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Litigation Update: Arizona Court of Appeals Addresses Who Can Be Liable for Alleged Securities Fraud

By James D. Burgess

On September 29, 2009, in *Grand v. Nacchio et al.*,¹ the Arizona Court of Appeals affirmed the dismissal of a securities fraud action that Fennemore Craig successfully defended for Qwest Communications International, Inc. (“Qwest”) as its Arizona counsel along with Boies, Schiller & Flexner, LLP of Washington, D.C. The Court of Appeals ruled that Qwest and two of its former executives were not liable for investors’ alleged losses because they did not “participate in” the investors’ stock purchases within the meaning of the Arizona Securities Act. The Court of Appeals also ruled that Qwest and its former executives were not liable as “controlling persons” under the Act or for aiding and abetting the alleged securities fraud. The decision is an important development under the Arizona Securities Act, which unlike the federal securities laws, expressly limits the class of defendants against whom securities fraud claims may be brought.

Background

The plaintiffs filed a securities fraud action concerning their purchases of stock in KPNQwest N.V. (“KPNQwest”), a joint venture between Qwest and a European telecommunications company. The lawsuit named Qwest, its former CEO who was also the chairman of KPNQwest’s supervisory board, and a former Qwest executive who became KPNQwest’s CEO.

The plaintiffs purchased KPNQwest stock on the open market in 1999 and 2000. The plaintiffs alleged that during the time they were purchasing KPNQwest stock, Qwest was inflating its own earnings with fictitious revenue. The plaintiffs claimed that Qwest and its former executives controlled KPNQwest, and that if Qwest’s activities had been known to the public, “KPNQwest’s stock would have been unmarketable.” The plaintiffs’ lawsuit sought to rescind their purchases of KPNQwest stock under the Arizona Securities Act.

Qwest and its former executives filed separate motions to dismiss the lawsuit, which the trial court granted. The plaintiffs appealed, but the Arizona Court of Appeals affirmed the dismissal.

The Arizona Securities Act Limits Who Can Be Liable For Alleged Securities Fraud.

The Arizona Securities Act provides investors with a private cause of action to rescind their investments or to recover damages for securities sold in violation of the Act’s antifraud provisions. The Act provides for both direct and vicarious liability against certain classes of defendants. Specifically, Section 44-1991 broadly prohibits fraudulent practices in the offer, sale or purchase of securities. Section 44-2001(A) allows an investor injured by a violation of Section 44-1991’s antifraud provisions to file an action for rescission or damages.

1 *Grand v. Nacchio*, --- P.3d ---, 2009 WL 3103761, 2009 Ariz. App. Lexis 727 (9/29/09).
2 *Grand*, 2009 WL 3103761 at *1, 2009 Ariz. App. Lexis 727 at *3.

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A defendant who violates Section 44-1991's antifraud provisions may be directly liable to the investor. A defendant who "controls any person liable for a violation of § 44-1991" may be vicariously liable to the investor pursuant to Section 44-1999(B). Section 44-2003(A) defines and limits those defendants against whom an action for rescission or damages may be brought: "any person ... who made, participated in or induced the unlawful sale or purchase."

The Defendants Were Not Directly Liable For The Alleged Securities Fraud.

The plaintiffs argued that the defendants were directly liable for securities fraud because they "participated in" the plaintiffs' purchases of KPNQwest stock by: (1) allegedly targeting them with "a stream of reassuring written communications," including favorable analyst reports and purportedly misleading press releases; (2) referring plaintiffs to a broker of KPNQwest stock; (3) promoting "KPNQwest by linking [it] to the management strength and financial growth with which Qwest was publicly perceived;" (4) allegedly misleading the plaintiffs with a "banner of management integrity that did not exist;" and (5) acting as "information gatekeepers" who "controlled the disclosures that were made to the market."³

The Court of Appeals ruled that these allegations were insufficient to demonstrate that the defendants had "participated in" the plaintiffs' purchases of KPNQwest stock for purposes of Section 44-2003(A).⁴ The court interpreted the statute's phrase, "participated in," to mean "to take part in something" or "have a part or share in something."⁵ The court held that the defendants did not "participate in" the plaintiffs' stock purchases by having supplied allegedly incorrect and misleading financial information concerning the value of KPNQwest stock.⁶

The court reasoned that to rule otherwise would be to impose liability on all publicly traded companies and their management "only upon the showing that by creating an open market, they later 'participate in' each and every sale conducted in that market."⁷ The court rejected the plaintiffs' theory of participatory liability because it would punish as statutory "participants" every insider of every public company who said or did anything that may have persuaded the plaintiff to purchase the stock.⁸ The court reaffirmed an earlier precedent, which held that the private civil remedy set forth in Sections 44-2001 and 44-2003 does not apply to all violations of Section 44-1991, but "only against the narrower range of persons 'who made, participated in or induced the unlawful sale.'"⁹

The Defendants Were Not Vicariously Liable For The Alleged Securities Fraud.

The plaintiffs also argued that the defendants were vicariously liable for KPNQWest's alleged securities fraud under theories of aiding and abetting and the "controlling person" liability statute, A.R.S. § 44-1999. The Court of Appeals, however, also affirmed the dismissal of those claims.

The court ruled that for the defendants to be held vicariously liable for controlling KPNQwest or aiding and abetting its alleged securities fraud, the plaintiffs had to allege that KPNQwest "participated in" the plaintiffs' stock purchases within the meaning of Section 44-2003(A).¹⁰ The Plaintiffs argued that KPNQwest participated in their stock purchases by concealing adverse information about the company's finances and management. The Court of Appeals concluded, however, that these allegations did not constitute allegations that KPNQwest "participated in" the plaintiffs' stock purchases for purposes of Section 44-2003(A). Accordingly, the Court of Appeals affirmed the dismissal of the plaintiffs' lawsuit.

³ *Grand*, 2009 WL 3103761 at *2, 2009 Ariz. App. Lexis 727 at *7.

⁴ *Grand*, 2009 WL 3103761 at *3, 2009 Ariz. App. Lexis 727 at *7-8.

⁵ *Grand*, 2009 WL 3103761 at *2, 2009 Ariz. App. Lexis 727 at *6.

⁶ *Grand*, 2009 WL 3103761 at *3, 2009 Ariz. App. Lexis 727 at *8.

⁷ *Grand*, 2009 WL 3103761 at *3, 2009 Ariz. App. Lexis 727 at *8.

⁸ *Grand*, 2009 WL 3103761 at *5, 2009 Ariz. App. Lexis 727 at *15.

⁹ *Grand*, 2009 WL 3103761 at *3, 2009 Ariz. App. Lexis 727

at *8 (quoting *Standard Chartered PLC v. Price Waterhouse*, 190 Ariz. 6, 22, 945 P.2d 317, 333 (App. 1996)).

¹⁰ *Grand*, 2009 WL 3103761 at *5-7, 2009 Ariz. App. Lexis 727 at *17-18, *28.

The Significance Of The Court Of Appeals' Opinion In *Grand*

In many respects, the Arizona Securities Act promotes investor protection more so than the federal securities laws.¹¹ Because of the Act's more investor-oriented and remedial purposes, Arizona courts often do not follow federal decisions that do not advance Arizona's policy of protecting the public from securities fraud. For these reasons, a private cause of action under the Arizona Securities Act can be a powerful tool for defrauded investors to recover their money.

As the Court of Appeals' opinion in *Grand* makes clear, however, the Arizona Securities Act is not a universal investor protection law and it has limits. The Act does not provide a private civil remedy against anyone who makes a material misstatement in connection with a securities transaction. Instead, unlike its federal analog, the Act imposes liability only against a narrower range of persons "who made, participated in or induced" the fraudulent purchase or sale. A.R.S. § 44-2003(A).

In the wake of *Grand*, investors will no longer be able to sue under the Act based on the theory that because a company and its executives issued financial information that later proved to be inaccurate, they should be held liable for securities fraud. Instead, plaintiffs will now have to demonstrate that the defendants, or someone they controlled, actually made, induced or participated in the plaintiffs' stock purchases.

¹¹ See, e.g., *Siporin v. Carrington*, 200 Ariz. 97, 103, 23 P.3d 92, 98 (App. 2001) (refusing to follow federal securities law decision because its rationale did not serve the remedial purposes of the Arizona Securities Act).

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