

THE IMPORTANCE OF STATUTORY TEXT: From Scienter to Nonstatutory Defenses under Arizona Securities Law

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INTRODUCTION

Although securities cases are statutory cases, attorneys commonly begin their securities research with a search for cases. We do not begin by reading the statutes. We turn first to Arizona case law, and if that is missing, we usually search for SEC rule 10b-5¹ cases that address the issue. Not often does anyone begin Arizona securities research with an analysis of the statutory text and the principles of interpretation that guide courts in construing statutes. This is a mistake.²

It is a mistake for at least two reasons. First, unlike actions under rule 10b-5, liability under Arizona's securities statutes is express liability.³ The

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1. 17 C.F.R. § 240.10b-5 (2007).

2. It is a common mistake that extends beyond securities cases. Justice Scalia was asked in a 2008 interview, "Do you think law students would be better served if they focused more on statutory construction than the case method?" *A Voice for the Write: Tips on Making Your Case from a Supremely Reliable Source*, 94 A.B.A. J. 36, 38 (May 2008) (containing excerpts of a March 2008 interview by Richard Bust with U.S. Supreme Court Justice Antonin Scalia and author Bryan Garner). Justice Scalia agreed wholeheartedly, "Well, I have made that very point . . . what judges do nowadays is very little common law. But what they do almost all the time is that they interpret a [statutory or other] text. They almost always have a text in front of them." *Id.*; see also ANTONIN SCALIA & BRYAN A. GARNER, MAKING YOUR CASE: THE ART OF PERSUADING JUDGES xxii (2008) ("[U]nconstrained common-law decision-making is an increasing rarity. Courts are usually confronted with interpreting a governing text, whether a constitutional provision, a statute, an agency regulation, or a municipal ordinance.").

3. See ARIZ. REV. STAT. ANN. § 44-2001(A) (2008) (providing that a defrauded purchaser "may bring an action in a court of competent jurisdiction to recover the consideration paid for the securities, with interest, taxable court costs and reasonable attorney fees, less the amount of any income received by dividend or otherwise from ownership of the securities, on tender of the securities purchased or the contract made, or for damages if the purchaser no longer owns the securities."); *id.* § 44-2002(A) (2008) (providing that a defrauded seller "may bring an action in a court of competent jurisdiction to recover the amount of the seller's damages, with interest, taxable court costs and reasonable attorney fees"); see also *Grand v. Nacchio*, 147 P.3d 763,

rule 10b-5 action is an implied right of action. The federal courts have looked to the rules governing common-law fraud to define the 10b-5 action.⁴ In contrast, the elements of liability under Arizona's express-liability provisions are defined by the statutes themselves.⁵ It is a mistake therefore to use the common law to define what the legislature defined. Besides that, Arizona's securities laws were passed for public protection that the common law did not provide.⁶ Using the common law to interpret the securities statutes risks undermining the expanded protection the legislature envisioned.

Second, statutory construction requires careful thought. American courts have no "generally accepted, and consistently applied theory of statutory interpretation."⁷ This means we must make choices about what may be competing theories of statutory interpretation. Reasoned analysis will typically require consideration of a mix of interpretative approaches including analysis of the statute's words; legislative history, intent, and purpose; canons of construction; and precedent, both judicial and administrative.⁸ Anyone who addresses a securities-law issue without

772-73 (Ariz. Ct. App. 2006) (explaining the statutory remedies under Arizona Revised Statutes section 44-2001(A)).

4. See *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005) ("Judicially implied private securities-fraud actions resemble in many (but not all) respects common-law deceit and misrepresentation actions."); *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (referring to "positive and common-law requirements for a violation of [section] 10(b) or of rule 10b-5"); 9 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 4379 (3d rev. ed. 2004) (stating as to rule 10b-5 that "if it is 'cricket' for the federal courts to invent new torts or tort-like actions, it seems fair enough for them to invent reasonable restrictions on the new actions as common law judges a long time ago invented doctrines like materiality, scienter, reliance, and causation in order to achieve a sense of balance").

5. *Aaron v. Fromkin*, 994 P.2d 1039, 1042 (Ariz. Ct. App. 2000) ("The elements of securities fraud are articulated within the statute itself").

6. See *id.* ("The legislature made the task of proving securities fraud much simpler than proving common-law fraud."); cf. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) ("[A]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry."); see also *Bullard v. Garvin*, 401 P.2d 417, 419 (Ariz. Ct. App. 1965) (interpreting the securities registration statutes and stating that, "[g]enerally, statutes of this nature providing a remedy for those who may have been taken advantage of have been liberally construed in favor of those persons whom they are designed to protect").

7. HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW* 1169 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994); accord ANTONIN SCALIA, *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* 14 (1997).

8. See WILLIAM N. ESKRIDGE, JR., PHILIP P. FRICKEY & ELIZABETH GARRET, *LEGISLATION AND STATUTORY INTERPRETATION* 9 (2000) (suggesting that practitioners should "craft their arguments as cumulative rhetoric; taking the most convincing pieces of whatever approaches best fit their side of the case"); SCALIA & GARNER, *supra* note 2, at 44-51

focusing on the legislative text and the approaches to statutory interpretation that courts use is not fully analyzing the issue.

The following discussion is divided into four parts. Through a discussion of scienter, Part I introduces the use of reasoned statutory interpretation as a framework within which to apply case law in resolving securities issues. It shows that administrative precedent and statements of legislative intent play an especially important role in interpreting Arizona's securities statutes. Part II expands upon the importance of administrative precedent, particularly decisions by the Arizona Corporation Commission, in interpreting the state's securities laws. Part III returns to the use of legislative statements and shows how Arizona's courts, since 2001, have used these legislative statements to explain and interpret the state's securities laws. With the aid of this background information, Part IV analyzes six securities issues on which Arizona case law is unsettled or could be clarified through statutory analysis: unauthorized trading, reliance, contributory fault by investors, participant liability, aiding and abetting, and nonstatutory defenses. In each instance statutory analysis is used to provide insights and answers that a purely case-driven approach would overlook. Through these examples the Article shows the importance of using statutory interpretation as the foundation for developing reasoned securities-law precedent.

I. AN EXAMPLE: SCIENTER

In trial-court litigation, arguments are occasionally made that subsection (3) of Arizona Revised Statutes section 44-1991(A)⁹ requires scienter, i.e.,

(explaining the importance of collectively using textual analysis, canons of construction, and legislative history to make persuasive arguments).

9. Section 44-1991(A) (2008) provides:

It is a fraudulent practice and unlawful for a person, in connection with a transaction or transactions within or from this state involving an offer to sell or buy securities, or a sale or purchase of securities, including securities exempted under [sections] 44-1843 or 44-1843.01 and including transactions exempted under [sections] 44-1844, 44-1845 or 44-1850, directly or indirectly to do any of the following:

1. Employ any device, scheme or artifice to defraud.
2. Make any untrue statement of material fact, or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.
3. Engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit.

intent to defraud.¹⁰ The argument is not surprising since all three subsections of rule 10b-5 require scienter.¹¹ No Arizona appellate case addresses scienter under section 44-1991(A)(3). But as a matter of statutory construction, a reasoned analysis might proceed as follows.

First, the language of subsection (3) does not by its words require intent to defraud. By its terms, subsection (3) makes it a fraudulent practice to “[e]ngage in any transaction, practice or course of business which operates or would operate as a fraud or deceit.”¹² These words focus on the effect of the defendant’s conduct, not the defendant’s culpability. Under a plain reading of the statute’s language, someone could engage in a course of business that operates as a fraud on investors without intending to deceive.

Second, the 1951 Arizona Securities Act was enacted with a statement of legislative intent that instructs courts to construe the securities statutes liberally, as remedial measures.¹³ Reading subsection (3) to focus on the effect on investors, rather than the defendant’s intent, furthers this legislative directive. Likewise, reading the statute to prohibit unintentional fraud enhances investor protection and is faithful to the liberal reading the legislature mandated.

Third, in 1996 a second statement of legislative intent was enacted. This legislative statement provides that, “[T]he courts may use as a guide the interpretations given by the securities and exchange commission and the federal or other courts in construing substantially similar provisions in the federal securities laws of the United States.”¹⁴ Through this statement, the legislature has expressed its intent to allow courts to find guidance in interpretations under “substantially similar” federal securities laws.

Substantially the same language found in section 44-1991(A) appears in section 17(a) of the 1933 Securities Act.¹⁵ The 1996 statement of intent

10. See, e.g., *Little v. First Cal. Co.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,226, at 92,561 (Oct. 17, 1977), available at 1977 WL 1055, at *8 (concluding without citation of authority that subsections (1) and (3) of the Arizona Revised Statutes section 44-1991 (now section 44-1991(A)) require scienter).

11. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212 (1976) (rejecting arguments that the language of subsections (b) and (c) of rule 10b-5 encompass negligent behavior).

12. ARIZ. REV. STAT. ANN § 44-1991(A)(3) (2008).

13. Securities Act of Arizona, ch. 18, § 20, 1951 Ariz. Sess. Laws 46, 75 (quoted *infra* text accompanying note 26).

14. Sales of Securities—Litigation—Fraud, Unlawful Activity, Etc., ch. 197, sec. 11(C), § 44-2126, 1996 Ariz. Legis. Serv. 1168, 1189 (West).

15. Compare 1933 Securities Act § 17(a), 15 U.S.C. § 77q(a) (2006), with ARIZ. REV. STAT. ANN § 44-1991(A) (quoted *supra* note 9). Section 17(a) reads:

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) by the use of any means or instruments of

therefore suggests that interpretations under section 17(a) may provide guidance on the meaning of section 44-1991(A). And even before 1996, the Arizona Supreme Court looked to the U.S. Supreme Court's interpretation of section 17(a) for guidance on scienter under section 44-1991. In *State v. Gunnison*, a 1980 decision, the Arizona Supreme Court adopted the reasoning of *Aaron v. SEC*, a U.S. Supreme Court decision, and its interpretation of section 17(a)(2) to decide whether scienter was required under subsection (2) of Arizona Revised Statutes section 44-1991 (now 44-1991(A)).¹⁶ Section 17(a)(2) makes it unlawful to make "any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading."¹⁷ *Aaron* found nothing in this language to require intent to deceive.¹⁸ *Gunnison*, in turn,

transportation or communication in interstate commerce or by use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a). Nearly the same language appears in rule 10b-5. But as explained in *Ernst & Ernst v. Hochfelder*, rule 10b-5 is limited by section 10(b) of the 1934 Act. 425 U.S. at 212-13. Section 10(b) does not contain the language that appears in rule 10b-5. The operative language of section 10(b) makes it,

unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (2006). *Hochfelder* interpreted this language to require scienter and held that arguably broader language in subsections (b) and (c) of rule 10b-5 is limited by the statute. 425 U.S. at 214 ("[D]espite the broad view of the Rule [10b-5] advanced by the Commission in this case, its scope cannot exceed the power granted the Commission . . . under [§] 10(b)."). *Aaron v. SEC* reaffirmed *Hochfelder*, but reached a different conclusion as to subsections (2) and (3) of section 17(a) because those subsections, like subsections (2) and (3) of Arizona Revised Statutes section 44-1991(A), are part of the statute itself. 446 U.S. 680, 695-96 (1980) ("The language of § 17(a) strongly suggests that Congress contemplated a scienter requirement under § 17(a)(1) but not under § 17(a)(2) or § 17(a)(3).").

16. *State v. Gunnison*, 618 P.2d 604, 606-07 (Ariz. 1980); see *Aaron*, 446 U.S. at 680.

17. 15 U.S.C. § 77q(a)(2).

18. *Aaron*, 446 U.S. at 696 ("[T]he language of § 17(a)(2), which prohibits any person from obtaining money or property 'by means of any untrue statement of a material fact or any omission to state a material fact,' is devoid of any suggestion whatsoever of a scienter requirement.").

found this textual interpretation persuasive and concluded that scienter is not required for a violation of section 44-1991(2).¹⁹

Gunnison did not interpret subsection (3) of Arizona Revised Statutes section 44-1991, but because the language of subsection (3) is nearly identical under both sections 17(a) and 44-1991(A), it is reasonable, especially given the 1996 statement of intent, to look to *Aaron's* interpretation of section 17(a)(3). Under subsection (3), *Aaron* holds that scienter is not required.²⁰ Subsection (3) looks to whether the investor would be misled. The defendant's intent is irrelevant. The Court explained:

[T]he language of [section] 17(a)(3), under which it is unlawful for any person "to engage in any transaction, practice, or course of business which *operates* or *would operate* as a fraud or deceit," . . . quite plainly focuses upon the *effect* of particular conduct on members of the investing public, rather than upon the culpability of the person responsible.²¹

This is a logical way to read parallel language in section 44-1991(A)(3).²²

Finally, securities law interpretations by the Arizona Corporation Commission ("ACC") are entitled to "great deference."²³ Decisions by the ACC hold that scienter is not required for violations of subsection (3).²⁴

In sum, the language of section 44-1991(A)(3), legislative intent, analogous federal interpretation, and deference to administrative precedent support the conclusion that scienter is not required for a subsection (3) violation. This is a departure from federal law under rule 10b-5, which has required scienter since the 1976 *Hochfelder* decision.²⁵ But by analyzing section 44-1991(A)(3) through the lens of statutory interpretation, it can be seen that scienter is not an element of a subsection (3) claim.

19. *Gunnison*, 618 P.2d at 607.

20. *Aaron*, 446 U.S. at 697.

21. *Id.* at 696-97 (emphasis in original).

22. See *Orthologic Corp. v. Columbia/HCA Healthcare Corp.*, No. CIV 01-0006, 2002 WL 1331735, at *5 (D. Ariz. Jan. 7, 2002) ("Because the language of [section] 17(a) of the 1933 Act and [section] 1991 of the Arizona Securities Act are identical in all relevant respects and because the Arizona Supreme Court has acknowledged its concurrence with the United States Supreme Court's interpretation of section 17(a), this court finds that proof of scienter is required to succeed on a claim under [section] 1991(A)(1), but not under [section] 1991(A)(2) or [section] 1991(A)(3).").

23. *Eastern Vanguard Forex, Ltd. v. Ariz. Corp. Comm'n*, 79 P.3d 86, 97 (Ariz. Ct. App. 2003).

24. See *In re Nutek Info. Sys., Inc.*, No. S-3046-I, 1996 WL 494745 (Ariz. Corp. Comm'n Aug. 22, 1996) ("Scienter is not an element of a violation of A.R.S. §§ 44-1991(2) or 44-1991(3)."). *In re Lost Dutchman Invs., Inc.*, No. S-2299-I, 1993 WL 173726, at *13 (Ariz. Corp. Comm'n Apr. 8, 1993) (same).

25. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-94 (1976).

II. STATEMENTS OF LEGISLATIVE INTENT

A. *The 1951 Statement of Intent*

As mentioned, two statements of legislative intent have been enacted by the Arizona legislature. The first was enacted with the 1951 Securities Act. It directs the courts to avoid narrow interpretations in favor of liberal constructions that advance the Act's remedial goals:

Sec. 20. INTENT AND CONSTRUCTION. The intent and purpose of this Act is for the protection of the public, the preservation of fair and equitable business practices, the suppression of fraudulent or deceptive practices in the sale or purchase of securities, and the prosecution of persons engaged in fraudulent or deceptive practices in the sale or purchase of securities. This Act shall not be given a narrow or restricted interpretation or construction, but shall be liberally construed as a remedial measure in order not to defeat the purpose thereof.²⁶

Three points are made in this legislative statement:

- The securities laws are intended to deter fraud and protect the public.
- Narrow interpretations are to be avoided.
- The Act is to be liberally construed.

Each point is a useful guidepost in understanding how Arizona's securities laws should be interpreted.

The 1951 statement of intent has been quoted in three decisions by the Court of Appeals. In each decision, the Court of Appeals departed from federal law in favor of a broad reading that promoted public protection.²⁷ The initial decision was the 2001 decision in *Siporin v. Carrington*.²⁸ *Siporin* refused to follow federal precedent on the treatment of viatical

26. Securities Act of Arizona, ch. 18, § 20, 1951 Ariz. Sess. Laws 46, 75.

27. The 1951 statement of intent has also been advanced by the ACC as a reason to explain why civil liability under Arizona's securities laws is broader than under federal securities law. See, e.g., *In re Woodington Group, Inc.*, No. S-2798-I, 1992 WL 409822, at *6 (Ariz. Corp. Comm'n Dec. 10, 1992) ("Because state securities laws should be more broadly construed than federal securities laws, and because of our legislative mandate, this Commission must broadly interpret the Act as a remedial measure to ensure the protection of Arizona investors.").

28. 23 P.3d 92 (Ariz. Ct. App. 2001).

