matter of law that the omitted facts were not material. This Court must conclude that

Investors may state a claim for negligent misrepresentation against Perkins Coie and that such claim was not the proper subject of dismissal by summary judgment.

V. ARGUMENT- BARNARD & BOIN

A. Barnard And Boin Did Not Establish, As A Matter Of Law, That Peterson's Health Condition Was Not A Material Fact Subject To Disclosure.

This issue is factually and legally identical to that discussed in Section IV.B. above, and the argument will not be repeated here. Investors submit that the summary judgment granted to Barnard and Boin cannot be supported on the ground that Peterson's health condition was not material as a matter of law.

B. Outside Directors Of An Issuing Company Are Subject To Liability Under RCW 21.20.010 And 21.20.430(3) Irrespective Of Whether They Are Controlling Persons Of The Issuer.

One possible basis for the trial court's grant of summary judgment was the legal conclusion that outside directors cannot be liable unless they are controlling persons. However, § 21.20.430(3) expressly makes directors of an issuing corporation liable *per se*, subject to a due diligence defense which each director bears the burden of proving. The statute clearly does not distinguish between "inside" and "outside" directors, and liability may exist without control person status. Although no Washington case directly addresses the specific language in question, the courts of other states with Blue Sky laws identical to Washington's have addressed the question and have concluded that the plain language should be given its obvious meaning.

In Foelker v. Kwake, 568 P.2d 1369 (Ore. S. Ct. 1977), an officer/defendant argued that the evidence did not reflect in any way her participation in any of the illegal transactions. The court responded:

> Under the provisions of ORS 59.115(3), however, no such personal participation need be proved to impose liability, it being sufficient that the defendant was an officer of the corporation, unless the defendant sustains the burden of proof that he or she did not and could not reasonably have had knowledge of the facts on which liability was based. There was evidence in this case that Nancy Kwake was an officer of Verde. She testified that she did not "participate" in the business activities of Verde, but offered no evidence that she did not know or could not reasonably have known of the existence of the facts on which liability was based, as required by ORS 59 115(3).

Id. at 1373 (emphasis added).

Similarly, in Arnold v. Dirrim, 398 N.E.2d 426 (Ind. App. 1979), director Arnold argued that the language of Indiana Code 1971, 23-2-1-19(b), which is substantially identical to RCW 21.20.430(3), should be read to impose liability only on directors who materially aid in a sale. The court quickly rejected this contention, stating:

> From a grammatical standpoint, with due regard for punctuation, it seems apparent that the statutory provision imposes absolute liability upon the director of a corporation to purchasers of securities sold in violation of the Securities Act based upon his position as a director unless he proves the statutory defense. It should be observed that the [material aid] clause relates only to employees of the seller, broker-dealers or agents. If it had been the intent of the General Assembly to make directors liable only in the event they had materially aided in the sale, it would have been an easy matter to have the statute read "every partner, officer, or director of such a seller who materially aids in the sale."

Arnold at 433-434 (Emphasis added).

In 1977 the Washington Legislature amended § 21.20.430(3) to clearly disjoin the material-aid clause from the language making directors *per se* liable. While the rule may be different in states where *scienter* is an element of the offense, *per se* liability of a director is well established in states with statutes similar to Washington's where *scienter* is not an element. *See*, *e.g.* *Moerman* v. *Zipco*, *Inc*., 302 F. Supp 439 (E.D.N.Y. 1969);

Mitchell v. Beard, 513 S.W.2d 905 (Ark. 1974); Gardner v. Donovan, 613 P.2d 1097 (Ore. App. 1980).

Barnard and Boin cited two cases in support of the proposition that outside directors are held to a different legal standard. Both of these cases are easily distinguished. One of the cases is Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973). In Lanza, the court focused on the liability of outside director Coleman. The facts accepted by the Court demonstrated that Coleman had no actual knowledge of any of the pertinent misrepresentations, nor did he have any other "active participation" in the wrongful conduct. His alleged liability hinged solely upon his status as a director of the issuing company.

An injured investor filed suit against Coleman and others under federal Rule 10b-5. While the language of 10b-5 is substantially identical to RCW 21.20.010, 10b-5 is enforced by an implied right of action, whereas § 21.20.010 is primarily enforced by the express rights of action set forth in § 21.20.430(1) and (3). As recognized in Lanza, courts have held that there is no implied per se individual liability under 10b-5; individual liability requires either active participation in the wrongdoing or an unjustified failure to act by one in a control capacity. RCW 21.20.430(3), on the other hand, imposes an express legal duty upon directors in excess of the liability implied under 10b-5.

The other case is Burgess v. Premier Corp., 727 F.2d 826 (9th Cir. 1984). In Burgess, outside directors Schrock and Darby were found to have had no active involvement in the misrepresentations, nor -- as a matter of fact -- were they control persons. The court properly held that, absent active participation in the misrepresentation, and absent control person status, a Federal Rule 10b-5 claim could not be established against them.

The court then addressed the WSSA claims against Schrock and Darby. While the court's decision is correct as far as it goes, it failed to address a critical issue. From the structure of the brief passage discussing the WSSA, it is clear that the court did not consider or address the per se liability issue. The court first addressed potential liability under 21.20.010 without regard to the express rights of action created by § 21.20.430. The court concluded that any implied remedy would be the same as under 10b-5, i.e., there would be no liability for a director absent some active participation in the misconduct. The court then addressed control person liability as created by § 21.20.430(3). The court concluded that, as with control person liability under 10b-5, some actual participation in the corporation's operation was required. The court quite clearly did _not_ address the language in § 21.20.430(3) expressly making directors liable _per se_. This omission is not explained. Whatever the reason, the gap clearly exists, and Barnard and Boin cannot cite _Burgess_ to negate the express _per se_ liability of directors created by § 21.20.430(3).

The proper test regarding the _per se_ liability of directors created by § 21.20 430(3) is as stated in _Arnold_:

> [I]t seems apparent that the statutory provision imposes _absolute liability upon the director_ of a corporation to purchasers of securities sold in violation of the Securities Act based upon his position as a director . . . .

Arnold at 433-34 (Emphasis added).

C. _Barnard And Boin Did Not Establish, As A Matter Of Law, That They Were Not Controlling Persons Of Data Line At The Time Of The Offering_.

In addition to _per se_ liability as directors, Barnard and Boin are expressly liable under

§ 21.20.430(3) if they directly or indirectly controlled Data Line. Barnard and Boin argued quite strenuously that they were not, as a matter of law, control persons of Data Line. Acceptance of this proposition by the trial court judge is a probable basis for the granting of summary judgment. Investors feel quite strongly that when the law is correctly applied to the facts as they must be assumed for purposes of summary judgment, such judgment was not warranted.

Barnard and Boin argued that Burgess holds that outside directors cannot be liable as control persons. Burgess does not so hold. Rather, it stands for the proposition that control person liability is dependent upon the actual facts of the case, and not upon one's characterization as an inside or outside director. In Burgess, the court found after presentation of all the evidence that two outside directors were not -- as a matter of fact -- control persons. The court noted:

> This court has indicated that there can be no liability if the controlling person "was not a participant in . . . activities which are claimed to violate the securities laws." [Citation deleted]. A director "is not automatically liable as a controlling person. There must be some showing of actual participation in the corporation's operation or

> some influence before the consequences of control may be imposed."

Burgess at 832.

The question then becomes one of establishing whether or not a particular director -- regardless of inside or outside status -- exerted the requisite control. The Burgess court found that the two directors escaping liability (1) were uninvolved in the corporation's day-to-day operations; (2) had no experience in the corporation's business; (3) had no experience in the corporation's industry; (4) had nothing to do with the preparation of the offering materials in question; and (5) (with respect to one of the directors) had minimal interaction, partly due to ill health, and resigned from the board before the investors lost money. Id. at 832-833. Burgess appears to state three tests by which control person liability may be established. As will be shown, Barnard and Boin did not establish as a matter of law that they do not qualify as control persons under one or more of these tests.

The first test is whether the director acted in bad faith and induced the violative conduct. The facts set forth above support the inference that Barnard and Boin, because of their interest in the success of the offering both as directors of Data Line and as substantial investors, were motivated by self-serving impulses, which inference in turn supports a finding of bad faith on their part in failing to disclose Peterson's serious health problems. The failure to insist upon disclosure of these facts clearly induced the violative conduct complained of here.

The second test is whether the director participated in the violative activities, i.e., the failure to disclose material facts to Investors. Contrary to the assertions that the outside directors had no part in the preparation of the offering materials or in the offering itself, the record is replete with instances of participation by Barnard and Boin in the offering process. Board minutes in January of 1982 reflect a discussion of how to satisfy the Company's financial requirements of from $1.5MM to $2MM over the next 18 months. (CP 351-354) At a February 1982 board meeting, a discussion identifying those underwriters that had been in contact with Data Line regarding financing was presented. The proposal of Evans Llewellyn was thoroughly discussed and several significant changes were recommended as negotiating points.

(CP 355-356) Cline testified at deposition that the Board was actively involved in coaching the officers on the terms of the agreement to be negotiated with Evans Llewellyn's underwriting of the private placement, and that it reviewed the contract between Data Line and Evans Llewellyn before it was entered into. (CP 412-413) Cline also testified that the full board of directors reviewed a number of drafts of the PPM before it was finalized. (CP 414-416)

The third test concerns "actual participation" in or at least "some influence" on the operation of the offending company. Again, the record supports the existence of such participation in or influence on Data Line's operation.

Moreover, the definition of control is not limited to the factors set forth in Burgess. As discussed in Section IV.A. above, there is an abundenace of authority interpreting the control language of Section 15 of the Securities Act of 1933 to the effect that the mere power to influence the critical decision constitutes control. The record amply supports a finding that both Barnard and Boin, as active participating directors, exercised a significant degree of control over the general operations of Data Line. Nor can it be denied that they had the very real power -- and the very real opportunity -- to insist upon disclosure of Peterson's serious health problems and thereby control and prevent the wrong which occurred here.

Mr. Barnard was elected to the board at Data Line's initial annual meeting. (CP 345-346) He was also a major stockholder of an investor in the corporation (CP 392-393) and brought to the board a significant level of management experience. He had been an owner and president of Seattle Packaging Corporation since 1967 and served on the board of directors of Fray Equipment Co. (CP 339-342)

Mr. Boin also was seated on Data Line's board from the start, having made a substantial investment in the Company. (CP 345-346; CP 392-393) He had been since 1972 a principal with the national actuarial firm of Milliman & Robertson, Inc. (CP 339-342)

In summary, the evidence before the trial court, together with reasonable inferences therefrom, shows an active group of outside directors contributing their seasoned judgment and direction to the management of the young company -- particularly in its efforts to finance the Company by use of the PPM which is the subject of this suit. By any of the various tests, Barnard and Boin qualified as "direct or indirect" control persons for purposes of RCW 21.20.430(3). Barnard and Boin clearly failed to establish that no reasonable mind could conclude that they were control persons within the meaning of § 20.21.430(3).

As a corollary to their control person argument, Investors anticipate that Barnard and Boin will argue that their duty to disclose was strictly limited to facts within their actual knowledge, and that they had no duty to investigate further. From this they will argue that their actual knowledge was limited to the fact that Peterson had undergone brain surgery and appeared to their inexperienced eyes to be recovering well. In support of this proposition, they will quote a footnote from <u>Lanza</u> pointing out that the language of the Uniform Securities Act does not expressly contain an "affirmative duty of investigation." <u>Lanza</u> at 1309, fn. 105. This is the sole underpinning of their argument that they as individual directors were justified in failing to disclose what they knew and in failing to investigate further. There are three problems with this argument.

First, any argument that individual directors had no duty to investigate facts beyond what they actually knew in no way mitigates their clear obligation to disclose the facts within their actual knowledge. It is a fact that Barnard and Boin knew of Peterson's first brain surgery as of the approximate date that the PPM was issued. This fact was material, and their failure to disclose it renders them liable for all injuries that occurred to Investors. Investors' proof could stop here and they would prevail.

Second, although the PPM was issued on June 10, 1982, the actual closings occurred over the ensuing eight months. It is fundamental securities law that Barnard and Boin had an ongoing duty to supplement and/or amend the PPM to reflect material changes since the initial publication of the PPM. E.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972). While Barnard and Boin may, in fact, not have known about the additional aneurysms and the need for a second craniotomy on June 10, 1982, on January 11, 1983 -- the date of the last closing involving an Investor -- they certainly knew about the second craniotomy which had taken place one month before. Other closings involving Investors occurred on August 11, 1982, October 14, 1982, and December 1, 1982. Barnard and Boin produced no evidence that they could not have learned about the remaining aneurysms in time to have insisted upon disclosure to Investors who purchased Data Line stock after June 10, 1982.

Third, Lanza fn. 105 does not correctly state the law in Washington. The Lanza court was addressing a director's duty to investigate and to convey information to potential investors under federal Rule 10b-5. As the Lanza court noted in the text of its decision, 10b-5 liability requires a showing of scienter on the part of a defendant, i.e., that he acted with knowledge of the falsity or with reckless disregard as to its truth or falsity. The Lanza court was understandably reluctant to conclude that recklessness or an intent to deceive could be implied to an individual who had no actual knowledge of the problem absent some express duty to investigate. When Lanza was decided in 1973, it was not clear that comparable state Blue Sky laws would not similarily require scienter as an element of state claims. This is the context in which, in pure dicta, the Lanza court commented that the Uniform Securities Act did not expressly contain an affirmative duty to investigate.

In 1980, the Washington Supreme Court declared that scienter is not an element of a claim under the WSSA. Kittilson v. Ford, 93 Wn.2d 223, 608 P.2d 264 (1980). The standard is one of strict liability. Thus, the logic of Lanza is not compelling -- while it might not be appropriate to imply intent or recklessness from a mere failure to investigate, where strict liability controls, it does not follow that the failure to investigate is pertinent.

This proposition is supported by the clear language of § 21.20.430(3). After making certain classes of individuals expressly liable for securities violations, it goes on to provide a good faith defense. A named person is liable:

> unless such person sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

(Emphasis added.)

While there may be no express duty to investigate, the statute clearly places the burden of proof upon an individual otherwise liable to negate liability by affirmatively proving that the individual could not in the exercise of reasonable care have known about the misrepresentation or omission. As discussed above, Barnard and Boin (i) are expressly liable under the terms of § 21.20.430(3); (ii) were in fact aware of Peterson's first brain surgery; (iii) were undeniably aware of the importance of Peterson to the success of Data Line; and (iv) were in a position to command access to Peterson's true medical condition. Neither can credibly contend that it was beyond his reasonable ability to learn the full truth about Peterson's serious medical condition.

D. Barnard And Boin, As Outside Directors, May Not Rely With Impunity On Officers, Inside Directors, And/or Independent Counsel To Make Factual Investigations And Determinations As To What Facts Are Material And Therefore Subject To Disclosure In Offering Materials.

Even If The Law Recognizes A "Defense Of Reliance," Barnard And Boin Did Not Establish, As A Matter Of Law, That They Are Entitled To The Protection Of The Defense.

In their summary judgment motion, Barnard and Boin raised as a defense to liability that they expressly delegated to the inside directors the task of gathering all material facts and making all determinations as to which facts were material and therefore subject to disclosure. While this is not per se offensive to Investors, it becomes so when Barnard and Boin also seek to place full liability for any resulting mistakes on the inside directors. Further, although the matter was not specifically raised in their summary judgment papers, Barnard and Boin may assert as an additional argument on appeal that they had a similar right to rely on the advice of Perkins Coie as to what facts were material and therefore subject to disclosure.

Barnard and Boin cannot claim justifiable reliance upon the advice of the inside directors. In Arnold v. Dirrim, 398 N.E.2d 426 (Ind. App. 1979), the Court was called upon to interpret Indiana's Blue Sky laws, which are in pertinent part substantially identical to those of Washington. Defendant Arnold attempted to escape liability by claiming that he justifiably relied on assurances of the company's president as to the existence of certain material facts. In rejecting this defense, the court noted:

> Actually, the bulk of Arnold's argument focuses not on his lack of knowledge about the facts but rather that he was unaware the law attached significance to those facts. He directs attention to the portions of the transcript indicating that he relied on [the company president's] representations and judgment that the sales were proper. Moreover, he proposes that an affirmative defense

> requiring a "director need only have a good faith belief that the sales are legal to escape liability" should be engrafted into the statute.
>
> These assertions miss the mark. The statute imposes liability on those who know the applicable facts without regard to their knowledge of the law.

Arnold at 435 (Emphasis added).

This position is clearly reinforced by Rzepka v. Farm Estates, Inc., 269 N.W.2d 270 (Mich. App. 1978). Defendant directors appealed a state securities claim judgment entered against them, claiming in essence that they were not aware of the legal significance of the facts either known to them or within their knowledge. The court rejected this proposition, stating:

> Although no evidence exists that Refior knew of the stock's unregistered status, likewise no evidence appears that he "could not have known" of this fact. Since the individual defendants have clearly failed to establish their lack of knowledge, actual or constructive, we find them liable under [the Michigan blue sky laws] in their positions of directors and officers of the corporation. Their ignorance of Blue Sky Laws is irrelevant for purposes of this statute, as the exception only speaks to the lack of knowledge of "the existence of the facts by reason of which the liability is alleged to exist." Clearly, under the statute, ignorance of the law is no excuse.

Rzepka at 273 (Emphasis added).

Nor can Barnard or Boin claim justifiable reliance on the advice of Perkins Coie. From a factual standpoint, there is no evidence to dispute that Barnard and Boin had access to the full facts concerning Peterson's health condition in a degree at least equal to that of Perkins Coie. They cannot say that they relied on Perkins Coie to gather the pertinent facts.

Moreover, reliance on the legal advice of Perkins Coie would be no defense to liability in this case. In support of their claim of justifiable reliance, Barnard and Boin cited § 23A.08.343 of the Washington Business Corporation Act. Barnard and Boin will ask this Court to construe this statute to create a new and additional defense to RCW 21.20.430(3). In fact, § 23A.08.343 was designed to implement the business judgment rule vis-a-vis a director's liability to the corporation.[1] Respondents can offer no compelling statutory or case support for an interpretation of § 23A.08.343 that would effectively emasculate the

1 Indeed, this defense was raised by a director in Everets v. Holtman, 667 P 2d 1028, 1033 (Ore. App. 1983). The court reviewed the language of the Oregon Corporation Code, which is similar to § 23A.08.343, and concluded that compliance sheltered a director from liability to the corporation but not from investors with a securities claim.

liability imposed upon individuals under the WSSA. Nor can they reconcile their desired narrowing of the statute with the pronouncement of the Washington Supreme Court in McClellan v. Sundholm, 89 Wn.2d 527, 533, 574 P.2d 371, 374 (1978):

> We note also that securities legislation is remedial in nature and has as its purpose broad protection of the public. Thus it is appropriate to construe the statute broadly in order to maximize the protection offered.

When the Legislature adopted § 21.20.430(3), it saw fit to provide one defense. If the Legislature had desired to provide the additional defense of reliance on inside directors or outside counsel, it would have been a simple matter to do so.

While no Washington case addresses this point directly, the courts of other states have had the opportunity to consider the question of reliance on outside experts. In Marshall v. Harris, 555 P.2d 756 (Ore. S. Ct. 1976), the defendant attempted to escape liability for failure to register a security by claiming reliance upon advice of counsel that the interest sold was not a security subject to registration. After noting that the Oregon Securities Law must be "liberally construed to afford the greatest possible protection to the public," the court concluded:

> Consistent with that view, we have held that good faith and even reliance upon advice of counsel is not a defense

Marshall at 760.

Neither Barnard nor Boin can honestly claim ignorance of the facts -- or inability to obtain the full facts -- as to Peterson's serious health problems. They contend that they relied on Perkins Coie to advise them of the legal significance of these facts, and additionally contend that they relied on assurances by the inside directors that Peterson's health condition was not material. However, having either actual knowledge of or reasonable access to the true facts, neither Barnard nor Boin can seek refuge in a claim that he did not know the legal significance of the facts.

E. Investors Need Not Prove That The Specific Fact(s) Omitted From The Offering Materials Directly Caused The Securities To Become Worthless.

Barnard And Boin Did Not Establish, As A Matter Of Law, That Petersons's Health Condition Was Not A Substantial Contributing Factor To The Failure Of Data Line.

Barnard and Boin contended below that traditional tort causation is an element of a claim under the Washington State Securities Act, and that at trial Investors will bear the burden of proving (i) that Peterson's aneurysms caused his retirement from Data Line and (ii) that Peterson's retirement caused the failure of Data Line. Although Investors believe that the facts support the inference that Peterson's aneurysm operations did indeed substantially contribute to the demise of Data Line, Barnard and Boin are incorrect in their assertion of the level of causation which Investors must prove to establish their case.

Barnard and Boin relied primarily on the case of Shermer v. Baker, 2 Wn. App. 845, 472 P.2d 589 (1970), in support of their contention that causation is an element of a WSSA claim. They are reading far more into Shermer than is there. In Shermer, Division II of tle Court of Appeals approved a jury instruction that, inter alia, "advised the jury that plaintiff had the burden of proving that defendant violated one or more of the legal duties imposed upon him by law" and that "defendant's violation of one or more of the described legal duties caused the plaintiff's damages." Shermer, at 851. Legal research has failed to reveal any other Washington case where the words "cause" or "causation" are used in this context.

Respondents' misunderstanding as to the "element" of causation is understandable. Reliance and causation are terms not always defined consistently by the courts in analyzing securities claims. As the second circuit noted in Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981):

> The concepts of reliance and causation have often been used interchangeably in the context of rule 10b-5 cases. [Citation deleted]. Indeed, in addressing the issue of reliance, courts have said that "the test is properly one of tort 'causation in fact.'" [Citation deleted]. Although we will speak primarily in terms of reliance, a distinction should be noted between cases involving affirmative misrepresentations and those involving non-disclosure. The concept of reliance in a case of affirmative misrepresentations embodies two separate questions: (1) Did the plaintiff believe what the defendant said, and (2) was this belief the cause of the plaintiff's action?

Id. at 92, n. 6 (Emphasis in original).

Thus, in a typical misrepresentation case, plaintiff would have to prove that he relied on the misrepresentation, that is, that he believed it and that this belief, in part, caused him to purchase the security. Quite clearly, it is not incumbent upon plaintiff to prove that the misrepresented fact was the cause for the security to become worthless.

This doctrine has been expressly reinforced by the Ninth Circuit in Hatrock v. Edward D. Jone & Co., 750 F.2d 767 (9th Cir. 1984). The court addressed a recent trend in federal 10b-5 cases to distinguish between "transaction causation," i.e., whether the violative conduct induced the purchase of securities, and "loss causation," i.e., whether the violative conduct was causally related to the decrease in value of the security. Where plaintiffs are claiming not that the misrepresentation or omission caused them to pay more for the stock than they otherwise would have, but that the misrepresentation or omission caused them to buy the stock in the first place, then loss causation is not an element. The Ninth Circuit stated:

> The plaintiff, however, should not have to prove loss causation where the evil is not the price the investor paid for a security, but the broker's fraudulent inducement of the investor to purchase the security. See Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1173 (2d Cir. 1970).

Hatrock, at 773.

In Kelsey v. Nagy, 410 N.E.2d 1333 (Ind. App. 1980), the Indiana Court of Appeals confronted a similar situation in applying the Indiana State Blue Sky laws, which are substantially identical to those of Washington. The court held:

> Kelsey further argues that the judgment on the evidence was improper because the Nagys did not show that the failure to disclose the source of the stock affected the price of the stock. The Nagys, however, were not seeking damages; they were seeking a rescission of the purchase. It is not necessary that the party seeking to rescind a purchase establish that the facts misrepresented or omitted were such as to affect the price of the stock. It is sufficient if that party shows that the facts misrepresented or omitted were material. Associated Lathing & Plaster Co. v. Louis C. Dunn, Inc., (1955), 135 Cal. App. 2d 40, 286 P.2d 825; E. E. Atkinson & Co. v. Neisner Bros., (1935), 193 Minn. 175, 258 NW 151, 259 NW 185., Fawkes v. Knapp, (1970), 138 Minn. 384, 165 NW 236.

Kelsey at 1337.[2]

Thus, at the very most, Investors here will have to demonstrate at trial a causal nexus not between Peterson's aneurysms and Data Line's demise, but between Respondents' failure to disclose material facts and Investors' decision to purchase the stock. If the law were otherwise, issuers would be tempted to gamble on future events to bail them out of even nominal liability for hiding facts from potential purchasers.

---

2 The use of the word "rescission" by the Kelsey court may be technically imprecise. Under both the Indiana and Washington statutes, the measure of damages is the price paid for the security plus interest and costs, or if it has been sold, the actual loss plus interest until sold and costs. This remedy is effectively that of rescission rather than benefit of the bargain.

Moreover, as clearly pointed out in the Wilson case, in non-disclosure cases reliance will be presumed if the omission is material:

> In a case of non-disclosure, the task of positively proving reliance may become impossible to perform, and although the courts still refer to the element of causation in fact, the question really becomes one of materiality . . . .

Wilson, supra, at 92. This principle has been expressly recognized by the United States Supreme Court:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of his decision. [Citations deleted.] This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741, 761 (1972). This identical issue was resolved in the same manner by the Indiana Appellate Court in Kelsey, supra, at 1337.

Investors do not have to prove in the negative that they affirmatively relied on the absence of any representations as to Peterson's health condition in reaching their investment decision. List

v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir. 1965). The record amply supports the conclusion that the omissions were material. This fact alone renders the granting of summary judgment based upon a finding of no causation unsupportable.

Even if causation is an element of a WSSA claim, Barnard and Boin did not establish as a matter of law that Peterson's undisclosed health condition was not a significant contributing cause to the demise of Data Line. The information set forth in the affidavit of Dr. Hamm (CP 307-309) and the testimony of Peterson's own treating surgeon, Dr. Ojemann (CP 387-388) at the very least create a material question of fact as to loss causation. As the Second Circuit noted in addressing the so-called "causation" element in Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27, 34 (2d Cir. 1976):

> [Plaintiff] was not required to prove that the Laventhol material was the sole and exclusive cause of his action, he must only show that there was "substantial," i.e., a significant contributing cause.

(Emphasis added)

In fact, the court in Herzfeld used the "significant contributing cause" language in connection with the proof of transaction causation. As to the level of proof required for loss causation, the court in Wilson v. Comtech Telecommunications Corp., supra, stated:

> [D]emonstration of [transaction causation] is the critical issue, as once this is done, [loss causation] is demonstrated rather easily by [the plaintiff's] proof of some form of economic damage -- the loss he suffered upon selling his shares.

Wilson, supra. at 92-93, n. 7.

VI. CONCLUSION

Investors respectfully request this Court to reverse the decisions below and rule that:

(1) Injured investors may state a cause of action directly against outside counsel for an issuer pursuant to RCW 21.20.010, RCW 21.20.430(1) and RCW 21.20.430(3);

(2) Injured investors may state a cause of action for negligent misrepresentation direcily against outside counsel for an issuer;

(3) Injured investors may state a cause of action for negligent misrepresentation against directors of an issuer;

(4) Outside directors are per se liable for violations of the Washington State Securities Act, subject to the defense stated in

RCW 21.20.430(3), irrespective of whether or not they are control persons of the issuer;

(5) Outside directors may not delegate their liability under RCW 21.20.430(3) to officers, inside directors, or independent counsel who are assigned or retained to make factual investigations and/or legal determinations as to what facts are material and therefore subject to disclosure;

(6) Injured investors need not prove "loss causation," i.e., that the omitted fact(s) directly caused the security to become worthless;

Investors also request this Court to declare that material questions of fact exist as to the following:

(a) Whether Peterson's health condition was a material fact subject to disclosure;

(b) Whether Perkins Coie was a control person of Data Line, performed the function of a director of Data Line, or was an employee of Data Line for purposes of RCW 21.20.430(3);

(c) Whether Barnard and Boin were control persons of Data Line for purposes of RCW 21.20.430(3);

(d) Whether Barnard and Boin satisfied the criteria of the defense stated in RCW 21.20.430(3);

(e) Whether Peterson's health condition was a substantial contributing cause to the failure of Data Line;

(f) Whether Perkins Coie, Barnard, and/or Boin were negligent in allowing the facts concerning Peterson's health condition to be omitted from the offering materials.

Respectfully submitted this 16th day of September, 1987.

FERGUSON & BURDELL

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NO. 20506-4-I

IN THE COURT OF APPEALS, DIVISION I,
OF THE STATE OF WASHINGTON

GREGORY HINES, et al.,

Appellants,

v.

DONALD E. BARNARD, BRUNO V. BOIN,

and

PERKINS COIE,

Respondents.

BRIEF OF RESPONDENTS BARNARD AND BOIN

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STATEMENT OF ISSUES

1. Whether outside directors who are not controlling persons are subject to liability under the Washington State Securities Act regardless of fault.

2. Whether the Washington Business Corporations Act's definition of a director's duties should be read _in para materia_ with the Washington State Securities Act.

3. Whether outside directors who are not controlling persons have a duty under the Washington State Securities Act to investigate representations made by inside directors absent suspicious circumstances.

4. Whether proximate causation is an element of a Washington State Securities Act violation.

II.

STATEMENT OF THE CASE

A. Procedural Posture

This action involves two consolidated cases, one initiated on February 11, 1985, and one initiated February 14, 1986, in which plaintiff investors in Data Line Systems, Inc. ("Data Line") brought suit against Data Line, the directors of the company individually, the underwriting firm of Evans-Llewelyn and the law firm of Perkins Coie, alleging violations of the Washington State

Securities Act, the Washington Unfair Business Practices Act and the common law torts of material misrepresentation and fraud for the defendants' failure to disclose to investors that the chief executive officer of the company had a brain aneurysm.

On November 26, 1986, Data Line and its directors brought a summary judgment motion arguing, among other issues, that the outside directors, e.g., directors who were not officers of the corporation, should be dismissed from the lawsuit because they did not actively participate in the day-to-day management of the company and did not aid in preparing the offering circular upon which liability was alleged. Accordingly, the directors argued that they are not liable under the Washington State Securities Act or the common law torts alleged. Defendant Perkins Coie joined in the motion, arguing that it was not subject to liability under the Washington State Securities Act.

As to Perkins Coie and two of the outside directors, Donald Barnard ("Barnard") and Bruno Boin ("Boin"), the court agreed with defendants and dismissed them from the lawsuit. As to the two other outside directors, Lewis Zirkle ("Zirkle") and Robert Cline ("Cline"), the court dismissed the common law fraud and negligent misrepresentation claims but did not dismiss the claim based on the Washington State Securities Act. The court refused to grant summary judgment on any issue to the corporation's inside directors or the corporation itself.

Pursuant to C.R. 54, the trial court certified as a final order the dismissal of the claims against Perkins Coie, and Barnard and Boin and the dismissal of the fraud and negligent misrepresentation claims against Cline and Zirkle. Pursuant to that order, plaintiffs appealed the dismissal of the lawsuit against Perkins Coie and Barnard and Boin. Plaintiffs have not appealed the dismissal of the negligent misrepresentation and fraud claims against Cline and Zirkle.

B. <u>Statement of Facts</u>

1. <u>Origins of Data Line</u>

In 1980, Gary Morgan ("Morgan") and Dale Peterson ("Peterson") provided the impetus for the formation of Data Line Systems, Inc., a corporation that designed and marketed a slot reader which optically reads the line across the bottom of a check. The slot reader enables a bank to automate its check verification and proofing functions. The technology was advanced and filled an expressed need of banks.

Data Line's initial board of directors was composed of Peterson who held 5,833 shares of stock, Morgan who held 3,334 shares of stock, and John Mason ("Mason") who held 833 shares of stock. (CP 35) The board's first meeting was held on June 10, 1980. At the meeting, Morgan was elected chairman, Peterson was elected president and treasurer, and Mason was elected secretary. (CP 36) These three were the only officers of the corporation during all material times involved in the lawsuit.

At the first meeting of shareholders held on June 18, 1980, Boin, Barnard and Cline were elected to the board of directors. Each of these board members purchased 2,222 shares at a total price of $41,666. (CP 42) These three never became officers of, nor were they ever employed by, the corporation.

Throughout 1980 and 1981, the corporation was refining and attempting to develop a market for its product. Also during this period the corporation was suffering from inadequate capitalization. (CP 44) To remedy this problem, Peterson was given authority at the April 6, 1981 board meeting to negotiate, subject to final board approval, an agreement with Keytronic Corporation whereby Keytronic would purchase an equity interest in Data Line. (CP 47)

Between the April 6, 1981 board meeting and the July 17, 1981 board meeting, Peterson negotiated an agreement with Keytrônic Corporation. (CP 51) On July 20, 1981, the board of directors approved the agreement and elected Zirkle to a seat on the board of directors, as a representative of Keytronic. (CP 53)

2. <u>Preparations for the Private Placement Memorandum</u>

The corporation still needed additional capital and at the board of directors meeting on February 23, 1982, the board of directors passed a motion authorizing Peterson, Morgan and Mason to negotiate a financing plan on behalf of Data Line. (CP 55) On April 19, 1982, Peterson wrote the board of directors to report on his progress regarding the development of the financing plan.

> A letter of intent from Evans, Llewelyn, investment bankers in Bellevue, Washington has been received and signed and agreed to between Evans, Llewelyn and Data Line Systems. A formal proposal and letter is available for this board meeting and the board of directors' approval. After interviewing firms like Piper, Jaffray, Langdon, Simons, E.F. Hutton, et al., we determined Evans, Llewelyn to be the most aggressive, cooperative and business-like of any of the above firm (sic). (CP 57)

In the same letter, Peterson informed the board that:

> A new corporate attorney was selected for SEC experience for use in the

> private offering as well as future public offerings. The firm is Perkins, Coie, Stone, Olsen & Williams of Seattle.

Boin and Barnard did not participate in the decision to hire Evans, Llewelyn or Perkins Coie except that Boin and Barnard attended the April 19 board meeting where the officers' decision was ratified. (CP 149)

In May 1982, Data Line published a business plan that was researched and prepared by the officers. (CP 149) On May 24, 1982 Peterson, on behalf of Data Line, entered into a "Best Efforts Selling Agreement" with Evans, Llewelyn to offer for sale 70,000 shares of common stock of the company at a price of $25 per share. (CP 65) At the June 1, 1982 board meeting, the board of directors ratified this agreement and authorized the sale of 70,000 shares. The board also resolved:

> That the officers of this corporation are hereby authorized, in the name and on behalf of this corporation, in connection with such offering, to take all actions which may be necessary or advisable in order to effect the registration or qualification (or exemption therefrom) of this corporation's common stock for issue, offer, sale or trade under the federal securities laws and the Blue Sky or securities laws of such state or the United States of America as they may deem necessary . . . . (CP 84)

Pursuant to this authorization, the officers worked closely with Perkins Coie and Evans, Llewelyn in preparing the offering. Barnard and Boin did not participate in the offering's preparation beyond their attendance at board meetings. (CP 149)

3. The First Aneurysm Operation

On June 6, 1982, after having a severe headache, Peterson entered Sacred Heart Hospital in Spokane where he was diagnosed as having a bleeding brain aneurysm on the left side of his brain and was flown to the University of Washington Hospital for surgery. He was treated by Dr. George Ojemann, a nationally respected neurological surgeon. Prior to the surgery, Dr. Ojemann discovered a second aneurysm that was not bleeding on the right side of Peterson's brain. After the surgery, Dr. Ojemann advised Peterson of the second aneurysm. He recommended that Peterson have an operation to repair the second aneurysm, but characterized that as "elective" surgery because the risk of an aneurysm rupturing that has never bled before is approximately 2 percent per year. (CP 90, 91, 150)

Peterson was discharged from the hospital on June 18, 1982. Dr. Ojemann described Peterson's recovery as follows:

> Mr Peterson had a remarkably benign course after the first surgery. The various things that we worry about did

> not seem to occur, and he seemed to--he recovered very quickly. (CP 89)

In the discharge summary, Dr. Ojemann described his recommendation for the remaining aneurysm and Peterson's health condition as follows:

> The patient was discharged on 6/18/82 in excellent condition, and we have given him our opinion that he would benefit from having the remaining aneurysm clipped sometime in the near future, hopefully within a year.

Peterson was back at work in June after being discharged from the hospital and, within a month of the operation, was fully recovered. (CP 149)

Peterson did not disclose the existence of the remaining aneurysm to any other director, until after October 15, 1982. (CP 133-34; 142-45; 215-20)

4. Circulating the Memorandum

At the June 1, 1982 board meeting, which was held prior to any known health problems of Peterson, the board approved the Private Placement Memorandum ("PPM"). On June 10, 1982, Evans, Llewelyn had prepared and began circulating the PPM. Mason informed Perkins Coie and Evans, Llewelyn of the aneurysm operation immediately upon his learning of the operation. Perkins Coie recommended to Mason that investors be informed. (CP 94) However, apparently due to Peterson's recovery, Perkins Coie changed its opinion and concluded that no disclosure was necessary. Its Opinion Letter dated July 15, 1982, the date of the offering's first closing, stated:

> Although we assume no responsibility for the factual accuracy or completeness of the Private Placement Memorandum, we have participated in the preparation of and have reviewed the Private Placement Memorandum and successive prior drafts thereof. In light of this participation and conferences with representatives of the company, <u>no facts have come to our attention that lead us to believe that the Private Placement Memorandum contains any untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading</u>.

(Emphasis added). (CP 96)

On the same day, Peterson and Mason issued an officer's certificate which stated

> The Private Placement Memorandum of the company dated June 10, 1982 (the "Private Placement Memorandum"), does not include any untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading; and there has occurred no event required to be set forth in an amendment or supplement to such memorandum which has not been set forth. (CP 99)

Closings were also held on August 11 and October 14, 1982. Prior to each of these closings, Peterson and

Morgan issued Officers Certificates identical to the July 15 certificate and Perkins Coie issued Opinion Letters identical to its July 15 Opinion Letter.

5. Plaintiffs' Investments

Plaintiffs purchased their interest in Data Line as follows:

Plaintiffs' Investments

Name	No. of Shares	Cert. #	Date of Issuance of Cert.
Gregory Hines	1,000	35	10/14/82
Arne Midtskog (Private Investors Ltd.)	2,200	32	8/11/82
Vance Mylroie	2,000	31	8/11/82
Michael Schwartz	2,000	44	1/11/83
Robert Arnold	2,000	16	7/15/82
Andrew Mathisen	2,000	39	12/1/82
William Vieser (d/b/a Circle V Associates IV)	2,000	19	7/15/82
Richard Swan	2,000	28	7/15/82

The earliest any of the plaintiffs was issued a stock certificate was July 15, at which time Peterson was back at work and fully recovered. (CP 147)

6. Peterson's Second Aneurysm Operation

In October, Peterson had not decided whether to undergo surgery for the second aneurysm, and traveled to Los Angeles for a second opinion. (CP 150) The Los Angeles doctors with whom he consulted felt that Peterson should have the second aneurysm operation.

On December 7, 1982, Peterson had the second surgery performed at University Hospital. On December 15, 1982, Dr. Ojemann wrote a letter to Morgan regarding Peterson's anticipated recovery. The letter stated:

> In the course of evaluating him [Peterson] for this repair earlier this month, a repeat arteriogram showed in addition to the known aneurysm on the right side a second, much smaller one a little further out on the middle cerebral artery. We repaired both of these aneurysms at craniotomy earlier this month. Mr. Peterson seems to be making a very uneventful recovery from that operation as well. <u>The nature of the aneurysm repair is such that the chances he will have any further difficulties with aneurysms is very small</u>. He will need to continue taking medication in relation to his blood pressure, and one other at least for some months, to prevent the appearance of seizures from the operation he has had. Other than this, <u>the intercranial problems for which I have been treating him over the last six months should not represent any kind of continuing medical problem for him</u>.

(Emphasis added.) (CP 100) However, Peterson continued to have health problems after the operation.

On March 28, 1983, Peterson submitted his resignation as president and chief executive officer due to health reasons. Dr. Ojemann ultimately concluded that Peterson's health problems were related to depression, not to the aneurysm operations. (CP 111)

Data Line never obtained an adequate market for its product and in July of 1984, the shareholders voted to wind up the corporation's affairs.

III.

ARGUMENT

A. The Standard for Outside Director Liability Under the Washington State Securities Act Should be the Same as the Standard for Control Person Liability Under Federal Law.

Essentially, plaintiffs argue that the Washington State Securities Act imposes strict liability on a seller for any failure to disclose a material fact and further imposes strict liability on an outside director of the issuing company for a seller's failure to disclose a material fact, regardless of whether the outside director knew of the omission or was involved in the preparation of the document upon which liability is alleged. Plaintiffs' reading of the Washington State Securities Act is not supported by cases construing that Act, by sound policy considerations, or by cases construing other similar state statutes or the federal statutes upon which the Washington State Securities Act is based.

To establish a claim under the Washington State Securities Act, the plaintiffs must show:

> First, that the defendant violated one or more of the legal duties owed by him to the plaintiff . . . ;
>
> Second, that plaintiff suffered damages;
>
> Third, that the defendant's violation of one or more of the described legal duties caused the plaintiff's damages.

Shermer v. Baker, 2 Wn. App. 845, 851, 472 P.2d 589 (1970). The legal duties referred to above are contained in RCW 21.20.010, which provides in pertinent part:

> It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (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 light of the circumstances under which they are made, not misleading.

RCW 21.20.430(1) makes a seller liable for a violation of RCW 21.20.010 and provides in pertinent part:

> Any person, who offers or sells a security in violation of any provisions of RCW 21.20.010 or 21.20.140 through 21.20.230, is liable to the person buying the security from him or her.

(Emphasis added.)

Barnard and Boin did not personally offer or sell a security, and therefore are not liable under

21.20.430(1). See Naye v. Boyd, [1986 Transfer Binder] Blue Sky Rep. (CCH) ¶ 72,393 (W.D. Wash.). Thus, any liability of Barnard and Boin must be premised on RCW 21.20.430(3), which imposes liability on several categories of persons for a seller's violation of RCW 21.20.010. That section provides:

> Every person who directly or indirectly controls a seller or buyer liable under subsection (1) or subsection (2) above, every partner, officer, director or person who occupies a similar status or performs a similar function of such seller or buyer, every employee of such seller or buyer who materially aids in a transaction, and every broker-dealer, salesperson or person exempt under the provisions of 21.20.040 who materially aids in the transaction is also liable jointly and severally with and to the same extent as the seller or buyer, unless such person sustains the burden of proof that he or she did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

The Washington State Securities Act does not explicitly address the level of culpability a seller must have to violate 21.20.010 nor does it address the level of culpability a director must have to be liable for a seller's violation of 21.20.010.

The only case to analyze the level of culpability an outside director must have to violate RCW 21.20.430(3) held that the standard for outside director liability under the Washington State Securities Act is the same as the standards for "control person" liability under Section 20 of the Securities and Exchange Act of 1934. Burgess v. Premier Corporation, 727 F.2d 826 (9th Cir. 1984). Under Section 20, a control person is liable only if he is a "culpable participant" in the activity upon which liability is based. Durham v. Kelly, 810 F.2d 1500 (9th Cir. 1987).

In Burgess, plaintiff's doctors sued Premier Corporation and each of its five directors individually alleging violations of the Securities and Exchange Act of 1934 and the Washington State Securities Act. Two of the directors sued were outside directors who were not involved with Premier's day-to-day operations and were not involved in the preparation of the prospectus upon which liability was alleged. In dismissing the claim against the two outside directors under the Washington State Securities Act, the court held:

> Darby's and Schrock's motion for directed verdict on the ground that they could not be found liable under the Washington State Securities Act, RCW 21.20.010 and 21.20.430, also should have been granted. First, 21.20.010 closely resembles its federal counterpart, Rule 10b-5. Although scienter is not required under Washington law, Kittilson v. Ford,

> 93 Wn.2d 223, 225-227, 508 P.2d 264, 265 (1980), some liability producing action by Darby and Schrock themselves was required. And because there is no evidence that either Schrock or Darby made any misrepresentations, they are not subject to liability under the statute.

Burgess, 727 F.2d at 833 (emphasis added).

In requiring "liability producing action" for outside directors while, at the same time, explicitly recognizing that seller liability is not premised on scienter, the Burgess court essentially distinguished between what level of culpability results in seller liability under 21.20.010 and what level results in outside director liability under RCW 21.20.430(3). Such a distinction is supported by sound policy considerations. As one court reasoned in rejecting strict liability rule for outside directors:

> [T]he Court is not callous toward the interests of CLIC's investors who suffered considerable financial losses as a consequence of mismanagement and ultimate bankruptcy. Nevertheless, it cannot be impervious to the rights and interests of this defendant. To saddle an innocent director with the responsibility of financial loss occasioned by the acts of others, simply to atone for the injuries suffered by the investors and not because of fault on his part, would be incredibly unjust and would serve to

> undermine, rather than strengthen, corporate responsibility.

Harman v. Willbern, 374 F. Supp. 1149, 1164 (D. Kan. 1974).

In establishing a culpability standard for outside directors, the Burgess court looked to federal law and applied the test of control person liability used under Section 20 of the Securites and Exchange Act of 1934 to the Washington State Securities Act. The court stated:

> While a controlling person could be liable under 21.20.430(3) on derivative liability, there is no reason to infer that "controlling person" has a different meaning in Washington law than in federal law. Since Schrock and Darby were not controlling persons under the federal definition, they could not properly be liable under Washington law.

Burgess, 727 F.2d at 833.

Since Burgess, the Ninth Circuit has refined the standard a plaintiff must meet before liability can be imposed on an outside director for a violation of Section 20. Present Ninth Circuit law holds that an outside director is liable only if:

> (1) The defendant had actual power or influence over the alleged control person, and

> (2) The defendant was a culpable participant in the alleged illegal activity.

Buhler v. Audio Leasing Corp., 807 F.2d 833, 835 (9th Cir. 1987) (emphasis added); see also Orloff v. Allman, 819 F.2d 904 (9th Cir. 1987).

Although Washington courts are not required to construe Washington law in accord with federal securities law, both state statute and case law strive for uniformity of interpretation. As RCW 21.20.900 provides:

> This chapter shall be so construed as to effectuate its general purpose to make uniform the laws of those states in which enacted and to coordinate the interpretation and administration of this chapter with the related federal regulation.

(Emphasis added.); see also Shermer v. Baker, 2 Wn. App. 845, 857, 472 P.2d 589 (1970).

Further, the Ninth Circuit standard of "culpable participation" for control person liability should be adopted for outside director liability under the Washington State Securities Act because the definition successfully balances the rights of investors to recover and the necessity of not deterring qualified individuals from serving on boards of directors. As expressed by one court:

> The day to day affairs of any company are generally, by necessity, largely

> entrusted to managing officers. To mechanically hold directors constructively responsible for the acts of their officers would indirectly do harm to the concept of corporate responsibility by deterring men of good character from becoming directors of companies.

Harman v. Willbern, 374 F. Supp. 149, 161 (D. Kan. 1974).

Here, plaintiffs present no facts upon which an inference can be made that Barnard and Boin culpably participated in any concealment of material facts from potential investors. Thus, this Court should adopt the culpability standard for outside directors and, accordingly, affirm the dismissal of Barnard and Boin from this lawsuit.

B. The Washington Business Corporations Act's Definition of Director Duties Should Be Read In Para Materia With the Washington State Securities Act.

The Washington Business Corporations Act specifically circumscribes the duties of corporate directors. RCW 23A.08.343 provides in pertinent part:

> In performing the duties of director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data in each case prepared or presented by:
>
> (1) one or more officers or employees of the corporation whom the director believes to be reliable and competent in the manner presented.

(2) counsel, public accountants, or other persons as to matters which the director believes to be within such person's professional or expert competence.

"The rules of statutory construction require that statutes be interpreted to give meaning and effect to each, if possible." Miller v. King County, 59 Wn.2d 601, 605, 369 P.2d 304 (1962).

Here, Barnard and Boin relied on the officers, counsel and underwriters to research, prepare, circulate and provide opinions regarding the PPM. In doing so, Barnard and Boin complied with their obligations under RCW 23A.08.343.

Plaintiffs argue that the Washington Business Corporations Act relates only to a director's duties to the corporation, not to investors. However, directors' responsibilities cannot be so neatly dichotomized. The duties and obligations of directors to investors and to the corporation overlap and cannot be segregated. Plaintiffs' argument, if adopted, would essentially prohibit directors from relying on the mandate of RCW 23A.08.343 for fear of violating a stricter duty to investors; hence the Washington Business Corporations

Act's attempt to limit and define a director's responsibilities would be rendered meaningless.

C. <u>Outside Directors Who Are Not Controlling Persons Do Not Have a Duty to Investigate Representations Made by Inside Directors Absent Suspicious Circumstances</u>.

Even if this court finds that Barnard and Boin should be strictly liable under the Washington State Securities Act, the trial court correctly granted summary judgment because Barnard and Boin established their affirmative defense under RCW 21.20.430(3) as a matter of law. The affirmative defense provision provides that directors are not liable if they:

> did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

RCW 21.20.430(3).

It is undisputed that Peterson was back at work and fully recovered by the time of the first closing. It is further undisputed that Barnard and Boin did not know of Peterson's second aneurysm. Thus, any imposition of liability on Barnard and Boin must be predicated on a holding that Barnard and Boin could not establish their affirmative defense unless they undertook to investigate and uncover facts not within their knowledge. Such a finding would do violence to the legislative history of the Washington State Securities Act and depart from other states' case law construing analogs to the affirmative defense provision of RCW 21.20.430(3).

The affirmative defense provision of the Washington State Securities Act was taken from Section 410(b) of the Uniform Securities Act which uses wording identical to that used in the Washington statute. The Comment to the Uniform Securities Act regarding the affirmative defense provision states:

> The defense of lack of knowledge is modeled on <u>Section 15 of the Securities Act of 1933</u>, 15 U.S.C. § 77B and <u>Section 20(a) of the Securities Exchange Act of 1934</u>, 15 U.S.C. § 78t(a).

(Emphasis added.) The affirmative defense provision of Section 15 of the Securities Act of 1933 provides a defense to liability if:

> [t]he controlling person has no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

The affirmative defense provision of Section 20(a) of the Securities and Exchange Act of 1934 provides a defense to liability if:

> the controlling person acted in good faith and did not directly or indirectly induce the act or acts

> constituting the violation or cause of action.

Section 15 of the 1933 Act and Section 20(a) of the 1934 Act should be construed identically. Durham v. Kelly, 810 F.2d 1500, 1504 (9th Cir. 1987).

Section 15 of the Securities Act of 1933 was amended in 1934. The purpose of the amendment was explained by one federal court:

> Prior to the amendment, that section held control persons absolutely liable for the Section 11 or Section 12 violations of those whom they controlled. The amendment added the clause "unless the controlling person 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." Senator Fletcher's memorandum explained the purpose of a similar amendment to be: "to restrict the scope of the section so as more accurately to carry out its real purpose. The mere existence of control is not made a basis for liability unless that control is effectively exercised to bring about the action upon which liability is based."

Lanza v. Drexel & Co., 479 F.2d 1277, 1298 (2d Cir. 1973). As the Comment to the Uniform Act makes clear, the amended Section 15 was specifically incorporated into the Uniform Securities Act, which Washington adopted.

Based on this analysis of the legislative history of Section 15 and the Uniform Act, the Lanza court stated that under Washington's Act an outside director has no affirmative duty of investigation:

> Congress was quite aware of the "agonizingly subtle" choice continually facing directors when it passed the Securities Act.[105] . . .
>
> 105 State legislatures were equally aware. State Blue Sky Laws universally exempt directors from liability for fraud perpetrated by corporate officers unless the directors were in some meaningful sense culpable participants in the fraud . . . <u>notice that there is no affirmative duty of investigation</u> . . . Wash. Rev. Code Ann. § 21.20.430(2) (Supp. 1972).

<u>Lanza</u> <u>v</u>. <u>Drexel</u> <u>&</u> <u>Co</u>., 479 F.2d 1277, 1308-09 n.105 (2d Cir. 1973) (emphasis added).

The court in <u>Lanza</u> also compared the language of the Uniform Securities Act with another Section of the 1933 Act, Section 11, which by its plain terms specifically imposes a reasonable duty to investigate. The <u>Lanza</u> court reasoned that the drafters of the Uniform Act had the "duty to investigate" language of Section 11 before it, but chose not to incorporate that language into the Uniform Act. Accordingly, the <u>Lanza</u> court concludes that the Uniform Securities Act's duties of inquiry were similar, not to the 1933 Act, but to SEC Rule 10b-5.

Under Rule 10b-5, an outside director who has not been a participant in the negotiation for the sale of securities or made any representation with respect thereto may rightfully rely on other officers or directors of the corporation on whose board he sits. Lanza v. Drexel & Co., supra. The Lanza court refused, absent the presence of suspicious circumstances, to impose a duty of inquiry on outside directors. The Lanza court's reasoning is directly applicable here:

> As in all lawsuits, we deal in the sometimes unreal certainties of hindsight. When we move toward the kind of novelty plaintiffs propose for one in the position of Coleman, it may not be amiss to recall the ambiguities of real life. A director like Coleman, not involved in the daily business, may think he "knows" things contrary to what he is told by the management upon which he must of course rely. He may be wrong. His primary loyalties are familiar and stern ones. How and when he must--or may--run off to "warn" or advise outsiders dealing with this corporation could suggest questions of great refinement. At the very least, such action would violate the decorum of the management heiarchy; at most, it could cost him his seat on the Board and a judgment for interfering with the corporate opportunity. If people of stature and creative potential are still wanted for corporate directorship, we must take care how agonizingly subtle their choices are to be . . . . In short, if the type of liability plaintiff's urge ever be imposed, it ought to be reasonably clear that the wrong is palpable and that the balance of advantage lies in that course.

Lanza, 479 F.2d at 1307.

The Lanza analysis was specifically applied to Section 15(b) of the Georgia Securities Act of 1973 which in all material respects is identical to RCW 21.20.430(3). Hamilton Bank and Trust Co. v. Holliday, 464 F. Supp. 1229 (N.D. Ga. 1979). Like RCW 21.20.430(3), Section 15(b) of the Georgia Act provides for liability:

> unless the person whose liability arises under this subsection sustains the burden of proof that he did not know when and in the exercise of reasonable care could not have known of the existence of the facts by reason of which liability is alleged to exist.

In Hamilton Bank, plaintiff Bank brought suit under federal securities law and the Georgia Securities Act against officers and directors of Hamilton Bank Shares, Inc. and Hamilton Factors, Inc. for alleged misrepresentations made in the sale of an interest in a loan pool to the plaintiff. The defendant outside directors brought a summary judgment motion which the court granted. The court framed the issue as follows:

> The real issue confronting the court is the legal question of whether the outside directors had reason to know of the facts by reason of which liability is alleged to exist.

Id. at 1240. Like the Lanza court, the Hamilton Bank Court then compared the affirmative defense provisions of

Section 15 of the Securities Act of 1933, Section 20(a) of the Securities and Exchange Act of 1934 and the Georgia Securities Act. The court found these provisions to be identical in all material respects. The Hamilton Court then adopted the Lanza analysis and applied that analysis to the Georgia Securities Act.

The court held:

> This Court believes that, based on Lanza, the Outside Directors had no duty to insure that all material adverse information was conveyed to plaintiff HB&T in connection with the sale of the loan participations to the plaintiff.

Id. In applying the Lanza rule to the Georgia Securities Act, the court in Hamilton concluded:

> "A director . . . is chargeable [only] with a degree of notice of those facts which the corporate books and the directors' meetings would fairly disclose." Myzel v. Fields, 386 F.2d 718, 736 (8th Cir. 1967), cert. denied, 397 U.S. 951, 88 S. Ct. 1043, 19 L. Ed. 2d 1143 (1968). In addition, a director is entitled to rely on the corporation's officers and is "not . . . required to presume rascality, maintain a constant vigilance over the corporation's business transactions, or assume the responsibilities of the corporation's managing officers." Harman v. Willbern, 374 F. Supp. 1149, 1164 (Dist. Kan. 1974), aff'd, 520 F.2d 1333 (10th Cir. 1975).

Id at 1242.

Plaintiffs attempt to distinguish Lanza on four grounds: (1) Barnard and Boin participated in the wrongful conduct to a greater extent than the defendant in Lanza, (2) Barnard and Boin had a duty to disclose Peterson's first aneurysm operation, (3) that unlike Lanza, scienter is required to establish a violation of 21.20.010, and (4) Barnard and Boin had an ongoing duty to inform investors of material facts as they discovered them. None of these contentions is persuasive. Each contention will be discussed in turn.

1. Lanza Is Not Distinguishable on Its Facts From the Instant Case.

Plaintiffs contend that Lanza is distinguishable because the defendant in that case, Coleman, had less involvement in the alleged wrongful conduct than Barnard and Boin did. That argument simply ignores the facts of Coleman's involvement. The securities transaction involved in Lanza was an exchange of all the stock of the plaintiffs' corporation for the stock in BarChris, with the plaintiffs receiving the BarChris stock. In connection with the exchanged stock, the plaintiffs were found to have been misled and damaged by material misrepresentations and omissions on the part of certain officers and directors of BarChris. Lanza v. Drexel & Co., 479 F.2d 1277, 1280 (2d Cir. 1973). Coleman was either present at the BarChris directors meetings at which the exchange of stock was discussed and approved or, at least, had read the minutes of that meeting. Id. at 1284. He had substantial information about the general business and financial condition of BarChris. Id. at 1285-86. Several days before the exchange of stock he learned of negative financial developments at BarChris which were not disclosed to the plaintiffs. Id. at 1286-88. The Lanza Court, nonetheless, found that the negative financial developments did not require Coleman to undertake an independent investigation.

Here, like Coleman, Barnard and Boin attended or read the minutes of board of directors meetings. However, unlike Coleman, they did not have knowledge of material information which was not disclosed to the plaintiffs. If any distinction be made between this case and Lanza, it is that Barnard and Boin had less notice of any material omission than did Coleman.

2. Whether Scienter Is Required to Establish a Seller's Violation of RCW 21.20.010 Is Not Relevant to What an Outside Director Must Establish to Meet His Affirmative Defense.

A director is not directly liable for violations of RCW 21.20.010, unless he is also a seller. Any liability of a director is derivative. RCW 21.20.430(3) specifically provides for an affirmative defense to derivative liability. This court's construction of that affirmative defense provision bears no relation to whether scienter is required before a seller violates 21.20.010.

3. Barnard and Boin Had No Duty to Disclose an Operation From Which a Full Recovery Had Been Made.

Plaintiffs also argue that Barnard and Boin had an obligation to disclose Peterson's first aneurysm operation. However, it is undisputed that by the time of the first closing Peterson was back at work and fully functional. Defendants respectfully submit that an operation from which a full recovery had been made is not a material fact which must be disclosed to potential investors. Further, as discussed above, Barnard and Boin complied with their duties under the Washington Business Corporations Act and rightfully relied on the attorneys and the inside directors to determine what must be disclosed.

4. At the Time Plaintiffs Purchased Their Investments, Barnard and Boin Did Not Fail to Supplement the Private Placement Memorandum.

On the record before this court, all of plaintiffs' investments except for Mathisen's and Schwartz' were made prior to October 15, 1987, the earliest date upon which Barnard and Boin could have known of Peterson's second brain aneurysm. Thus, as to these investors, Barnard and

Boin had no information with which to supplement the Private Placement Memorandum. Further, as to defendant Mathisen, there is no evidence before this court that Barnard and Boin knew of Peterson's second aneurysm operation before the closing of his purchase. Finally, as to defendant Schwartz, his interest was purchased after the second operation and after a doctor's letter was issued stating that Peterson should have no continuing health problem. Thus, Barnard and Boin had no duty, under the facts presented here to supplement the private placement memorandum.

D. Plaintiffs Must Establish That Defendants' Misrepresentation Caused Their Investments to Decline in Value Before They Can Recover Under the Washington State Securities Act

Barnard and Boin admit that plaintiffs have raised material issues of fact regarding the materiality of Peterson's second brain aneurysm and the element of causation. In the event that this Court reverses the trial court's ruling and remands this case for trial, Barnard and Boin submit this argument on causation to enable the Court, if it so desires, to provide guidance to the trial court on the issue of whether causation is an element of 21.20.010.

This court has previously found that a causal relationship is required under the Washington State

Securities Act. Shermer v. Baker, 2 Wn. App. 845, 851, 472 P.2d 589 (1970). In Shermer, the trial court had instructed the jury that:

> The plaintiff has the burden of proving each of the following propositions:
>
> First, the defendant violated one or more of the legal duties owed by him to the plaintiff which duties are described in these instructions;
>
> Second, the plaintiff suffered damages;
>
> Third, the defendant's violation of one or more of the described legal duties caused the plaintiff's damages.

Id. at 851 n.4 (emphasis added). The Court of Appeals specifically approved this instruction stating:

> By instruction 8, the trial court advised the jury plaintiff had the burden of proving that defendant violated one or more of the legal duties imposed upon him by law, and that the plaintiff suffered damages because of such violation . . . . we find no error in the giving of these instructions.

Id. (emphasis added).

Washington, like other states, has adopted the Uniform Securities Act. Other states also hold that a plaintiff must establish causation to prevail. See, e.g., Alna Capital Associates v. Wagner, 758 F.2d 562, 565 (11th Cir. 1985) (construing Florida law) (plaintiff must prove that a misrepresentation or omission "proximately caused" injury); Dupont v. Brady, [1986 Transfer Binder] Blue Sky Rep. (CCH) ¶ 42,457 (S.D.N.Y. 1986) (proof of proximate damage is requisite for civil liability under New York Act).

Plaintiffs argue that courts often confuse causation with reliance, and only proof of reliance is required under the federal analog to 21.20.010. While plaintiffs are correct that federal courts often confuse these two elements, commentators and courts that clearly distinguish between the two hold that proof of the traditional tort element of causation is a requirement for recovery under the securities law. As the Fifth Circuit stated:

> Causation is related to but distinct from reliance. Reliance is a causa sine qua non, a type of "but for" requirement: had the investor known the truth, he would not have acted. Causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? Herpich v. Wallace, 430 F.2d 792, 810 (5th Cir. 1970). The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate way, responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the

> proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

Huddleston v. Herman and MacLean, 640 F.2d 534, 549, rehearing denied, 650 F.2d 815 (5th Cir. 1982) affirmed in part and reversed in part on other grounds, 459 U.S. 375, 103 S.Ct. 683, 74 L. Ed. 2d 548 (1983).

A prominent commentator agrees:

> There is little doubt that the causal nexus must exist between the defendants' acts and the plaintiffs' loss, notwithstanding some contrary authority indicating that the relationship should be between the defendants' acts and the plaintiffs' purchase or sale.

Jacobs, The Impact of Rule 10b-5 (rev. ed. 1980) at Section 64.02.

Thus, if this court decides to reach the causation issue, the court should find that, like other tort cases, causation is an element of an RCW 21.20.010 violation.

IV.

CONCLUSION

The trial court's grant of summary judgment should be affirmed on any of three alternative grounds. First, outside directors who are not controlling persons should not be subject to liability under the Washington State Securities Act when the outside directors did not culpably participate in the preparation of the private placement memorandum. Second, Barnard and Boin's actions complied with their obligations under the Washington Business Corporations Act, and the Washington State Securities Act should not be read to undermine the Washington Business Corporations Act's mandate. Third, Barnard and Boin did not have a duty to investigate representations made by inside directors absent suspicious circumstances. Finally, if this court reaches the issue of causation it should find that any violation of the Washington State Securities Act was not a proximate cause of plaintiffs' injury.

Dated this 3rd day of December, 1987.

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