5 | 27 | 2011

California Court of Appeal Interprets "Controlling Person" Liability Under State and Federal Securities Laws

In *Hellum v. Breyer*, No. A127660, 2011 WL 1631662 (Cal. App. 1st Dist. Apr. 29, 2011), the California Court of Appeal for the First District reversed the dismissal of state and federal securities law claims against three outside directors of a closely held California corporation. The Court held that under Section 25504 of the California Corporations Code ("Section 25504"), directors and officers of a corporation are presumptively liable for the corporation's violations of state securities laws. The Court held that plaintiffs need not allege that directors or officers exercised actual control over the corporation or its purported wrongdoing in order to state a cause of action under Section 25504. This decision makes it easier for a controlling person claim against officers and directors of a California corporation to survive the pleadings stage.

Defendant Prosper Marketplace, Inc. ("Prosper") is an online money lending service. Plaintiffs brought a class action against Prosper, its officers and its outside directors after suffering losses from purchasing nonexempt, unqualified, and unregistered loan notes through Prosper, alleging violations of state and federal securities laws.

Three of the seven causes of action were asserted against Prosper's outside directors. Plaintiffs alleged that the outside directors violated two different provisions of Section 25504, and Section 15 of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. § 77*o*. Section 25504 provides, in pertinent part, that the following persons are jointly and severally liable for selling unqualified securities with those who have engaged in an unlawful practice: "Every person who directly or indirectly controls a person liable under Section 25501 or 25503, every partner in a firm so liable, every principal executive officer or director of a corporation so liable . . . unless the other person who is so liable had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist."

In the first cause of action against the outside directors, plaintiffs alleged that they were liable under 25504 because through "their executive positions, and/or Board membership . . . these individuals had the power to influence and control and did influence and control, directly or indirectly, the decision-making of the Company." In the second cause of action against the outside directors, plaintiffs alleged liability under Section 25504 solely because they were directors of Prosper, therefore falling within the classification of "every principal executive officer or director of a corporation so liable." In the third cause of action against the outside directors, plaintiffs alleged liability under Section 15 of the Securities Act, which provides joint and several liability on persons for acts committed by actors under their control that violate federal securities laws (including registration requirements). Plaintiffs alleged that the outside directors' status necessarily provided them with "the power to influence and control" Prosper.

The outside directors filed a demurrer arguing that plaintiffs failed to allege "a single fact" demonstrating that the outside directors were "control persons" under Section 25504 and Section 15 of the Securities Act, and therefore failed to establish liability on any of the three causes of action. The California Superior Court for the City and County of San Francisco sustained the demurrer on these grounds, without leave to amend, and dismissed the outside directors from the action.

The question before the Court of Appeal regarding the second cause of action against the outside directors was whether a finding of liability under Section 25504 required proof of actual control over the primary violator, or whether Section 25504 imposed presumptive liability. Noting that separate clauses of the statute described a different category of individuals who may be involved in corporate securities law violations, and delineated the liability imposed for each category, the Court held that the plain language of statute imposed presumptive liability on a corporation's executive officers and directors. The Court reasoned further that failing to attribute presumptive liability to corporate officers and directors based on their status would render a portion of Section 25504 superfluous, since officers and directors are implicitly included in the statute's first clause but are also separately addressed in a different clause.

The Court then turned to the first and third causes of action against the outside directors. The Court construed the outside directors' role holistically in holding that plaintiffs had alleged facts supporting the conclusion that the outside directors had the power to directly or indirectly control or influence Prosper's alleged violations of securities laws. The outside directors' ownership interests in Prosper, their responsibility under the company's bylaws for managing the company, their implicit authority to sign corporate documents, their considerable voting power, and their affiliation with the capital venture firms that financed Prosper supported the conclusion that they had the power to directly or indirectly influence Prosper's decision-making.

This decision lessens the burden that a plaintiff must overcome to state a Section 25504 cause of action against directors and officers of a California corporation. The Court interpreted "control" as involving the direct or indirect power to influence the business decisions of a corporation, but did not require a showing at the pleading stage of any actual exercise of that power.

For further information, please contact John Stigi at (310) 228-3717 or Laura Waluch at (213) 617-5423.