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The Anti-Fraud Provisions of the North Carolina Securities Act

CLIFTON L. BRINSON*

INTRODUCTION

Recently, a number of civil cases have been brought under the once dormant North Carolina Securities Act.¹ One of these cases gained attention in 2012 when Judge Murphy of the North Carolina Business Court held that a plaintiff asserting claims under the North Carolina Securities Act need not show “scienter”—i.e., intent to defraud.² Judge Murphy held that material misrepresentations made in connection with the purchase or sale of a security are actionable even if the person making the misrepresentations did not know they were false, so long as the person was negligent in making the statements.³

The decision came as a surprise to many practitioners. The *North Carolina Business Litigation Report* stated:

This decision definitely breaks some new ground. You don’t have to show scienter for a state securities claim? . . . Those are real relaxations of requirements for plaintiffs. It is not clear that these rulings are the law of North Carolina, but they are the law in Judge Murphy’s courtroom. Whether they’ll stick on appeal is an open question.⁴

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1. See, e.g., *William L. Thorpe Revocable Trust v. Ameritas Inv. Corp.*, No. 4:11-CV-193-D, 2012 U.S. Dist. LEXIS 134049 (E.D.N.C. Sept. 19, 2012); *Latta v. Rainey*, 689 S.E.2d 898, 908–11 (N.C. Ct. App. 2010); *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 17 (N.C. Super. Ct. Mar. 24, 2013); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 12 (N.C. Super. Ct. Feb. 19, 2013); *Blue Ridge Pediatric & Adolescent Med. v. First Colony Healthcare*, No. 11 CVS 127, 2012 NCBC LEXIS 52 (N.C. Super. Ct. Oct. 3, 2012); *Associated Packaging v. Jackson Paper Mfg.*, No. 10 CVS 745, 2012 NCBC LEXIS 13 (N.C. Super. Ct. Mar. 1, 2012).

2. *Associated Packaging*, 2012 NCBC LEXIS 13, at *33–38.

3. *Id.* at *37–38.

4. Mack Sperling, *Claims Under The North Carolina Securities Act Are Easier To Make Now*, N.C. BUS. LITIG. REP. (Mar. 5, 2012), <http://www.ncbusinesslitigationreport>

The appellate question is moot because the case has since settled.⁵ But the legal question remains: what is required to state a claim under the North Carolina Securities Act, specifically under the antifraud provisions of the Act?

Until quite recently, this question had not been examined in any depth, perhaps because most attorneys (and many courts) assumed the antifraud provisions of North Carolina Securities Act are merely duplicative of the federal securities laws. This assumption is understandable, given that the language of the North Carolina antifraud provisions is similar to the language of their federal counterparts; both federal and state laws prohibit selling or purchasing a security 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 the light of the circumstances under which they were made, not misleading”⁶ Furthermore, North Carolina courts have held that the State’s antifraud provisions are to be interpreted consistently with the corresponding federal provisions.⁷

There are, however, important differences between the antifraud provisions of the North Carolina Securities Act and the antifraud provisions of the federal securities laws. The two antifraud provisions of the North Carolina Securities Act are Section 78A-8 and Section 78A-56(a)(2). Section 78A-8 closely parallels Rule 10b-5 under the federal securities laws.⁸ But, whereas Rule 10b-5 has been interpreted to include a scienter requirement,⁹ there is no necessary reason to read a scienter requirement into Section 78A-8 of the North Carolina Securities Act. There is also, however, no evidence that the General Assembly intended to create a private right of action under Section 78A-8 for alleged misrepresentations. To the contrary, the statute expressly *excludes* any private right of action under the pertinent portion of the statute.¹⁰

.com/2012/03/articles/watching-the-court/claims-under-the-north-carolina-securities-act-are-easier-to-make-now/.

5. *Trial Court Desktop*, N.C. BUS. CT. (Oct. 16, 2012), <http://www.ncbusinesscourt.net/tcddotnetpublic/default.aspx?CID=3&caseNumber=10CVS745>.

6. *Compare* N.C. GEN. STAT. § 78A-56(a)(2) (2011), *with* 15 U.S.C. § 77l(a)(2) (2012); *accord* N.C. GEN. STAT. § 78A-8(2); 17 C.F.R. § 240.10b-5(b) (2011).

7. *See* *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 588 (E.D.N.C. 1992); *State v. Davidson*, 506 S.E.2d 743, 748 (N.C. Ct. App. 1998).

8. *Compare* N.C. GEN. STAT. § 78A-8, *with* 17 C.F.R. § 240.10b-5(b).

9. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

10. *See* N.C. GEN. STAT. §§ 78A-56(a)(1), 78A-56(j).

The other antifraud provision of the North Carolina Securities Act is Section 78A-56(a)(2), which parallels the lesser-known Section 12(a)(2) of the federal Securities Act of 1933.¹¹ This provision of the North Carolina law creates strict liability for material misrepresentations in connection with the purchase or sale of securities, subject to an affirmative defense that the person making the misrepresentation “did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.”¹² There is no requirement of scienter, nor is there any requirement that the purchaser have relied on the misrepresentation.¹³ Furthermore, while the federal Section 12(a)(2) is significantly limited by the requirement that the misrepresentation appear in a “prospectus,”¹⁴ Section 78A-56(a)(2) of the North Carolina law contains no such limitation on its face.¹⁵ And, unlike Rule 10b-5 and Section 78A-8(2), a private right of action clearly is available under Section 78A-56(a)(2).¹⁶

Three recent opinions from the North Carolina Business Court have taken a closer look at the requirements for a cause of action under the antifraud provisions North Carolina Securities Act.¹⁷ The remainder of this Article explores the antifraud provisions of the North Carolina Securities Act, the distinctions from their federal counterparts, and the way in which the North Carolina Business Court has recently interpreted these provisions.

I. SECTION 78A-8: NORTH CAROLINA’S ANSWER TO RULE 10B-5

The first antifraud provision of the North Carolina Securities Act is Section 78A-8, which states:

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

¹¹ Compare *id.* § 78A-56(a)(2), with 15 U.S.C. § 77l(a)(2).

¹² N.C. GEN. STAT. § 78A-56(a)(2).

¹³ See *id.*

¹⁴ 15 U.S.C. § 77l(a)(2).

¹⁵ See N.C. GEN. STAT. § 78A-56(a)(2).

¹⁶ *Id.*

¹⁷ See *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 16 (N.C. Super. Ct. Mar. 24, 2013); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11 (N.C. Super. Ct. Feb. 19, 2013); *Associated Packaging v. Jackson Paper Mfg.*, No. 10 CVS 745, 2012 NCBC LEXIS 13 (N.C. Super. Ct. Mar. 1, 2012).

- (1) To employ any device, scheme, or artifice to defraud,
- (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading or,
- (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.¹⁸

This section of the Act will look familiar to any securities law practitioner, or indeed anyone who has taken the introductory corporations class in law school; it is taken almost verbatim from the U.S Securities and Exchange Commission's Rule 10b-5,¹⁹ which is probably the best known provision of the federal securities laws. The resemblance is not accidental; the drafters of the Uniform Securities Act of 1956, upon which the North Carolina Securities Act is based, explained that "[t]his section is substantially the Securities and Exchange Commission's [Rule 10b-5]."²⁰

Given that the North Carolina statute uses exactly the same language as Rule 10b-5, and that it was deliberately based on the federal rule, one might expect North Carolina courts to follow federal interpretations of Rule 10b-5 when interpreting Section 78A-8 of the North Carolina Securities Act. And, in fact, North Carolina courts have stated that they do just that: "N.C. Gen. Stat. § 78A-8 closely parallels the Rule 10b-5 antifraud provision of the Securities Exchange Act. Cases construing the federal rule are instructive when examining our statute."²¹

At first glance, this all appears to be quite neat and tidy—the North Carolina statute is a verbatim copy of Rule 10b-5, North Carolina courts follow federal law when interpreting the statute, and, therefore, it would seem that we can simply import wholesale all of the extensive case law and commentary regarding the federal Rule 10b-5 into any case involving Section 78A-8. Upon closer inspection, however, the interpretative issue is not so simple. There are some important questions on which Section 78A-8 may diverge significantly from Rule 10b-5, as discussed below.

18. N.C. GEN. STAT. § 78A-8.

19. 17 C.F.R. 240.10b-5 (2011).

20. UNIF. SEC. ACT § 101 cmt. .01 (1956) (amended 2005); *see also* Skinner v. E.F. Hutton & Co., 320 S.E.2d 424, 427 (N.C. Ct. App. 1984) ("The North Carolina securities anti-fraud provision, G.S. 78A-8, closely parallels the S.E.C. Rule 10b-5."), *rev'd on other grounds*, 333 S.E.2d 236 (N.C. 1985).

21. State v. Davidson, 506 S.E.2d 743, 748 (N.C. Ct. App. 1998) (internal citations omitted).

A. *Is there a private right of action under Section 78A-8?*

A fundamental—and thus far unanswered—question under Section 78A-8 of the North Carolina Securities Act is whether the section confers a right of action upon private litigants. The Act is clear that, at least as to the most important prong of Section 78A-8, it does not.

The North Carolina Securities Act contains provisions for administrative, criminal, and civil enforcement. On the administrative side, the North Carolina Securities Division of the Secretary of State's office is authorized to seek injunctive relief, restitution, and in some cases civil penalties for any violation of the Act.²² On the criminal side, a willful violation of most provisions of the Act, including Section 78A-8, is defined in the statute as a felony.²³

The civil remedies provision of the Act, however, makes clear that private rights of action are available under only certain sections of the Act. Specifically, civil liability under the North Carolina Securities Act is imposed upon any person who “[o]ffers or sells a security in violation of G.S. 78A-8(1), 78A-8(3), 78A-10(b), 78A-13, 78A-14, 78A-24, or 78A-36(a), or of any rule or order under G.S. 78A-49(d) which requires the affirmative approval of sales literature before it is used, or of any condition imposed under G.S. 78A-27(d) or 78A-28(g)”²⁴ The statute thus creates civil liability for violations of specified sections of the Act (including Sections 78A-8(1) and 78A-8(3)), but not for Section 78A-8(2).²⁵

22. N.C. GEN. STAT. § 78A-47.

23. *Id.* § 78A-57(a2). For examples of criminal prosecutions under Section 78A-8, see *Davidson*, 506 S.E.2d 743 and *State v. Williams*, 390 S.E. 2d 746 (N.C. Ct. App. 1990).

24. N.C. GEN. STAT. § 78A-56(a)(1).

25. In recent decisions arising under the North Carolina Securities Act, the North Carolina Business Court affirmatively recognized—for the first time—that the Act creates civil liability only for violations of the first and third prongs of 78A-8. *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 16, *33 (N.C. Super. Ct. Mar. 24, 2013) (“Section 8 does not by its terms provide for civil liability for violations of its provisions. Instead, Subsections (1) and (3) of § 8 are made actionable by § 56(a)(1).”); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *29 (N.C. Super. Ct. Feb. 19, 2013) (“One pathway [to primary liability] sounds in fraud . . . and is represented by Section 78A-8 of the NCSA . . . , of which violations in part are made actionable under § 56(a)(1).”); *Blue Ridge Pediatric & Adolescent Med., Inc. v. First Colony Healthcare, LLC*, No. 11 CVS 127, 2012 NCBC LEXIS 52, at *24–26 (N.C. Super. Ct. Oct. 3, 2012). In *Skoog*, the court recognized that the private right of action is limited to scheme liability; liability for misrepresentations is excluded. See *Skoog*, 2013 NCBC LEXIS 16, at *33–34, *38. If the appellate courts

Section 78A-8(2), the provision for which no civil liability is created, is the most important part of Section 78A-8. That prong of the statute makes it unlawful to “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.”²⁶ It is under this prong that almost all of the case law under Rule 10b-5 has developed. The other two prongs of the North Carolina statute, like Rule 10b-5, do not prohibit material misstatements, but rather prohibit fraudulent schemes.²⁷ Federal courts, interpreting these other two prongs of Rule 10b-5, have held that the “scheme liability” provisions do not apply in cases of material misstatements or omissions—for claims of material misstatement or omission, a plaintiff may proceed *only* under the second prong.²⁸ The usefulness of the first and third prongs of Section 78A-8 to private plaintiffs is thus significantly limited. The heart of the statute is in the second prong, and the second prong is not listed as one for which there is civil liability.

Lest there be any confusion as to the significance of only certain statutory provisions giving rise to civil remedies, the North Carolina Securities Act, after enumerating the provisions of the Act for which civil remedies are available, states: “The rights and remedies provided by this Chapter are in addition to any other rights or remedies that may exist at law or in equity, *but this Chapter does not create any cause of action not specified in this section or G.S. 78A-37(d).*”²⁹ This language is taken

uphold these rulings, whether in these cases or another, it would establish a significant difference between North Carolina and federal securities laws.

26. N.C. GEN. STAT. § 78A-8(2).

27. *Id.* §§ 78A-8(1), (3).

28. See *Pub. Pension Fund Grp. v. KV Pharm. Co.*, 679 F.3d 972, 987 (8th Cir. 2012); *WPP Luxembourg Gamma Three Sarl v. Spot Runner, Inc.*, 655 F.3d 1039, 1057 (9th Cir. 2011); *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 177 (2d Cir. 2005); *SEC v. Kelly*, 817 F. Supp. 2d 340, 344 (S.D.N.Y. 2011). Presumably, this principle would apply in interpreting “scheme liability” under the North Carolina Securities Act, although a recent opinion from Judge Murphy seems to apply the scheme liability provisions to claims based only on alleged misstatements. See *Blue Ridge Pediatric & Adolescent Med., Inc. v. First Colony Healthcare, LLC*, No. 11 CVS 127, 2012 NCBC LEXIS 52, at *24–26 (N.C. Super. Ct. Oct. 3, 2012).

29. N.C. GEN. STAT. § 78A-56(j) (emphasis added). Section 78A-37(d) allows the State to require registered dealers and salespersons to post surety bonds and allows recovery against those bonds in a suit under the North Carolina Securities Act. *Id.* § 78A-37(d).

verbatim from Section 410(j) of the Uniform Securities Act of 1956.³⁰ The official comment to this section states:

Notwithstanding the presence of several specific liability provisions in each of the several SEC statutes, the federal courts have implied a civil cause of action by a defrauded seller against the buyer under SEC Rule X-10b-5. . . . [This provision] is designed to assure that no comparable development is based on violation of § 101 of this Act.³¹

Section 101 of the Uniform Securities Act, in turn, is the provision upon which Section 78A-8 is based.³² The North Carolina Securities Act was thus drafted with the specific intention to exclude the implication of a private right of action under the state-law equivalent of Rule 10b-5.

Given all this, it should be clear that there is no private right of action for violations of Section 78A-8(2). But that is not necessarily the end of the matter. It is well established that a private right of action is available under federal Rule 10b-5, even though it is equally well established that neither Congress nor the U.S. Securities and Exchange Commission initially intended the rule to be enforced by private parties.³³ The federal courts simply invented the private right of action under Rule 10b-5, and by the time the issue reached the U.S. Supreme Court, it was accepted without analysis that such a private right of action was available under the rule.³⁴

North Carolina courts conceivably could do the same with Section 78A-8(2). In fact, a number of North Carolina cases have assumed, without ever explicitly addressing the issue, that a private right of action is available under Section 78A-8(2).³⁵ At least one civil defendant has been held liable by a jury in a lawsuit brought under the statute, with the verdict

30. UNIF. SEC. ACT § 410(j) (1956) (amended 2005).

31. *Id.* § 410 cmt. .01.

32. See Daniel B. Dean, Note, *Underdevelopment of Securities Fraud in North Carolina Courts and the Potential Effect of the North Carolina Securities Act of 1975*, 53 N.C. L. REV. 1104, 1112 (1975).

33. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (“Although [§] 10(b) does not by its terms create an express civil remedy for its violation, and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy, the existence of a private cause of action for violations of the statute and the Rule is now well established.”).

34. See *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

35. See, e.g., *William L. Thorpe Revocable Trust v. Ameritas Inv. Corp.*, No. 4:11-CV-193-D, 2012 U.S. Dist. LEXIS 134049, at *17–18 (E.D.N.C. Sept. 19, 2012); *Bob Timberlake Collection, Inc. v. Edwards*, 626 S.E.2d 315, 322 (N.C. Ct. App. 2006); *Latta v. Rainey*, 689 S.E.2d 898, 908–11 (N.C. Ct. App. 2010).

being upheld on appeal.³⁶ Such a result, however, appears manifestly inconsistent with the plain language of the statute.

B. Is scienter an element of a claim under Section 78A-8?

As to Sections 78A-8(1) and (3) and to Section 78A-8(2), if the North Carolina courts continue to allow a private right of action under that latter prong despite the statutory prohibition, the next question is whether the statute is subject to a scienter requirement.³⁷

One of the most significant limitations on claims under federal Rule 10b-5 is the requirement that the plaintiff prove “scienter,” meaning “a mental state embracing intent to deceive, manipulate, or defraud.”³⁸ Motions to dismiss securities fraud claims almost always include, as part of the motion, an argument that the plaintiff has not adequately pled scienter, and, indeed, an entire body of case law has developed around the pleading requirements for this element of the claim.³⁹ A recent study of motions to dismiss in federal private securities fraud cases showed that 72% of the motions contended that the plaintiff had not adequately pled scienter.⁴⁰ Of those cases, the court found the pleading of scienter to be inadequate, at least as to some claims, 77% of the time.⁴¹ Accordingly, the question of whether such a requirement exists under North Carolina law is of great importance.

Section 78A-8, like federal Rule 10b-5, has no scienter requirement on its face.⁴² Section 78A-8(2) makes it unlawful “[t]o make any untrue

36. See *Latta*, 689 S.E.2d at 908–11.

37. In *Skoog and NNN Durham Office Portfolio 1, LLC*, the court did not find any legislative intent to provide a private right of action under Section 78A-8(2) and therefore did not discuss whether scienter is a requirement under that prong, but it held that scienter—and reliance—are necessary for liability under Sections 78A-8(1) and (3). *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 16, *33–35 (N.C. Super. Ct. Mar. 24, 2013); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *32–34 (N.C. Super. Ct. Feb. 19, 2013).

38. *Ernst & Ernst*, 425 U.S. at 193 n.12.

39. See, e.g., *id.*

40. Wendy G. Couture, *The Falsity-Scienter Inference*, 40 SEC. REG. L.J. 303, 304 (2012).

41. *Id.*

42. See *Associated Packaging, Inc.*, 2012 NCBC LEXIS 13, at *33–36; *Ernst & Ernst*, 425 U.S. at 196. In *Ernst & Ernst*, the Court examined the three prongs of federal Rule 10b-5. *Ernst & Ernst*, 425 U.S. at 196. Although there is no scienter requirement expressed outright, prongs one and three clearly require a showing of scienter, albeit impliedly—it is implied in the “defraud” provision of prong one, which makes it unlawful “[t]o employ any

statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.”⁴³ Sections 78A-8(1) and (3) deal with fraudulent schemes;⁴⁴ the idea of “fraud” suggests scienter, but the statute does not expressly require it. The U.S. Supreme Court has nevertheless read a scienter requirement into Rule 10b-5 despite the absence of any express scienter requirement in the rule itself.⁴⁵ Given that North Carolina courts have repeatedly stated their intent to follow federal interpretations of Rule 10b-5, it would seem logical that a scienter requirement would likewise be read into the North Carolina rule.

However, as Judge Murphy pointed out in his *Associated Packaging* opinion, the U.S. Supreme Court’s importation of a scienter requirement into Rule 10b-5 was based, in part, on administrative law doctrines.⁴⁶ The rule was adopted by the SEC pursuant to its authority under Section 10(b) of the Securities and Exchange Act, which gives the SEC rulemaking power to prohibit the use of “any manipulative or deceptive device or contrivance.”⁴⁷ Because Section 10(b)—the statutory authority for Rule 10b-5—gives the SEC rulemaking authority only as to “manipulative or deceptive” behavior, any SEC rule based on Section 10(b) would necessarily be so limited as well. And the phrase “manipulative or deceptive,” in turn, implies scienter.⁴⁸

Section 78A-8 of the North Carolina Securities Act, in contrast, was enacted directly by the legislature. Accordingly, the administrative law considerations that affect the interpretation of Rule 10b-5 are inapplicable in interpreting the North Carolina statute.⁴⁹ In other words, there is no

device, scheme, or artifice to defraud.” *Id.* Likewise, scienter is implied in the “fraud or deceit” provision of prong 3, which makes it unlawful “[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.” *Id.*; cf. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 474 (S.D.N.Y. 2005) (holding that scienter is a requirement for a claim under Rule 10b-5(a) or (c)).

43. N.C. GEN. STAT. § 78A-8(2) (2011).

44. *Id.* §§ 78A-8(1), (3).

45. See *Ernst & Ernst*, 425 U.S. at 193.

46. *Associated Packaging*, 2012 NCBC LEXIS 13, at *33.

47. 15 U.S.C. § 78j(b) (2012); see also *Associated Packaging*, 2012 NCBC LEXIS 13, at *30–32; *Ernst & Ernst*, 425 U.S. at 197.

48. See *Ernst & Ernst*, 425 U.S. at 197.

49. Cf. *Teague v. Bakker*, 35 F.3d 978, 991 (4th Cir. 1994) (“We must assume that the North Carolina legislature consciously chose to model its anti-fraud provision on an SEC rule and not on the underlying federal statute.”).

North Carolina equivalent of federal Section 10(b) to influence the interpretation of Section 78A-8.

Even absent the Section 10(b) issue, however, there are reasons to read a scienter requirement into Section 78A-8. While it is true that the section contains no scienter requirement on its face, that is because it contains no culpability standard at all on its face.⁵⁰ Read literally, Section 78A-8(2) would impose strict liability for any material misstatement. It is hard to believe that the General Assembly intended such a result. If one assumes that some culpability standard must be read into the statute, then it makes sense that North Carolina courts would look to federal law to pick the standard—and federal law imposes a scienter requirement.⁵¹

C. Is reliance an element of a claim under Section 78A-8?

In addition to scienter, another requirement that federal courts have read into Rule 10b-5 is reliance. Pursuant to this requirement, for a private plaintiff to recover under the rule, the plaintiff must prove that he or she relied on the allegedly false representation.⁵² Nothing on the face of Rule 10b-5 expressly requires reliance.⁵³ Rather, the federal courts have reasoned that because the private cause of action under Rule 10b-5 is implied, rather than express, the courts would look to the most closely analogous express cause of action—Section 18(a) of the Exchange Act—for guidance, and that provision contains an express reliance requirement.⁵⁴

Once again, the federal courts' reasoning cannot be seamlessly applied to the North Carolina statute because there are no "implied" causes of action under the North Carolina statute.⁵⁵ As explained above, as to Section 78A-8(2), the statute expressly rejects any implied cause of action.⁵⁶ As to the other prongs of the statute—Sections 78A-8(1) and 78A-8(3)—the private cause of action is express, rather than implied.⁵⁷

50. See N.C. GEN. STAT. § 78A-8(2) (2011).

51. *Ernst & Ernst*, 425 U.S. at 193.

52. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988). For exchange-traded securities, plaintiffs can show reliance via the "fraud on the market" theory. *Id.* at 247.

53. See 17 C.F.R. § 240.10b-5 (2011).

54. See *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 178 (1994).

55. See N.C. GEN. STAT. § 78A-8(2).

56. *Id.*; see also *id.* § 78A-56.

57. *Id.* §§ 78A-8(1), (3); see also *id.* § 78A-56(a)(1); *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 16, *10, *33 (N.C. Super. Ct. Mar. 24, 2013).

Thus, in considering whether 78A-8 contains a reliance requirement, North Carolina courts will need to look at the language of the statute, policy considerations, and other issues beyond simply what the federal courts have done under federal law. Although the statute does not expressly require reliance, the language can be read to support such a requirement. The first and third prongs deal with fraudulent schemes; the idea of “fraud” suggests reliance. And indeed, federal courts dealing with the first and third prongs of Rule 10b-5 have found a reliance requirement, even though those prongs do not directly parallel Section 18(a).⁵⁸ The second prong deals with “misleading” statements; the idea of being misled likewise suggests a reliance requirement. Furthermore, reliance is an implicit part of any claim for damages because “[r]eliance provides the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”⁵⁹

At least two federal cases—both assuming without discussion the existence of a private right of action—have held that reliance is an element of a civil claim under Rule 78A-8.⁶⁰ One of those cases, however, explicitly admits that the court is guessing as to what a North Carolina state court would do.⁶¹ The other simply asserts without support that reliance is “an element of a claim under the North Carolina Securities Act.”⁶² More recently, a pair of North Carolina Business Court opinions have held that reliance is an element of a claim under Section 78A-8.⁶³ The North Carolina appellate courts, however, have yet to address the issue.

II. SECTION 78A-56(A)(2): NORTH CAROLINA’S ANSWER TO SECTION 12(A)(2)

Section 78A-8, discussed in the last section, has been mistakenly described by at least one court as “*the* antifraud provision of the North

58. See, e.g., *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 474 (S.D.N.Y. 2005).

59. *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988).

60. *Teague v. Bakker*, 35 F.3d 978, 992 (4th Cir. 1994); *Jadoff v. Gleason*, 140 F.R.D. 330, 334 (M.D.N.C. 1991).

61. See *Teague*, 35 F.3d at 991.

62. *Jadoff*, 140 F.R.D. at 334.

63. *Skoog v. Harbert Private Equity Fund, II, LLC*, No. 12 CVS 406, 2013 NCBC LEXIS 16, *35 (N.C. Super. Ct. Mar. 24, 2013); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *33–35 (N.C. Super. Ct. Feb. 19, 2013).

Carolina Securities Act.”⁶⁴ In fact, there is a second antifraud provision of the North Carolina Securities Act. This second provision is found in Section 78A-56 of the Act, and reads as follows:

Any person who . . . [o]ffers or sells a security 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 the light of the circumstances under which they were made, not misleading (the purchaser not knowing of the untruth or omission), and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission, is liable to the person purchasing the security from him, who may sue either at law or in equity to recover the consideration paid for the security⁶⁵

Section 78A-56(a)(2) closely resembles 15 U.S.C. § 77l(a)(2), which reads:

Any person who . . . offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon⁶⁶

The resemblance is intentional. Section 78A-56(a)(2) of the North Carolina Securities Act is based on Section 410 of the Uniform Securities Act, which in turn recognizes that “[t]his clause is almost identical with § 12(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2).”⁶⁷ Thus, Section 78A-56(a)(2) of the North Carolina Act was intended to parallel Section 12(a)(2) of the federal Securities Act.

Given that Section 78A-56(a)(2) was borrowed from Section 12(a)(2) of the federal Securities Act, one would expect courts interpreting Section

64. *Teague*, 35 F.3d at 985 (emphasis added).

65. N.C. GEN. STAT. § 78A-56(a)(2) (2011).

66. 15 U.S.C. § 77l(a)(2) (2012).

67. UNIF. SEC. ACT § 410(a)(2) cmt. .01 (1956) (amended 2005).

78A-56(a)(2) to look to judicial interpretations of the corresponding federal law. And that is exactly what has happened. As the Eastern District of North Carolina has stated: “Because § 78A-56 parallels § 12(a)(2) of the 1933 Act, cases construing § 12(a)(2) should be considered when interpreting § 78A-56.”⁶⁸ The North Carolina Business Court has likewise held that this section should be interpreted in accordance with its federal counterpart.⁶⁹

The prohibition created by Section 78A-56(a)(2)—offering or selling a security “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”⁷⁰—is substantially identical to that which is prohibited under Section 78A-8(2), which was discussed in the prior section. As a result, some courts have treated Sections 78A-8(2) and 78A-56(a)(2) interchangeably.⁷¹ There are, however, significant differences between the two sections.

First, the complicated issues that arise under Section 78A-8 are much simpler under Section 78A-56(a)(2), and all in ways that favor private plaintiffs:

- *Private right of action.* There is indisputably a private right of action under Section 78A-56(a)(2). Indeed, this section appears in the section of the statute titled “Civil Liabilities.”⁷²
- *Scienter.* There is no scienter requirement under Section 78A-56(a)(2). Not only does no scienter requirement appear on the face of the statute, but cases under the parallel federal law have expressly rejected a scienter requirement.⁷³
- *Reliance.* A plaintiff proceeding under Section 78A-56(a)(2) need not show reliance on the alleged misrepresentation or omission. Again, there is no reliance requirement on the face of the statute, and cases

68. *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 588 (E.D.N.C. 1992).

69. *See* *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *37–38 (N.C. Super. Ct. Feb. 19, 2013).

70. N.C. GEN. STAT. § 78A-56(a)(2).

71. *See, e.g.,* *Latta v. Rainey*, 689 S.E.2d 898, 908 (N.C. Ct. App. 2010); *Bob Timberlake Collection, Inc. v. Edwards*, 626 S.E.2d 315, 322 (N.C. Ct. App. 2006).

72. N.C. GEN. STAT. § 78A-56.

73. *See, e.g.,* *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1217 (1st Cir. 1996) (“[A] Rule 10b-5 plaintiff, unlike a plaintiff asserting claims under Section 11 or 12(a)(2) of the Securities Act, must establish that the defendant acted with scienter, and that the plaintiff’s reliance on the defendant’s misstatement caused his injury.”).

under the parallel federal statute have expressly rejected a reliance requirement.⁷⁴

Not only is there no scienter requirement under Section 78A-56(a)(2), a plaintiff does not even need to prove negligence on the part of a defendant. Rather, the statute creates strict liability for material misstatements or omissions, subject to an affirmative defense if a defendant can prove “that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.”⁷⁵ The burden shifting is not a mere technicality—by relieving a plaintiff of the burden to show negligence, it becomes considerably more difficult for a defendant to dismiss a securities fraud claim under Rule 12(b)(6).

There are, however, limitations on a cause of action under Section 78A-56(a)(2) that are not present under Rule 10b-5 or its North Carolina counterpart. First, liability is limited to a person who “offers or sells” a security.⁷⁶ This means that the buyer’s cause of action is against only: (a) the person from whom the buyer purchased the security; and (b) brokers and others who solicited the purchase.⁷⁷ Additionally, professionals who

74. See, e.g., *id.*; see also *Bradley v. Hullander*, 249 S.E.2d 486, 494, 499 (S.C. 1978) (holding that equivalent provision of the South Carolina Securities Act does not require reliance and that merely negligent misrepresentations or omissions are sufficient to trigger liability under the statute).

75. N.C. GEN. STAT. § 78A-56(a)(2); accord *Sullivan v. Mebane Packaging Grp., Inc.*, 581 S.E.2d 452, 463 (N.C. Ct. App. 2003) (setting forth the elements of claim under the statute). Setting them out specifically, the North Carolina Business Court stated that

[T]he elements of a claim under § 56(a)(2) include: (1) a statement which was false or misleading, or which under the circumstances was false or misleading because of the omission of other facts (the purchaser not knowing of the untruth or omission); (2) that such statement was material; and (3) that such statement was made by one who offered or sold a security. The offeror or seller may escape liability for such a false or misleading statement if he can show that he did not know and in the exercise of reasonable diligence could not have known that the statement was false or misleading.

NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *38–39 (N.C. Super. Ct. Feb. 19, 2013).

76. N.C. GEN. STAT. § 78A-56(a)(2).

77. See *Pinter v. Dahl*, 486 U.S. 622, 646–47 (1988); *State v. Williams*, 390 S.E.2d 746, 749 (N.C. Ct. App. 1990). A parallel provision allows defrauded sellers to recover from buyers, but the “quasi-privity” requirement is still present. See N.C. GEN. STAT. § 78A-56(b).

provide services in connection with a sale are not directly liable under the statute.⁷⁸

In addition, the remedy for violations of Section 78A-56(a)(2) is expressly defined as and limited to rescission.⁷⁹ Other measures or forms of damages are not available. Indeed, a defendant can preclude a lawsuit under 78A-56(a)(2) by making a pre-suit offer to refund the plaintiff's purchase price (with interest).⁸⁰ Whether the rescission remedy is better or worse than a standard damages remedy depends on the particular case.

A cause of action under Section 78A-56(a)(2) does not, however, appear to be encumbered by the most significant limitation on its federal counterpart—namely, the “prospectus” requirement. Section 12(a)(2) of the federal Securities Act limits liability to persons who offer or sell a security “by means of a prospectus.”⁸¹ The United States Supreme Court has interpreted this language to mean that a cause of action lies under Section 12(a)(2) only for statements contained in “documents related to public offerings by an issuer”⁸² Thus, private offerings and secondary market transactions are effectively exempt from Section 12(a)(2).

North Carolina's statute—Section 78A-56—does not contain the “prospectus” language of its federal counterpart.⁸³ Thus, on its face, the North Carolina statute has a much broader scope than the federal statute.

78. See *Pinter*, 486 U.S. at 651. It is unclear whether a cause of action might lie against service providers under an “aiding and abetting” theory. Cf. *Venturtech II v. Deloitte Haskins & Sells*, 790 F. Supp. 576, 587 (E.D.N.C. 1992) (noting but declining to address the “aiding and abetting” issue in the context of the commission of a fraud); *Bennett v. Durham*, 683 F.3d 734 (6th Cir. 2012) (affirming judgment as a matter of law under state Securities Act for attorneys involved in securities transaction because they were not “agents” under the statute). The North Carolina Securities Act, however, expressly creates liability for certain persons who “materially aid[]” in a transaction. N.C. GEN. STAT. § 78A-56(c); *NNN Durham Office Portfolio 1, LLC v. Highwoods Realty Ltd. P’ship*, No. 12 CVS 3945, 2013 NCBC LEXIS 11, *42–49 (N.C. Super. Ct. Feb. 19, 2013) (interpreting “materially aid” as contributing substantial assistance to the act or conduct).

79. N.C. GEN. STAT. § 78A-56(a) (allowing an aggrieved party “to recover the consideration paid for the security, together with interest at the legal rate from the date of payment, costs, and reasonable attorneys’ fees”). This is the exclusive remedy not only for Section 78A-56(a)(2), but for all civil actions under the North Carolina Securities Act. See generally *id.*

80. See N.C. GEN. STAT. § 78A-56(g)(1); *Mashburn v. First Investors Corp.*, 432 S.E.2d 869, 871–72 (N.C. Ct. App. 1993).

81. 15 U.S.C. § 77l(a)(2) (2012).

82. *Gustafson v. Alloyd Co.*, 513 U.S. 561, 569 (1995).

83. See N.C. GEN. STAT. § 78A-56(a)(2).

Statutory language, however, was not the only consideration applied by the United States Supreme Court in limiting the reach of Section 12(a)(2). The Court also stated:

It is understandable that Congress would provide buyers with a right to rescind, without proof of fraud or reliance, as to misstatements contained in a document prepared with care, following well-established procedures relating to investigations with due diligence and in the context of a public offering by an issuer or its controlling shareholders. It is not plausible to infer that Congress created this extensive liability for every casual communication between buyer and seller in the secondary market. It is often difficult, if not altogether impractical, for those engaged in casual communications not to omit some fact that would, if included, qualify the accuracy of a statement. Under [plaintiff's] view any casual communication between buyer and seller in the aftermarket could give rise to an action for rescission, with no evidence of fraud on the part of the seller or reliance on the part of the buyer. In many instances buyers in practical effect would have an option to rescind, impairing the stability of past transactions where neither fraud nor detrimental reliance on misstatements or omissions occurred. We find no basis for interpreting the statute to reach so far.⁸⁴

Those same policy concerns are present under North Carolina's statute. It remains to be seen whether North Carolina courts, like their federal counterparts, will find a way to limit the scope of Section 78A-56(a)(2) in light of these concerns. Delaware, for example, has a statute nearly identical to Section 78A-56(a)(2).⁸⁵ Delaware courts, however, have held that the statute does not create an independent cause of action; rather the statute must be read in connection with the Delaware equivalent of Rule 10b-5, which parallels North Carolina's Section 78A-8.⁸⁶

84. *Gustafson*, 513 U.S. at 578; see also *id.* at 594 (Thomas, J., dissenting) ("I share the majority's concern that extending § 12(a)(2) to secondary and private transactions might result in an unwanted increase in securities litigation."). Academic commentators have suggested that policy concerns were the driving reason for the Supreme Court's narrow interpretation of the "prospectus" requirement. See, e.g., Stephen M. Bainbridge, *Securities Act Section 12(a)(2) After the Gustafson Debacle*, 50 BUS. LAW. 1231, 1253-57 (1995).

85. See DEL. CODE ANN. tit. 6 § 73-605(a)(2) (2011).

86. See DEL. CODE ANN. tit. 6 § 73-201 (2011); *Singer v. Magnovox Co.*, 367 A.2d 1349, 1360-61 (Del. Ch. 1976), *rev'd on other grounds*, 380 A.2d 969 (Del. 1977); *Cooper v. Celente*, C.A. No. 90C-JL-215 1992 Del. Super. LEXIS 370, at *8 (Del. Super. Ct. Sept. 3, 1992). See also *Organ v. Byron*, 435 F. Supp. 2d 388, 393 (D. Del. 2006).

III. THE REACH OF THE NORTH CAROLINA SECURITIES ACT

The civil liability provisions of the North Carolina Securities Act reach broadly. They apply “to persons who sell or offer to sell when (i) an offer to sell is made in this State, or (ii) an offer to buy is made and accepted in this state.”⁸⁷ The Act defines an offer as being made in North Carolina “when the offer (i) originates from this State or (ii) is directed by the offeror to this State and received at the place to which it is directed”⁸⁸ There is an express exception for broadly circulated publications or media broadcasts, even if they reach North Carolina.⁸⁹

Federal law imposes few limits on the reach of the antifraud provisions of North Carolina Securities Act. The most significant federal restriction is the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”), which generally prohibits fraud-based state law securities claims from being brought as class actions.⁹⁰ Thus, claims under the antifraud provisions of the North Carolina Securities Act must be asserted on an individual basis. Although the National Securities Markets Improvement Act of 1996 (“NSMIA”) preempts many state securities laws regarding securities registration, it does not preempt state laws with respect to “fraud or deceit.”⁹¹ Meanwhile, the Private Securities Litigation Reform Act of 1995 (“PSLRA”) applies only to claims arising under the federal securities laws.⁹²

CONCLUSION

The antifraud provisions of the North Carolina Securities Act are commonly misunderstood both by practitioners and the courts, in large part because those provisions are mistakenly assumed to be duplicative of corresponding provisions of federal law. The North Carolina provisions, however, differ from federal law in important ways that courts and practitioners should keep in mind.

87. N.C. GEN. STAT. § 78A-63(a). There is a parallel provision for claims brought by sellers. *See id.* § 78A-63(b).

88. *Id.* § 78A-63(c).

89. *Id.* § 78A-63(e).

90. 15 U.S.C. § 78bb(f) (2012).

91. *Id.* § 77r(c).

92. *Id.* § 78u-4.