



California Corporate & Securities Law

Court Rejects Control Requirement For Director Liability

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Outside directors and their counsel should take note of yesterday's decision by the First District Court of Appeal in [Hellum v. Breyer](#). The case analyzes what a plaintiff must plead in attempting to assert liability against directors of an issuer that has allegedly violated the registration requirements of the Securities Act of 1933 and the qualification requirements of the Corporate Securities Law of 1968.

Hellum involved a class action lawsuit against an issuer and its corporate officials, including its outside directors. Under state law, the plaintiffs alleged that the outside directors could be held liable under Section 25504 of the Corporations Code. The plaintiffs also sought to impose liability on the outside directors under Section 15 of the Securities Act.

Section 25504

Corporations Code Section 25504 is often described as a "control person" liability statute. Indeed, the statute does explicitly impose liability on "every person who directly or indirectly controls a person liable under Section 25501 [prescribing the remedies for violations of Section 25401] or Section 25503 [prescribing the remedies for violations of the qualification provisions of the CSL]". Thus, the defendant directors in this case successfully demurred to the plaintiffs' complaint on the basis that the plaintiffs had failed to plead that the directors were in control. The Court of Appeal, however, disagreed finding that Section 25504 explicitly refers to directors without requiring that the directors be in control of the alleged violator.

Section 15

The Court of Appeal recognized that Section 15 of the Securities Act, unlike Section 25504, requires control in order for liability to attach. The trial court found that the plaintiffs had failed to allege facts that, if true, would show that the outside directors had control over the issuer. The Court of Appeal, however, disagreed – finding that the plaintiffs need not plead that the outside directors exercised day-to-day control over the issuer or that they were culpable participants in the decision not to register or qualify the offer and sale of securities.

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What About Privity?

The court's opinion does not address whether privity is a prerequisite for liability under Section 25504. As I discussed in this January 12, 2011 [post](#), the Fourth District Court of Appeal held in *Viterbi v. Wasserman* that privity is required under Section 25504 when a plaintiff is seeking rescission. However, it is unclear whether the California courts will require privity when the claim is for damages, as in the *Hellum* case. A federal district court has found that while privity is required, it is sufficient if there is privity between the controlled person and the plaintiff and strict privity between the controlling person and the plaintiff is not required. *ZZZZ Best Securities Litigation* (C.D. Cal. 1990) CCH Fed. Sec. L. Rptr. ¶ 95416. In *Bains v. Moores*, 172 Cal. App. 4th 445 (2009), the trial court suggested that the plaintiffs were required to allege that they purchased securities from the controlling persons. The Court of Appeal, assuming that this suggestion was correct, nevertheless found that the plaintiffs could not allege privity with the controlled person in that case because they had purchased in the open market.

Some Observations

The Court of Appeal's analysis of the pleading requirements for control appears to overlook the fact that directors are individuals. Directors have no individual authority to execute documents on behalf of a corporation, nor do they have the individual authority to approve corporate transactions. The court pointed to the fact that directors are required to sign registration statements filed with the SEC. However, the SEC requires only that a majority of the board sign. Thus, a single director's signature is insufficient and the failure to sign will not necessarily preclude a filing. The Court seems to overlook the fundamental reality that directors must act collectively.

The Court of Appeal also made several technical errors. For example, the Court refers to "Title 15 of the Securities Act" when it seems to mean Section 15 of the Securities Act. The Court also incorrectly states that the definition of "control" in Corporations Code § 160 is applicable "throughout the Corporations Code".

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