SECONDARY LIABILITY UNDER THE NEW JERSEY UNIFORM SECURITIES LAW

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It has been universally known, and accepted, that the various State blue sky laws have stepped in to fill the void as to a private cause of action for secondary liability. *See Securities Litigation Uniform Standards Act of 1997:* Hearing on S. 1260 Before the Subcomm. on Securities, S. Comm. on Banking, Housing, and Urban Affairs, 105th Cong. 47 (1997)(prepared statement of Arthur Levitt, Jr., Chairman & Isaac C. Hunt, Jr., Commissioner, U.S. Securities and Exchange Commission)(stating that according to the SEC, 49 of 50 states authorize private rights of action for aiding and abetting violations of state securities laws).

As such, "States often justify their stringent secondary liability standards on the grounds that secondary participants in securities transactions, such as lawyers and accountants, should perform a gatekeeper role: a view supported by most academics." *See* Professor Jennifer J. Johnson, *Secondary Liability for Securities Fraud: Gatekeepers in State Court*, Vol. 36 *Delaware Journal of Corporate Law*, 464, 497 (2011).

Accordingly, New Jersey, by and through the New Jersey Uniform Securities Law, *N.J.S.A.* 49:3-47, *et seq.*, has enacted one of the most reaching and investor protective acts in the country.

At the onset we must first address the various liabilities that exist under the New Jersey Uniform Securities Law.

Pursuant to *N.J.S.A.* 49:3-71(a), liability exists for violations committed by "*Sellers*" or those who make or cause an "*Offer to Sell*" or "*Sale*". These violations are considered primary violations. *C/f N.J.S.A.* 49:3-51 and *N.J.S.A.* 49:3-71(a).

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The Act also creates "*Control Person*" liability. This violation, pursuant to *N.J.S.A.* 49:3-71(d), exists when a person directly or indirectly controls a "*Seller*". This class of persons are also considered primary violators, and thus must meet the definition of "*Seller*".

"*Participant*" liability, pursuant to *N.J.S.A.* 49:3-71(d), pertains to partners, directors, officers, employees, etc., of a "*Seller*". In most cases, these classes of persons are also considered primary violators, and thus must meet the definition of "*Seller*". However, there are instances where a participant can be liable under a theory of secondary liability if the person materially aids in the sale or conduct of a securities transaction.

Lastly, there is "*secondary liability*", pursuant to *N.J.S.A.* 49:3-71(d).

Secondary liability is created by virtue of an agent, by and through a primary violator, who materially aids in the sale ***or*** conduct of a securities transaction.

It should be noted that privity is required for primary violations committed by "*Sellers*" or "*Control Persons*" pursuant to the New Jersey Uniform Securities Law, *Kaufman v. i-Stat Corp.*, 165 *N.J.* 94, 112 (2000).

However, ***privity is not required for secondary liability***. *Pinter v. Dahl*, U.S. 622, 643 (1988). *See also Lord Abbett Municipal Municipal Income Fund, Inc. v. Asami*, *No. CV-12-03694* DMR (N.D. Cal. 2014)(*In dictum*, a Federal District Court noted that requiring privity for secondary liability, under the New Jersey Uniform Securities Law, "would render the secondary liability provision [*N.J.S.A.* 49:3-71(d)] superfluous.").

Therefore, in order to successfully pursue a claim under a theory of secondary liability, a Plaintiff must establish that an 1) "*Offer to Sell*" or "*Sale*" was made by or through a person or entity ("*Seller*"); 2) Privity existed by and between the "*Seller*" and the Plaintiff; 3) That the transaction at issue violated some aspect of the New Jersey Uniform Securities Law; 4) An "*agent*" participated within the securities transaction; 5) The "agent" "*materially aided in the sale or conduct of the securities transaction*"; and 6) Plaintiff suffered a loss.

It is worth noting that reliance, on the part of the Plaintiff, is not an element necessary for purposes of pursuing a claim pursuant to the New Jersey Uniform Securities Law. *Kaufman v. i-Stat Corp.*, 165 *N.J.* at 112-113.

For purposes of applying *N.J.S.A.* 49:3-71(d), the New York Supreme Court, Appellate Division, 1st Department, has held that attorneys fall within the definition of "*agents*" for purposes of secondary liability pursuant to *N.J.S.A.* 49:3-71(d) of the New Jersey Uniform Securities Law. *Oster v Kirschner*, 77 A.D.3d 51 (1st Dept. 2010).

In *Oster*, the Appellate Court reversed a trial court grant of summary judgment in favor of several attorneys who drafted a private placement that was utilized in a Ponzi scheme.

The Court, in its holding, went out of its way to write that "[t]his Court cannot and will not endorse what is essentially a 'see no evil, hear no evil' approach." *Id.* at 57.

In Tandem, in applying the New Jersey Uniform Securities Law, New Jersey Courts have found liability involving an attorney and third parties who foreseeably rely on the attorney's opinion or other legal services. *Petrillo v. Bachenberg*, 139 *N.J.* 472, 485 (1995)(drawing comparison to the New Jersey Uniform Security Law, the New Jersey State Supreme Court held that "like certified public accountants or other professionals involved in commercial transactions, a lawyer's duty may run to third parties who foreseeably rely on the lawyer's opinion ***<u>or other legal services.</u>***")(*Emphasis Added*); *Zendell v. Newport Oil Corp.*, 226 *N.J. Super.* 431 (App. Div. 1988)(while affirming summary judgment on the issue of "*Seller*" liability, a primary violation, the Court held, nonetheless, that an attorney could be held liable for allowing a negligent offering of an unregistered security). [2]

As to what acts or omissions constitute material aid for purposes of secondary liability, courts look to the level of participation provided, by the third party, in furtherance of the sale, or conduct, within the underlying securities transaction.

For example, in *Cola v. Terzano*, 129 *N.J. Super.* 47 (Law Div. 1974), the court found that secondary liability, under earlier version of Section 49:3-71(d), could be imposed with "*minimal participation*" in a sale of securities. *See also Abrahamsen v. Laurel Gardens, Ltd.*, 276 *N.J. Super.* 199, 213 (Law Div. 1993)(Recognizing the *Cola* "*minimal participation*" standard for violations of the New Jersey Uniform Securities Law).

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[2] As stated, the Plaintiffs in *Zendell* originally sought "*Seller*" liability against the Defendant Law Firm. As referenced herein, in order to meet the definition of "*Seller*", a Plaintiff must establish, *inter alia*, that a person or entity committed a violation of the Act in violation of *N.J.S.A.* 49:3-71(a).

In *Zendell*, *supra*, as noted above, a New Jersey Appellate Division Panel held that liability, as to a law firm, for negligently allowing the offering of an unregistered security in violation of *N.J.S.A.* 48:3-60.(Citing drafting; role in venture; and managerial control as factors to consider for participation as exposure to potential liability within a securities transaction pursuant to both Federal Securities law and The New Jersey Uniform Securities Law).[3] *Zendell*, 226 *N.J. Super.* at 441

In *Oster*, the Court found that the drafting of a private placement, utilized by persons involved within a Ponzi scheme, coupled with actual or constructive notice of the actors fraudulent conduct, gave rise to potential secondary liability claims.

Finally, "a secondary party may be liable for the fraudulent sale of securities where the party aims to better the financial condition of another". *Pinter v. Dahl*, 486 U.S. 622, 655 (1988).

BURDEN SHIFT: A POWERFUL TOOL EMPOWERING THE INVESTOR

In furtherance of each states goal to protect its citizens, a vast majority of the states have enacted a statutory affirmative defense that shifts the burden of proof from the Plaintiff to the secondary defendant actors.[4]

New Jersey is one of the States that shifts the burden of proof from the Plaintiff to the secondary defendant actors.

Thus, *N.J.S.A.* 49:3-71(d) states, unequivocally, that " the non-seller who is so liable ***sustains the burden of proof*** that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts under paragraphs (1) through (5) of subsection (a) of this section which give rise to liability." (*Emphasis added*).

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[3] While the *Zendell* Court analyzed Defendant's participation conduct for purposes of whether Defendant met the statutory definition of a "*Seller*", nevertheless the participation analysis in *Zendell* is useful for analyzing participation for purposes of determining an agents liability with regard to "*materially aiding in the sale or conduct of a securities transaction*".

[4] In shifting the burden, the secondary liability provisions mirror the shifts in burden contained in sections 12(2) and 15 of the *Securities Act of 1933*.

This statutory shift of burden of proof, within the New Jersey statute, emanates directly from the Uniform Securities Act § 410 (1956),[5] *as amended*. *C/f* Legislative history of *N.J.S.A.* 49:3-71(d) citing § 410 of the Uniform Securities Act as the basis for *N.J.S.A.* 49:3-71(d).

Accordingly, this statutory shift of burden puts onto a secondary actor the burden to show that they did not know, and in the "*exercise of reasonable care*" could not have known, of the violations perpetrated by the primary violators.

When interpreting "*exercise of reasonable care*" in the context of securities law, Courts have routinely asserted, be it either primary or secondary liability, that "*reasonable care*" is predicated upon something similar to a negligence standard. *See In Re Refco, Inc. Sec. Litig.*, 503 F. *Supp*. 2d 611, 660-61, fn. 43 (S.D.N.Y. 2007)(finding that an allegation of negligence was sufficient under section 15 of the 1933 Act.).

New Jersey courts, therefore, look to federal securities law for guidance on issues relating to liability. *See Abrams v. Ohio Cas. Ins. Co..*, 322 *N.J. Super.* 330, 337 (App. Div. (1999); *Zendell v. Newport Oil Corp.*, 226 *N.J. Super.* 431, 439-40 (App. Div. 1988) (New Jersey Appellate Division Panel employed a negligence standard in holding that a law firm may be liable for allowing the sale of an unregistered security).[6]

For example, in the context of a Section 12(2) affirmative defense[7], Congress did not require the plaintiff to establish the defendant's intent.

Rather, in a modified form of a negligence standard, Congress left it to the defendant to show that he acted with the appropriate level of care considering all the circumstances

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[5] The drafters of §410 of the Uniform Securities Act (1956), *as amended*, utilized §12(2) and §15 of the *Securities Act of 1933*, and §20(a) of the *Securities Exchange Act of 1934* as a template. See commentary notes to §410. All three statutes have affirmative defenses that shift the burden to a defendant.

[6] While affirming summary judgment on the issue of "*Seller*" and/or "*Control Person*" liability, a primary violation, the *Zendell* Court held, nonetheless, that an attorney could be liable for allowing the negligent offering of an unregistered security.

[7] §12(2) of the *Securities Act of 1933* utilizes "*reasonable care*" as an affirmative defense.

surrounding the underlying sale. *See Wachovia Bank & Trust Co. v. National Student Mktg. Corp.*, 650 *F.2d* 342, 356 (D.C. Cir. 1980) (negligent conduct of defendant suffices), *cert. denied*, 452 *U.S.* 954 (1981); *Lanza v. Drexel & Co.*, 479 *F.2d* 1277, 1308-09 n.105 (2d Cir. 1973) (*en banc*)(citing within n.105 the statutory burden shift to non-seller defendants pursuant to *N.J.S.A.* 49:3-71(b)); *McLean v. Alexander*, 449 *F. Supp.* 1251, 1262 (D. Del. 1978)(defendant assumes the burden of proving that he could not have known of the misrepresentation while exercising reasonable care), *rev'd*, 599 *F.2d* 1190 (3d Cir. 1979); *Dorfman v. First Boston Corp.*, 336 *F. Supp.* 1089, 1093 (E.D. Pa.1972)(imposition on the defendants of the burden of proof); This view of the standard required under section 12(2) has received academic support in the commentary on section 12(2) as well. *See* Marc I. Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington*, 68 GEo. LJ. 163, 178 (1979) ("the standard of liability in an action brought under section 12(2) is negligence").

Once a secondarily liable defendant fails to meet his burden under the statute, “liability attaches by operation of law to sales of securities transacted in violation of state securities laws.” *Cola v. Terzano*, 129 *N.J. Super.* 47, 57 (Law Div. 1974), aff’d, 156 *N.J. Super.* 77 (App. Div. 1977)(The security at issue, in *Cola*, was the sale of an unregistered security, in violation of *N.J.S.A*. 49:3-60).

In fact, the court in *Cola* went on to hold that “the sale of this stock violated the above statutory provisions ***and gives rise to an action for rescission against all those who participated in the sale; N.J.S.A. 49:3-71.***” *Id.* at 57 (*Emphasis Added*).

TERRITORIAL REACH OF THE NEW JERSEY UNIFORM SECURITIES LAW: YOU CAN RUN, BUT YOU CAN’T HIDE

After the drafting of the Uniform Securities Act, courts eschewed choice-of-law determinations in favor of an approach whereby the law of more than one state could apply to a securities transaction. *In Re National Century Financial Enterprises, Inc.*, 755 *F. Supp.* 2d 857, 880 (S.D. Ohio 2010).

The State of New Jersey has adopted the Uniform Securities Act, and contained within its statutory scheme is a "*Scope of Act*" provision limiting the law's application to a sale or an offer to sell made in New Jersey, or to an offer to buy that is made or accepted in New Jersey. *See N.J.S.A.* 49:3-51 and *N.J.S.A.* 49:3-71, respectively.

As such, it has been held that the New Jersey statute can be applied outside the State of New Jersey, provided there is a "*transactional occurrence*" to the state. *A.S. Goldmen & Company v. New Jersey Bureau of Securities*, 163 *F.3d* 780, 787 (3rd Cir. 1999)

As held by the Third Circuit in *A.S. Goldmen* "when an offer is made in one state and accepted in another, we now recognize that elements of the transaction have occurred in each state, and that both states have an interest in regulating the terms and performance of the contract." *Id*. at 787. *See also Johnston v. Norton*, No. 92 Civ. 6844, 1993 *U.S. Dist. LEXIS 16000*, at *68 (S.D.N.Y. Nov. 19, 1993) (in order for the anti-fraud provisions of New Jersey's blue sky law to apply a plaintiff must demonstrate that an offer or purchase or sale occurred in New Jersey).

Accordingly, "elements of the transaction occur in each state, and each state has an interest in regulating the aspect of the transaction that occurs within its boundaries." *Id*. at 787. *See also Bramblewood Investors, Ltd v. C&G Associates, Ltd.*, 262 *N.J. Super.* 96 (Law Div. 1992)(statutory requirements of *N.J.S.A.* 49:3-51 and *N.J.S.A.* 49:3-71 must be met for New Jersey Uniform Securities Law to apply).

In reaching its decision, the Third Circuit reviewed Commerce Clause jurisprudence and found that a "consistent strain of these cases authorizes courts to invalidate state regulations when their extraterritorial impact is so great that their `practical effect ... is to control conduct beyond the boundaries of the state.'" *A.S. Goldmen*, 163 *F.3d* at 784-85 (quoting *Healy v. The Beer Institute*, 491 *U.S.* 324, 336 (1989).

However, the Court nevertheless went onto hold that "a state may regulate "in-state components of interstate transactions so long as the regulation furthers legitimate in-state interests." *Id*. at 785 (citing the Blue Sky Cases).

In reaching its holding, the Court found that "contracts formed between citizens in different states implicate the regulatory interests of both states." *Id*. at 787.

Additionally, the Court found that `[t]he provisions of the law ... apply to dispositions of securities *within* the state.'" *A.S. Goldmen*, 163 *F.3d* at 785. (*Emphasis in original*)(*citing Hall v. Geiger-Jones Co.*, 242 *U.S.* 539 (1917) wherein the United States Supreme Court has upheld the states' authority to enact such laws against Commerce Cause challenges. By enacting securities statutes concerning dispositions of securities within state, the states had merely enacted "police regulation[s]," that "affect[ed] interstate commerce ... only incidentally." *Id.* at 558).

The *A.S. Goldmen* Court noted that in securities transactions having points of contact with more than one state, the contacts that matter are the offer, sale, and purchase. *A.S. Goldmen*, 163 *F.3d* at 789, fn. 16.

Accordingly, the Third Circuit held that applying New Jersey's law did not violate the extraterritoriality principle and as such *N.J.S.A.* 49:3-51 can permissibility reach outside the State of New Jersey.

As noted by the Court in *A.S. Goldmen,* New Jersey had an interest in maintaining the integrity of legitimate, in-state sellers and brokers by preventing the state "`from being used as a base of operations for crooks marauding outside the state.'" *Id*. at 788 (quoting *Stevens v. Wrigley Pharm. Co.*, 9 *N.J. Misc.* 385 (N.J.Ch. Div. 1931)).

CONCLUSION

As stated herein, the New Jersey State Legislature has enacted one of the most reaching and investor protective acts in the country.

Professor Jennifer J. Johnson phrased it best when she wrote that stringent secondary liability standards further the reach upon secondary participants in securities transactions, such as lawyers and accountants, who, without question, should be perform a gatekeeper role with regard to investor protection.

Therefore, practitioners should be ever mindful of exploring secondary liability claims pursuant to the New Jersey Uniform Securities Law.