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California Court Of Appeal Holds That Privity Of Contract Is Necessary To Maintain An Action For Rescission Under California Corporations Code Sections 25504 And 25504.1

In *Viterbi v. Wasserman*, 2011 Cal. App. LEXIS 25 (Cal. App. Jan. 11, 2011), the Court of Appeal for the Fourth Appellate District of the State of California affirmed the judgment of the Superior Court of San Diego County holding that privity between the purchaser and seller of a security is necessary to maintain an action for rescission under Sections 25504 and 25504.1 of the California Corporations Code. This decision, which follows persuasive authority in the federal courts construing analogous federal law, confirms the limits of the remedy of rescission under the California Corporations Code.

This action arises out of plaintiffs Audrey Viterbi and Dan Smargon's purchase of $200,000 worth of securities of Economic Inventions, LLC ("EI"), which held patents on "expirationless options," a type of derivative security. Plaintiffs sued EI, its president and two of its board members, as well as Geneva Wasserman, an analyst Viterbi hired to advise her regarding at potential investments.

Beginning in 2002, Wasserman received and forwarded to Viterbi various documents about EI. In an e-mail attaching information about EI, Wasserman identified herself as being a "shareholder/officer" of that company. Viterbi reviewed the business plan, as well as the private placement memorandum ("PPM") and subscription agreement. The PPM explicitly warned that the securities involved a high degree of risk and that "only persons who [could] afford to lose a portion or all of their investment and have no need for a current return on their investment should consider the purchase." Viterbi also sought the advice of a childhood friend regarding the purchase of EI's securities. Viterbi's friend's advice was negative asserting that Viterbi should "find other ways to lose money." Despite the inherent risks and advice of others, in May 2003, Viterbi and Smargon bought membership interests in EI for $200,000 in cash.

Before plaintiffs purchased their shares in EI, EI entered into an exclusive license agreement with NexTrade Holdings, Inc. ("NexTrade"). Plaintiffs alleged that Wasserman engaged in securities fraud by failing to disclose this agreement, which they asserted made the stock worthless. Plaintiffs alleged the terms of the agreement with NexTrade were "a disaster" for EI. The agreement gave to NexTrade in perpetuity a worldwide royalty free exclusive license, thereby stripping EI of the rights necessary to commercialize the patents. The agreement gave to NexTrade all the intellectual property owned by EI for no fee or royalty. It granted to NexTrade all rights to patents arising from EI's existing patent for no fees or royalties. The agreement also gave NexTrade the right to sublicense the patents to third parties.

The only thing EI received in return was one-half of any sublicense fees and one half of any net income NexTrade received from use of the patents. According to plaintiffs, EI had received no money from the agreement and had no income. Also according to plaintiffs, Wasserman knew of the agreement and its problematic terms, but did not disclose them to plaintiffs prior to their investment. According to plaintiffs, the securities they purchased were not marketable and were worthless. Thus, they continued to own the securities.

The trial court dismissed the action against the board members based upon a lack of jurisdiction, and the Court of Appeal affirmed that dismissal. EI and its president filed for bankruptcy and the action was stayed as to them, leaving only Wasserman as a defendant. The trial court granted Wasserman's motion for summary adjudication as to all claims except for constructive trust and for statutory securities fraud brought under sections 25504 and 25504.1 of the California Corporations Code. Thereafter, the trial court granted a nonsuit on the securities fraud claim, holding that (1) plaintiffs had no damages remedy because they continued to own the securities; and (2) they could not seek rescission against Wasserman because she did not sell the stock to them. The case before the Court of Appeal concerned only the court's grant of nonsuit as to the securities fraud claim.

Plaintiffs asserted that under section 25504, which provides for control person liability, and under section 25504.1, which provides for secondary liability for persons who assist sellers in violation of the securities laws (*i.e.*, aider and abettor liability), plaintiffs were not required to prove privity of contract with the defendant to obtain what they called "rescissionary relief." In support of their position, plaintiffs cited several California cases holding that a "control person" under section 25504 and an "aider and abettor" under section 25504.1 could be sued for *damages* without privity of contract. The Court of Appeal was unconvinced, holding that plaintiffs "cited no California case, and we could locate none, allowing the remedy of *rescission* for securities fraud against a defendant *who is not in privity of contract with the purchaser*" (emphasis in original). To the contrary, the Court of Appeal discussed two federal cases, *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981), *rev'd on other grounds*, 459 U.S. 375 (1983), and *McFarland v. Memorex Corp.*, 493 F. Supp. 631 (N.D. Cal. 1980), construing analogous federal statutes which held that "rescission is usually limited to cases involving either privity between plaintiff and defendant or some specific fiduciary duty owed by brokers to their customers." The Court of Appeal agreed that "if the purchaser did not buy from the defendant or if he no longer owns the security, then the parties cannot be returned to the status quo ante and . . . damages, not rescission, is the proper remedy."

It was undisputed, the Court noted, that there was no privity of contract between plaintiffs and Wasserman. Rather, the contract of sale of securities was between *EI* and plaintiffs. Thus, the Court of Appeal held that Wasserman cannot restore to plaintiffs the $200,000 investment and place the parties in their precontractual positions because Wasserman could not return money she never received or rescind a transaction to which she was not a party. Under ordinary contract principles, then, Wasserman could not be held liable to plaintiffs for rescission.

Plaintiffs also asserted that because "control group" members and "aiders and abettors" who are not "sellers" can be held liable under sections 25504 and 25504.1, rescission can be had against these persons without privity of contract. The Court of Appeal again disagreed. The Court held that sections 25504 and 25504.1 of the California Corporations Code only addresses who may be held *liable*, not the *remedy* that is available against them. Thus, there was nothing in sections 25504 or 25504.1 that expressly or impliedly provided that privity of contract is not required for the remedy of rescission or that the definition of rescission was somehow different in corporate securities law than it was elsewhere.

This decision confirms that absent an explicit agreement between a plaintiff and a defendant, as a purchaser and a seller of securities, a plaintiff will not be able to obtain "rescissionary relief" from a defendant under the California Corporations Code, providing clearer guidance on the scope of remedies a plaintiff-purchaser of securities may bring against a defendant-seller of securities and those who participant with the seller in the alleged malfeasance.

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