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Fraud and Forbearance: State Courts Divided on Whether to Recognize Claims by Securities Holders

STANLEY J. PARZEN, BRIAN J. MASSENGILL, AND DANA S. DOUGLAS

Two recent state appellate court cases demonstrate the division in the law regarding whether holders of securities can maintain a cause of action related to alleged fraud and negligent misrepresentation.

Earlier this year, the Supreme Court of Georgia issued a decision[1] that expands the availability of fraud and negligent misrepresentation claims in the securities context. The court held that Georgia common law recognizes fraud and negligent misrepresentation claims based on forbearance in the sale of publicly traded securities — commonly known as "holder" claims — if plaintiffs allege that the misrepresentations were directed at them to their injury and that plaintiffs specifically relied on those purported misrepresentations.

Three months later, on May 27, 2010, a New York appellate court reached a contrary conclusion,[2] casting doubt on the longstanding recognition of holder suits under New York law. These decisions illustrate the

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current divergence between a number of U.S. states in their approaches to these suits.

GEORGIA: THE *HOLMES v. GRUBMAN* DECISION

Plaintiff William K. Holmes alleged that on June 25, 1999, he verbally ordered his broker at Salomon Smith Barney & Co., Inc. ("SSB") to sell his WorldCom shares. According to Holmes, SSB and its financial analyst, Jack Grubman, convinced him not to sell his 2.1 million shares in WorldCom. Instead of selling, Holmes purchased additional shares of WorldCom as the stock price declined. In October 2000, Holmes was forced to sell all of his WorldCom shares to meet margin calls, resulting in substantial losses. Holmes' complaint, which originated in a Georgia bankruptcy proceeding, was dismissed[3] for failure to state a claim by the U.S. District Court for the Southern District of New York, which is handling the WorldCom multidistrict litigation. The U.S. Court of Appeals for the Second Circuit affirmed[4] the dismissal but certified three questions to the Supreme Court of Georgia:

- Does Georgia common law recognize fraud claims based on forbearance in the sale of publicly traded securities?
- With respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, is proximate cause adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of defendant's false or misleading statements but does not allege that the truth concealed by the defendant entered the market place, thereby precipitating a drop in the price of the security?
- Under Georgia law, does a brokerage firm owe a fiduciary duty to the holder of a non-discretionary account?

The Supreme Court of Georgia answered the first question in the affirmative, stating that one of the elements for proving fraud under Georgia law is an intention to induce the plaintiff to act or refrain from acting. The Holmes court found support for its holding in both the Restatement (Sec-

ond) of Torts § 525 as well as *Blue Chip Stamps v. Manor Drug Stores*,[5] a case in which the U.S. Supreme Court held that holder claims were not available under Rule 10(b)(5) of the Securities Exchange Act of 1934, but also noted that holder claims may be available under state law. The Holmes court then set forth two limitations on such claims: direct communication and specific reliance. The "direct communication" limitation requires that plaintiffs allege that the misrepresentations were directed to them. The "specific reliance" limitation requires that plaintiffs allege actions, rather than unspoken or unrecorded thoughts and decisions, indicating that the plaintiffs actually relied on the misrepresentations.

With respect to the second question, the Holmes court rejected the argument that plaintiffs could establish proximate causation by simply alleging that injury was a "reasonably foreseeable result" of the misrepresentation. Rather, the court concluded that, with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, plaintiffs have the burden of proving that the truth concealed by the defendant actually entered the marketplace, thereby precipitating a drop in the price of the security. The court further held that plaintiffs must show that it was this revelation of the concealed truth that caused the loss and not merely one of several factors that affected the price.

Finally, the Holmes court held that a stockbroker has fiduciary duties towards a customer who holds a non-discretionary account. After recognizing that the broker owes a number of limited duties to the client regarding the transaction of business, the court further concluded that fiduciary duties owed by a broker to a customer with a non-discretionary account are not restricted to the actual execution of transactions. In addition, the broker has a heightened duty when recommending an investment which the holder of a non-discretionary account has previously rejected or as to which the broker has a conflict of interest.

With the *Holmes* decision, Georgia joins a handful of other states that have recognized holder claims either in the state courts or in federal courts interpreting states' laws, including California, Florida, Massachusetts, New Jersey, and Wisconsin.[6]

NEW YORK: THE *STARR v. AIG* DECISION

New York has traditionally recognized fraud claims where a defendant's misrepresentations induced investors to hold securities.[7]

On May 27, 2010, however, a New York appellate court held that a plaintiff's holder claim violated the "out-of-pocket" rule governing losses recoverable for fraud. Pursuant to the out-of-pocket rule, the true measure of damages for fraud is the actual pecuniary loss sustained as the direct result of the wrong. In *Starr Foundation v. American International Group, Inc.*, Starr Foundation alleged that, but for AIG's purported misrepresentations, it would have continued to sell 15.5 million shares of AIG stock. The appellate court held that Starr Foundation's holder claim was "virtually the paradigm of the kind of claim that is barred by the out-of-pocket rule," because "a lost bargain more 'undeterminable and speculative' than this is difficult to imagine." The court determined that, in continuing to hold the AIG stock, the plaintiff did not lose or give up any value; rather, the plaintiff remained in possession of the true value of the stock, whatever that value may have been at any given time. Accordingly, Starr Foundation did not suffer any out-of-pocket loss as a result of retaining its AIG stock.

In addition to the New York appellate court, several federal courts have expressed doubt with the approach taken by Georgia and other courts, noting that claims for damages under holder claims are untenable. The District of Connecticut dismissed a holder claim on the ground that "the claims for damages based on the plaintiffs' failure to sell or hedge their stock are too speculative to be actionable."[8] Federal courts applying Mississippi, Illinois, and Virginia law have relied on similar principles of loss causation to reject holder claims, reasoning that those who hold securities during the fraud are unable to plead that the misrepresentations caused their loss.[9]

IMPLICATIONS AND CONCLUSIONS

Given the division in state law, it is clear that potential liability to holders of securities varies widely depending upon the jurisdiction in which claims are brought. The Supreme Court of Georgia was quick to point out that "induced forbearance can be the basis for tort liability" and

is consistent with the Restatement (Second) of Torts § 525. Courts that have not yet considered the availability of fraud and negligent misrepresentation claims to holders of securities also could rely on the Restatement (Second) of Torts § 525 to permit holder claims.

The recent decision in New York, however, adds to the doubt cast upon the enforceability of holder claims. Holder plaintiffs will face difficulty pleading reliance, making holder claims susceptible to a motion to dismiss.[10] If a holder claim survives a motion to dismiss, the plaintiff will have difficulty proving causation and damages. Thus, while certain states recognize holder claims, they may remain a practical impossibility due to the difficulties most plaintiffs will have proving the critical elements of misrepresentation claims.

NOTES

[1] *Holmes v. Grubman*, 691 S.E.2d 196 (Ga. 2010).

[2] *Starr Foundation v. American Intern. Group, Inc.*, 2010 WL 2104535 (N.Y.A.D. 1st Dept. May 27, 2010).

[3] *Holmes v. Grubman (In re WorldCom, Inc. Securities Litigation),* 456 F. Supp. 2d 508 (S.D.N.Y. 2006).

[4] *Holmes v. Grubman*, 568 F.3d 329 (2nd Cir. 2009).

[5] *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730-31, 738 (1975).

[6] *Small v. Fritz Companies, Inc.*, 65 P.3d 1255, 1259 (Cal. 2003) (collecting cases); *see also Rogers v. Cisco Systems, Inc.*, 268 F. Supp. 2d 1305, 1314 (N.D. Fla. 2003) (applying Florida law and recognizing "holder" claims but dismissing claims because plaintiffs' allegations of reliance were too vague); *see also Seideman v. Sheboygan Loan & Trust Co., et al.*, 223 N.W. 430, 433 (Wis. 1929).

[7] *Continental Ins. Co. v. Mercadante*, 222 App. Div. 181 (N.Y.A.D. 1st Dept. 1927).

[8] *Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011, 1018 (D. Conn. 1994) (applying Connecticut law).

[9] *See In re WorldCom, Inc. Securities Litigation*, 336 F. Supp. 2d 310, 320 (S.D.N.Y. 2004) (collecting cases).

[10] *Dloogatch v. Brincat*, 396 Ill. App. 3d 842, 849-854 (1st Dist. 2009) (collecting cases and holding that plaintiffs failed to plead reliance or damages in holder claim).