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ANTIFRAUD

Suitability Claims for Investors Who Hold: The California Bloom Is Off the Rose

BY C. EVAN STEWART

The suitability of a particular security is often, like beauty, in the eye of the beholder. As an NASD unit observed in the not too distant past: ''Because they are the most common yet most ambiguous of all client accusations, 'unsuitability' claims can often create significant problems for [NASD] firm[s]. This is because what constitutes a viable unsuitability claim is open to debate.''[1]

This unsettling state of affairs has become even more obvious since the Millennium, with consecutive years of down markets leading many investors to claim that what had been suitable for them in the 1990's (e.g., tech stocks) became no longer suitable after March of 2000. And with the market going in a negative direction, discussions between clients and registered representatives have focused not only on whether to buy or sell a particular security, but whether to hold it (i.e., not sell). The issue of whether such a hold recommendation is actionable under the securities laws is the focus of this article.

The Birth of Suitability. The concept of suitability has its roots in the ''shingle'' theory put forward by the Securities and Exchange Commission in the first decade of its existence. By that theory, when a broker-dealer hangs out its shingle to do business, it is making an implied representation to the public that it has skilled professionals in the securities field who will give clients expert advice with respect to specific securities.[2]

The self regulatory organizations (SROs) have tried to give more specific guidance in this area. The New York Stock Exchange, for example, long ago issued the ''know your customer'' rule (Rule 405). This rule, origi-

[1] *See* 30 *Sec. Reg. & L. Rep. (BNA)* at 810 (May 29, 1998) (NASD Avoidance and Prevention Advisory) (up to 95% of NASD member claims under errors and omissions policies relate to unsuitability claims).

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[2] *See, e.g., Charles Hughes & Co. v. Securities and Exchange Commission*, 139 F.2d 434 (2d Cir. 1943). *See generally* R. H. Mundheim, ''Professional Responsibilities of Broker-Dealers: The Suitability Doctrine,'' 1965 *Duke L.J. 445*; A.S. Jacobs, ''The Impact of Securities Exchange Act Rule 10b-5 [17 C.F.R. § 240.10b-5] on Broker-Dealers,'' 57 *Cornell L. Rev.* 869 (1972). In a subsequent ''Special Study of the Securities Market'' (H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963)), the SEC gave heightened emphasis to the suitability theory, recommending objective standards, specific categories and amounts of securities that would be deemed unsuitable, and other far reaching notions. Those recommendations were not adopted, however, and suitability has continued to be judged on a subjective basis since that time.

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nally designed to protect member firms vis-a-vis clients' financial problems, morphed over time into a suitability rule.[3]

The NASD promulgated a more explicit suitability standard, which is set forth in NASD Rule 2310(a):

> "In recommending to a customer the *purchase*, *sale* or *exchange* of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any disclosed by such customer as to his other security holdings and as to his financial situation and needs" (emphasis added).

Over the course of its life, there has been much spirited debated regarding the appropriateness of NASD Rule 2310(a)'s application to unsolicited transactions, institutional clients, and a whole host of other significant matters.[4]

It is important to note that the SRO rules in this area subject member firms only to disciplinary sanction(s) by the SROs. As courts have made clear, the SRO suitability rules do not in and of themselves provide private rights of action for money damages.[5]

Instead of the SRO rules, plaintiffs (i.e., plaintiffs' counsel) and the SEC have looked to a more potent tool to enforce suitability: Section 10(b) and Rule 10b-5, which prohibit fraud in the "purchase or sale" of a security.[6] Other weapons for the litigious have included (sometimes successfully, sometimes not): common law fraud, individual state securities statutes (modeled after Section 10(b)), breach of fiduciary duty, and negligence (i.e., negligent misrepresentation).[7]

A Recommendation Neither to Buy or Sell. Regardless of the aforementioned theories of liability employed in seeking to recover money damages, they all share a common theme: that the broker-dealer made a unsuitable recommendation to *buy* a security or to *sell* a security. But what about (as Monte Hall use to say on "Let's Make a Deal") Door Number Three? Where the broker's advice is to do neither; rather, the advice is to hold?

In *Birnbaum v. Newport Steel Corp.*,[8] the United States Court of Appeals for the Second Circuit addressed that question for the first time in 1952. There, the court held that Rule 10b-5 was enforceable only as to " 'a fraud perpetrated upon the purchaser or seller' of securities." As such, the court determined that the rule could not be invoked by non-purchasers or non-sellers with respect to alleged breaches of fiduciary duties by corporate officers.

Twenty three years later, the United States Supreme Court agreed. In *Blue Chip Stamps v. Manor Drug Stores*,[9] the Court barred non-purchasers or sellers from invoking Rule 10b-5 to recover money damages. In light of that precedent, lower federal courts have consistently barred holder claims since.[10] And such a result would seem to be fully consistent with the SRO suitability rules (e.g., NASD Rule 2310(a)), which relate only to the "purchase, sale or exchange" of a security.

California Dreaming. A recent decision by the California Supreme Court—*Small v. Fritz Companies, Inc.*[11]—demonstrates that any such clarity in this area may be illusory, however. In *Small*, a stockholder instituted a class action proceeding, claiming common law fraud and misrepresentation regarding a company's quarterly earnings reports; said fraud and misrepresentation allegedly caused the plaintiff (and his putative fellow class members) to hold on to the company's stock. The trial court dismissed the action, with the intermediate appellate court reversing that decision. On appeal to the California Supreme Court, that court decided to recognize for the first time a cause of action for fraud or negligent misrepresentation when a plaintiff, in reliance thereon, decides to hold stock, rather than buying or selling it.

The California Supreme Court explicitly acknowledged that such a claim would not be permissible in federal court. At the same time, it noted that the U.S. Supreme Court in *Blue Chip Stamps* had observed (in a footnote) that all that was being extinguished in that case were *federal* remedies, and that remedies under *state* law were still open to the *Blue Chip Stamps* plaintiff.

The court then looked to California common law vis-à-vis fraud and negligent misrepresentation, and found each appropriate for holder cases. The court was bolstered in its determination by Section 525 of the Restatement Second of Torts, which makes actionable (among other things) a fraudulent misrepresentation which causes another "to refrain from action," as well as non-recent California precedent in which forbearance was held to constitute the basis for tort liability (outside the securities field).

Important to the California Supreme Court's endorsement of holder liability in the securities context was its reliance on pre-federal securities laws cases in the state courts of New York,[12] New Jersey,[13] and Massachu-

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[3] *See* L.D. Lowenfels and A.R. Bromberg, "Suitability in Securities Transactions," 54 *Bus. Law.* 1557, 1571-72 (1999). In enforcing this rule, disciplinary proceedings are brought under NYSE Rule 476(a), which bars conduct that is "inconsistent with just and equitable principles of trade." *Id.* at 1577-78.

[4] *See supra* note 3 at 1560-70. Other SROs (e.g., the MSRB, the CBOE) have similar suitability rules. *Id.* at 1573-74. Another important area for suitability scrutiny is that of on-line trading. *See* D.J. Kramer, B. Santangello & M.A. Jacobs, "Suitability in Cyberspace, 34 *Rev. of Sec. & Comm. Reg.* 123 (June 13, 2001).

[5] *See, e.g., Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293 (2d Cir. 2002); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413 (11th Cir. 1983); *Craighead v. E.F. Hutton*, 899 F.2d 485 (6th Cir. 1990).

[6] *See, e.g., In re Powell & McGowan, Inc.*, 41 S.E.C. 933 (1964); *In re Whitman & Stirling Co.*, 43 S.E.C. (1966); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1985); *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1990); *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893 (10th Cir. 1992); *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017 (4th Cir. 1997).

[7] *See supra* note 3 at 1587-93. This last theory of culpability (i.e., negligence) is controversial and extremely problematic. Pure negligence, *per se*, is undoubtedly not a basis for liability, especially where it cannot be shown that the brokers breached a fiduciary duty to the client. *See* R.A. Booth, "The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk," 54 *Bus. Law.* 1599, 1605 (1999).

[8] 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

[9] 421 U.S. 723 (1975).

[10] *See, e.g., Riley v. Merrill Lynch, Pierce Fenner & Smith*, 292 F.3d 1334 (11th Cir. 2002); *Goldman v. AG Becker*, 1983 WL 1302 at *3 (S.D.N.Y. April 20, 1983).

[11] 2003 WL 1792618 (April 7, 2003).

[12] *See Continental Insurance Co. v. Mercadante*, 222 A.D. 181, 225 N.Y.S. 488 (1st Dept. 1927).

[13] *See Smith v. Duffy*, 57 N.J.L. 679, 32 A. 371 (1895).

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setts.[14] In those dust-gathering cases, the courts upheld holder liability when misrepresentations involving corporate stock were alleged. At the same time it cited those cases, the California Supreme Court also acknowledged that the most recent court to look at this issue had rejected holder liability.[15]

And while the California Supreme Court embraced the concept of holder liability with some enthusiasm,[16] its members struggled in and among themselves on the issue of damages. Justice Marvin R. Baxter, for example, wrote a concurring opinion in which he questioned whether the plaintiff (or any member of the putative class) had suffered damages because there had been no allegation of a *realized* loss. By the pleading, it was not clear whether the stock in question had ever been sold. As a result, Justice Baxter posited that the plaintiff's damages calculation would necessarily be pursuant to a ''snapshot'' theory: ''any difference between the price to which the shares actually fell [on the disclosure of the bad news], and the price at which the shares could have been promptly sold if the true third quarter result had been announced in timely fashion.'' To Justice Baxter, such damages would be ''*paper* losses,'' and ''the law may only compensate [*permanent realized*] losses.''[17]

Justice Janice R. Brown, filing a concurring and dissenting opinion (also on behalf of Justice Ming W. Chin), agreed with Justice Baxter's analysis vis-à-vis the need to ''plead and prove an *actual, realized* loss which can be *directly attributed*, in a specific amount, to the fraud and its disclosure.'' Justice Brown, however, also went on to opine that, as a matter of pleading, the plaintiff's damages causation was fatally deficient. Invoking the efficient market theory espoused by the United States Supreme Court and leading commentators,[18] she ticked off various infirmities in the plaintiff's damages pleading: (i) plaintiff was not injured as a matter of law because of the content of the alleged misrepresentation (after the report of third quarter earnings, the stock was trading at an unlawfully inflated price; if the report of bad news had in fact been made in a timely fashion, then the market would have immediately assimilated that information with a resulting drop in the stock price; as such, the plaintiff cannot ''claim the right to profit from . . . an unlawfully inflated stock value.''); (ii) plaintiff was not injured because of the timing of the company's actual/true third quarter earnings (if the bad news had in fact been announced at the earlier date, then there would have been no resulting drop in the stock three months later); (iii) any drop in the stock price attributable to the market's loss of confidence in management because of the delay in the dissemination of the actual/true earnings was too remote and/or speculative (and would allow for a cognizable claim whenever a company announces bad news); and (iv) plaintiff's allegation that he would have sold at some (undefined) point after the original date of the third quarter earnings report—when there is no allegation that he ever sold his stock—''is, at best, conjectural, [and] it is impossible to ascertain which drops in stock price he would have avoided.''[19]

Justice Joyce L. Kennard, who had written the original opinion, felt compelled to pen a separate concurrence (on behalf of herself) to respond to Justices Baxter and Brown. With respect to Justice Baxter, Justice Kennard simply disagreed that ''paper losses'' are not proper and/or recoverable damages under tort law.[20] As to Justice Brown, Justice Kennard's response is that she did not correctly apply the efficient market theory. The speculative nature of damages, or the remoteness to the event, should not (to Justice Kennard) constitute a bar to a claim of this sort:

> ''[O]nce a plaintiff holder can show that a portion of the loss is attributable to fraud, difficulty in proving damages will not bar a cause of action. Proof will, of course, often require expert evidence. Such evidence is commonplace in securities fraud actions. [citations omitted] Experts may disagree—they often do—but that is no reason to reject a holder's cause of action.''

As California Goes, So Goes . . .? The California Justices' struggles with the concept and measure of damages in *Small* underscore the path breaking nature of their pro-holder decision in the first place. The court's citation to and reliance on a handful of old and dated state law cases[21] underscores the fact that those cases are at odds with the development of the modern securities laws (e.g., *Blue Chip Stamps*, NASD Rule 2310(a),

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[14] *See Fottler v. Moseley*, 179 Mass. 295, 60 N.E. 788 (1901).

[15] *See Chanoff v. U.S. Surgical Corp.*, 857 F. Supp. 1011 (D. Conn.), *aff'd*, 31 F.3d 66 (2d Cir.), *cert. denied*, 513 U.S. 1058 (1994) (applying Connecticut law). The most recent pro-holder case cited by the *Small* court was *Gutman v. Howard Savings Bank*, 748 F. Supp. 254 (D.N.J. 1990) (applying New York and New Jersey law).

[16] The California Supreme Court's enthusiasm was undeterred by the policy grounds identified by the U.S. Supreme Court in *Blue Chip Stamps* for barring money damages recovery for holder claims under Section 10(b). *See infra* notes 26 & 27 and accompanying text.

[17] Justice Baxter also reviewed the two most recent holder cases, which reached opposite results (*see supra* note 15). In the pro-holder case (*Gutman*) the plaintiff did in fact sell their stock ''at a great loss.'' In the anti-holder case (*Chanoff*), the court found that the non-selling plaintiff's damages ''were too speculative to be actionable.''

[18] *See Basic, Inc. v. Levinson*, 485 U.S. 224 (1988); Stout, ''Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law,'' 99 *Yale L.J.* 1235 (1990); Saari, ''The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry,'' 29 *Stan. L. Rev.* 1031 (1977). Justice Brown wrote that she neither accepted nor rejected this theory.

[19] In amplifying her analysis, Justice Brown wrote that ''the misrepresentations did *not* induce plaintiff to subject himself to the risk of drops in market price due to intervening causes unrelated to the misrepresentations. Plaintiff agreed to take this risk *before* the misrepresentations. Under these circumstances, he can hardly claim damages based on the fruition of these risks, especially where, as here, the date on which he would have sold the stock is wholly speculative. Any contrary conclusion would make defendant the unpaid insurers of plaintiff's risk'' (emphasis in original).

[20] As principle authority, Justice Kennard cited *Harris v. American Investment Company*, 523 F.2d 220 (8th Cir. 1975), for the propositions: (i) that a § 10(b) claim may be brought by a defrauded purchaser who then continues to hold the security; and, (ii) that damages may be measured as of the date of the public discovery of the fraud. As noted by Justice Baxter, however, neither proposition is surprising nor novel. The issues in *Small* are different ones: where the fraud does *not* relate to the purchase, so there can be no difference between the fraud-inflated price *paid* and the ''true value'' of the shares (i.e., when the fraud was disclosed); this is further muddied by the fact that was no allegation that the Fritz stock was ever, in fact, sold (ergo, no actual loss).

[21] *See supra* notes 12, 13 & 14.

etc.); furthermore, the specific factual predicates in those relatively ancient cases are (in the words of Justice Brown) ''unlikely to arise in today's highly regulated world of securities trading.''[22]

To discern a trend of recent courts with respect to such a cause of action, moreover, is to find no trend—one federal court has affirmed such a state law cause of action (where the plaintiff did, in fact, sell his stock) versus a more recent federal court that rejected holder liability under tort law concepts.[23]

This squishy state of affairs is made even more so given the fact that virtually all disputes over the suitability of investments are being (and will be) resolved by SRO arbitration panels. Such panels are subject to judicial review for misapplying the law in relatively few instances (although there has been some recent expansion on this score).[24] And given the ambiguous nature of this issue, about the only thing that may be clear is that arbitration panels will be petitioned to evaluate holder cases under concepts of equity and fairness.[25]

The procedural protocols of arbitration (or lack thereof) only serve to highlight the very concerns the U.S. Supreme Court noted when it barred federal securities claims for holders in *Blue Chip Stamps*—i.e., ''vexatious'' claims cannot be dismissed on pre-hearing motions; defendants/respondents will be disrupted from normal business activities, with the disproportionate burden of pre-hearing activity falling on them; and said vexatious claims will often turn on the plaintiffs'/claimants' oral testimony.[26] Those policy concerns—which, in the words of the U.S. Supreme Court, ''present[] a danger in degree and in kind from that which accompanies litigation in general''[27]—may well lie ahead in the arbitral setting as a result of the *Small* decision; and certainly those concerns will become more problematic if other states decide to follow the lead of the California Supreme Court.

Conclusion. Advising clients on how to avoid litigation based upon precedent is an important role the legal profession plays. This is especially so where conduct to be adjudicated is subject to a subjective standard. Where federal law explicitly rejects liability in one area, but one or more states recognize liability as a matter of common law (albeit under a different label), this role becomes very complex. Throw in huge vagaries vis-à-vis damages methodologies, as well as a dispute resolution process wherein law and precedent are not paramount concerns, and it rises to the level of seer-dom (or worse). With that as background, we have surely not heard the last of holder liability; in fact, thanks to the California Supreme Court we have likely only heard the first of it.

[22] *See* footnote 7 of Justice Brown's opinion.

[23] *See supra* notes 15 & 17.

[24] *See* C. Stewart, ''The Arbitration Quagmire,'' *New York Law Journal* (December 26, 2001); C. Stewart, ''The Judiciary's Increased Role in Reviewing Arbitration Awards,'' *New York Law Journal* (January 28, 2000).

[25] *See supra* note 3 at 1558, 1593-97 (collection of arbitration awards involving non-holder suitability claims). A review of recent arbitration awards would suggest that parcels are not giving holder claims a warm reception. *See, e.g., Johnson, et al. v. CIBC Oppenheimer Corp., et al.*, PCX Case # 98-S017 (Nov. 22, 1999) (no liability); *Scheingart v. First Security Van Kasper, et al.*, NASD DR # 99-03592 (August 22, 2000) (*same*); *Vitale v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., et al.*, NASD DR # 01-05618 (January 13, 2003) (same); *Mora v. Merrill Lynch, Pierce, Fenner & Smith, Inc., et al.*, NASD DR # 02-02595 (April 8, 2003) (*same*).

[26] 421 U.S. at 740-42.

[27] *Id. at 739*.

Note to Readers

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