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Commentary

The California Supreme Court Recognizes Holdings Claims For Securities Actions

By
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On April 7, 2003, the California Supreme Court in *Small v. Fritz*[1], held that California law authorizes a shareholder who is wrongfully induced to hold stock instead of selling it to bring a common law action for fraud or misrepresentation if the shareholder can make a bona fide showing of actual reliance upon the misrepresentations. In so doing, California joined a small group of states that have recognized common law claims brought by holders of stock alleging that they were fraudulently induced not to buy or sell stock, but to hold their stock.

In *Birnbaum v. Newport Steel Corp.*[2] the United States Court of Appeals for the Second Circuit held that the principal antifraud provision of the federal securities laws, Rule 10b-5 promulgated pursuant to the Securities Exchange Act of 1934, was aimed only at frauds perpetrated upon a purchaser or seller of securities. In 1975, the United States Supreme Court endorsed the holding in *Birnbaum* in *Blue Chip Stamps v. Manor Drugs*,[3] holding that only purchasers and sellers of securities could pursue a private cause of action under Rule 10b-5.[4] The Supreme Court noted that excluded from this group of potential plaintiffs were, "actual shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representation or a failure to disclose unfavorable material."[5] However, the Supreme Court specifically recognized that disadvantages attendant to the purchaser-seller limitation was, "attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law."[6]

The California Corporate Securities Law of 1968 similarly limited statutory antifraud actions to those brought by purchasers or sellers.[7] In *Small v. Fritz* the California Supreme Court recognized a cause of action by persons wrongfully induced to *hold* stock instead of selling it. The Court described this as a "holder's action" to distinguish it from suits claiming damages from the purchase or sale of stock.

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Small was a holder's action charging that the Fritz Companies ("Fritz") and its officers was sending stockholders a fraudulent quarterly financial report grossly overreporting earnings and profits. The plaintiff alleged that when the fraud was discovered, the price of the corporate stock dropped precipitously, causing injury to the plaintiff and the class. Although the case was filed as a class action, class certification issues were not the subject of the opinion. The pleadings alleged that Fritz, a service provider for importers and exporters, acquired numerous companies between April 1995 and May 1996, including Intertrans Corporation. Fritz allegedly encountered difficulties with these acquisitions, and in particular with the Intretrans accounting system that it adopted for much of its business. Nevertheless, on April 2, 1996 Fritz issued a press release reporting third quarter revenues of $274.3 million, net income of $10.3 million and earnings per share of $29. The same figures appeared in its third quarter report to shareholders issued on April 15. The plaintiff alleged that the report was incorrect for a variety of reasons and that on July 24, Fritz restated its third quarter earnings and revenues. Estimated third quarter earnings were reduced from $10.3 million to $3.1 million. In addition, Fritz announced that it would incur a $3.4 million loss in the fourth quarter. The plaintiff alleged that the individual defendants knew or should have known that the third quarter report and press releases were false and misleading and that, "defendants intended that investors, including plaintiff and the Class, would rely upon and act on the basis of those misrepresentations in deciding whether to retain Fritz shares."

The plaintiff alleged reliance and damages. As to damages, the pleadings alleged, "In response to defendant's disclosures on July 24, 1996, Fritz's stock plunged more than 55% in one day, dropping $15.25 to close at $12.55 per share. . . . Had defendants disclosed correct third quarter revenue, net income and earnings per share on April 2, 1996, as required by GAAP, Fritz's stock would likely have declined on April 2, 1996, and plaintiff and the Class would have disposed of their shares at a price above the $12.25 per share closing price of that day."[8]

The defendants demurred on the grounds that California law does not recognize claims by stockholders who neither bought nor sold based upon alleged misstatements and omissions and that the second amended complaint failed to plead actual reliance with requisite specificity. The trial court sustained the demurrer on the latter basis and entered judgment for the defendants. The Court of Appeals reversed. The Supreme Court granted review and reversed the judgment of the Court of Appeals and remanded the case for further proceedings consistent with its opinion.

Justice Kennard wrote the majority opinion in which Chief Justice George and Justices Werdegar and Moreno joined. The majority noted that California law has long recognized the principle that forebearance can be the basis for tort liability. The majority opinion then noted that while California had not previously applied the principle to lawsuits involving misrepresentations affecting corporate stock, most other states that have considered the issue had concluded that forebearance from selling stock was sufficient reliance to support a cause of action.[9]

The majority opinion reviewed and rejected countervailing policy considerations that the defendants raised to justify a different result for stock sold on a national exchange. The opinion noted that the United States Supreme Court in *Blue Chip Stamps* had considered similar policy issues to those raised by the defendants. These specifically

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included the danger of vexatious and meritless suits to extort a settlement and the difficulties of proof that arise when crucial issues may depend on oral testimony from a stockholder. The majority however concluded that the *Blue Chip Stamps* opinion recognized that even these policy consideration did not justify anything more than a denial of a federal forum to wronged stockholders who were not buyers or sellers.

The majority also considered both the Private Securities Litigation Reform Act of 1995 ("PSLRA")[10] and the Securities Litigation Uniform Standards Act ("SLUSA").[11] The majority held that the PSLRA was limited to *federal* actions and SLUSA applied by its terms only to suits involving the purchase or sale of stock.[12]

The majority opinion reflected further how recent events have influenced its view of policy considerations:

> When Congress enacted the [PSLRA] and [SLUSA], it was almost entirely concerned with preventing nonmeritorious suits. But events since 1998 have changed the perspective. The last few years have seen repeated reports of false financial statements and accounting fraud, demonstrating that many charges of corporate fraud were neither speculative nor attempts to extort settlement money, but were based on actual misconduct. "To open the newspaper today is to receive a daily dose of scandal, from Adelphia to Enron and Beyond. Sadly, each of us knows that these newly publicized instances of accounting-related securities fraud are no longer out of the ordinary, save perhaps in scale alone." The victims of the reported fraud, moreover, are often persons who were induced to hold corporate stock by rosy but false financial reports, while others who knew the true state of affairs exercised stock options and sold at inflated prices. Eliminating barriers that deny redress to actual victims of fraud now assumes an importance equal to that of deterring nonmetiorious suits.[13]

The majority concluded that California has a compelling interest in preserving a business climate free or fraud and deceptive practices and that private suits can assist in doing this.

The majority, however, held that the risk of nonmeritorious suits justifies using the requirement of specific pleading to place limits on a holder's claim even to the extent it is based on negligent misrepresentation. Accordingly, the Supreme Court held that the plaintiff's conclusory allegations in this action of having relied on defendants' misrepresentations were insufficient, but as the requirement had not been stated in previous cases, the plaintiff should be given leave to amend.[14]

In a concurring opinion, Justice Baxter agreed that a holder's action should be permitted when a plaintiff personally relied on misrepresentations by the company or its official to induce the plaintiff not to sell his shares, however, Justice Baxter was critical of the lack of guidance by the majority on the issue of damages. He asserts that a fundamental flaw in the plaintiff's pleading was, "the complaint's utter failure to state whether, or how the described shareholders [i.e., persons who held Fritz stock before April 2, 1996, when Fritz first overstated its third quarter results, through July 24, 1996 when Fritz downgraded its third quarter results and announced disappoint-

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ing fourth quarter earnings] have suffered a *realized loss* as a result of the alleged fraud."[15] Justice Baxter suggested a number of ways in which a plaintiff might establish damages and concludes, "I would require that those who assert they were fraudulently induced to *hold* company shares must plead and prove specific facts showing that they actually realized out-of-pocket losses as a result of the fraud and its disclosure. Pleading and proof that the price of the shares fell on a particular day as a result of the disclosure of the fraud would not suffice."[16]

Justice Brown in a separate opinion, concurring in part and dissenting in part, which Justice Chin joined, also focused on the issue of damages. However, because upon reviewing a judgment of dismissal following the sustaining of a demurrer a reviewing court may affirm on any grounds stated in the demurrer, he would affirm the decision on the trial court a decline remand. Justice Brown concluded that the plaintiff suffered no damage from the timing of Fritz's true third quarter results. Justice Brown reasoned first that the plaintiff suffered no injury due to the content of the misrepresentations because if the true information had been disclosed as required timely, the market price, assuming an efficient market,[17] would have reflected this information and would have dropped accordingly. He further reasoned that the market price on the date of the corrected disclosure was then the same price that the stock would have had on that date if the defendants reported the true facts instead of the misrepresentations earlier. He discounted other damages as too speculative or with sufficient causal allegations. Justice Brown did, however, join the majority in concluding that at least in certain circumstances, stockholders who allegedly held stock in reliance on another's misrepresentations may state a claim for fraud or deceit. Relying on out of state cases, he cited as examples, face-to-face misrepresentations that would not immediately be reflected in the market price of stock or cases where holders can show that they were actually preparing to sell or considering the sale of the stock.

In a separate concurring opinion, Justice Kennard who authored the majority opinion takes issue with the damage analyses advanced by Justices Baxter and Brown. Following a detailed analyses of her reasoning disputing the damage analyses offered by these fellow Justices, Justice Kennard concludes:

> In sum, disclosures during the past three years have revealed extensive fraud involving numerous corporations, often involving false financial reports and the concealment of true financial data — fraud so massive that it contributed to an overall decline in the stock market and perhaps to a decline in the economy generally. The victims include not only those who bought or sold stock in reliance upon the false statements, but also those who held stock in reliance. The majority opinion allows such holders to sue for damages. That remedy should not be so hedged and qualified that only a fraction of those actually injured would be able to gain redress.[18]

It is clear that the majority opinion, influenced by recent corporate scandals has opened the doors in California's state courts to holder actions. It remains to be seen whether issues that defense counsel will undoubtedly raise including class certification and possible SLUSA preemption, limit how wide those doors have been opened.

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ENDNOTES

1. 30 Cal. 4th 167.

2. 193 F.2d 461 (2nd Cir. 1952).

3. 421 U.S. 723, 95 S. Ct. 1917, 44 L.Ed. 2d 539 (1975).

4. 17 C.F.R. 240.10b-5.

5. *Id.* at 738.

6. *Id.* at 739, n.9.

7. *See, e.g.,* California Corporation Code section 25501 ("Any person who violates Section 25401 shall be liable to the person who purchases a security from him or sells a security to him, . . ."). ."). In *Small,* the Court noted that, "persons who hold stock in reliance upon misrepresentations . . . have no remedy under with federal Rule 10b-5 or Corporations Code section 25000 and 25400, because all of these provisions are limited to suits by buyers or sellers of securities." *Fritz, supra*, at 181.

8. *Id.* at 173.

9. The Court cited the following cases from Massachusetts, New Jersey and New York: *David v. Belmont* (1935) 291 Mass. 450 [197 N.E. 83], *Fottler v. Moseley* (1901) 179 Mass. 295 [60 N.E. 788]. *Smith v. Duffy* (1895) 57 N.J.L. 679, 32 A. 371 [*sub nom. Duffy v. Smith* 32 A. 371], *Continental Insurance Co. v. Mercadante* (1927) 222 A.D. 181 [225 N.Y.S. 488], *Rothmiller v. Stein* (1894) 143 N.Y. 581 [38 N.E. 718] and *Gutman v. Howard Sav. Bank, 748 F. Supp. 254, 268* (D.N.J. 1990) ("Lies which deceive and inure do not become innocent merely because the deceive continue to do something rather than begin to so something else. Inducement is the substance of reliance; the form of reliance — action or inaction — is not critical to the actionability of fraud.") (Fn. omitted.) The Court noted a contrary position in *Chanoff v. U.S. Surgical Corp.* 857 F. Supp. 1011 (D.Conn. 1994) (applying Connecticut law). In addition to the cases noted by the Supreme Court, authority for holder claims at least by analogy may also be found in a limited number of other jurisdictions. *See, e.g., Seidman v. Sheboygan Loan & Trust Co.,* 198 Wis. 97, 223 N.W. 430 (1929) (bondholder induced into holding bonds) and *Brown-Wales Co. v. Barber,* 88 N.H. 103, 184 A. 855 (1936) (creditor induced into forebearing action to collect on debt). *See also, Malone v. Brincat*, 722 A.2d 5 (Del. 1998) where shareholders who did not purchase or sell their shares brought a class action against the issuer, its officer director and auditors, after the issuer restated earnings for previous years. The Delaware Supreme Court affirmed a dismissal by the Chancery Court, but remanded to allow an opportunity to replead. The Supreme Court reminded the plaintiffs, however, that any class allegation would need to be consistent with the *Gaffin v. Teledyne, Inc.*, 611 A.2d 467, (Del. 1992) which held that a class action may not be maintained under Delaware law in a purely common law or equitable fraud case since individual questions of law or fact predominate, particularly as to the element of justifiable reliance. *Malone, supra,* at 14.

10. Pub. L. No. 104-67,Pub. L. No. 104-67,109 Stat. 737 (1995) (The PSLRA generally imposed limitations on federal securities fraud actions.)

11. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (SLUSA generally preempted certain state law claims by allowing removal to federal court. SLUSA was largely enacted in reaction to the perception that plaintiffs' attorney were avoiding the restriction of the PSLRA by proceeding in state court.)

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12. Commentators have expressed opposing views on whether or not SLUSA should preempt holding actions. *Compare*, Joshua D. Ratner, Stockholders' Holding Claim Class Action under State Law After the Uniform Standards Act of 1998, 68 U. Chi. L. Rev. (Summer 2001) arguing that holding claim class action should be viewed as obstructing the purpose of SLUSA and that such claims should be viewed as implicitly preempted, with Amanda M. Rose, Life After SLUSA: What is the Fate of Holding Claims, 69 Def.Couns.J. 455 (October 20002) arguing that although state holding claims have the potential to undermine the goals of the PSLRA, they rightly remain within the jurisdiction of state courts.

13. (Citations omitted.) *Small, supra* at 181-82.

14. The majority opinion, however, left open the possibility that conclusory pleading would be sufficient for a derivative claim: "Plaintiffs who cannot plead with sufficient specificity to show a bona fide claim of actual reliance do not stand out from the mass of stock holders who rely on the market. Under *Mirkin, supra,* 5 Cal. 4th 1082, 23 Cal. Rptr.2d 101, 858 P.2d 568, such persons cannot bring individual or class actions for fraud or misrepresentation. They may, however, be able to bring a corporate derivative action against the corporate officers and directors for harm caused to the corporation." *Id.* at 185.

15. *Id.* at 195.

16. *Id.* at 201.

17. In an *efficient market*, the market price of shares. . . reflects all publicly available information,." *Basic, Inc. v. Levinson* 485 U.S. 224, 246, 108 S.Ct. 978, 99 L.Ed.2d 194 (1988). Without necessarily accepting the efficient market model, Justice Brown appears to assume that the plaintiff's claim rest upon an efficient market model.

18. Small, supra *at 193.* ■