Counsel's Advisory

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STATE HIGH COURT RULING EXPANDS PRIVATE SECURITIES FRAUD CLAIMS

by
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On April 7, 2003, the California Supreme Court ruled in *Small v. Fritz Companies*, 30 Cal. 4th 167 (2003) that a shareholder plaintiff who "held" (decided not to sell) securities in actual reliance on a false or misleading statement may sue for common law fraud or negligent misrepresentation. The U.S. Supreme Court has previously held that federal securities law does not allow claims by such holders.

The ruling allows a claim under California state law for common law fraud or negligent misrepresentation brought by persons who had held their shares of stock based on alleged misrepresentations. In contrast, the U.S. Supreme Court held in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), that such "holding claims" may not be asserted under the federal securities laws. The principal federal anti-fraud statute and regulation (Section 10(b) of the Securities Exchange Act of 1934 and the accompanying Rule 10b-5) prohibit misrepresentations "in connection with the purchase or sale" of a security. *Blue Chip Stamps* held that this language did not extend to claims by persons who allegedly decided not to purchase (or sell) securities as a result of a misrepresentation. The Court also noted that such claims would be spurious and subject to abuse: how can it be proved with any degree of certainty that a particular person or class actually *would have* bought or sold shares had they received different information? The Court's concern was heightened by its perception that securities class actions were by their nature particularly subject to abuse.

The California Supreme Court not only allowed a holder claim for fraud or negligent misrepresentation, but assumed that the federal Uniform Standards Act would not preempt class actions asserting such claims because the Act "applies only to suits involving the purchase or sale of stock." (This assumption, however, may not necessarily be correct. The United States Supreme Court recently stated in *SEC v. Zandford*, 535 U.S. 813 (2002), that the "purchase or sale" requirement must be construed broadly and flexibly.) At the same time, the Court narrowly construed the claims it recognized: holder claims will be limited to stockholders who can plead and prove a bona fide showing of actual reliance upon the misrepresentations. As a concurring opinion recognized, under *Mirkin v. Wasserman*, 5 Cal. 4th 1082 (1993), this effectively will make it all but impossible to assert holding claims on a class-wide basis. After all, it is highly unlikely that a holder plaintiff can plead that an entire class of people who held their stock did so because they *personally* read or heard the alleged misrepresentation and on that basis held their stock; and as actual reliance is required, a holder plaintiff will not be able to invoke the "fraud-on-the-market" presumption of reliance used in federal securities class actions.

It is likely, then, that *Small* will have little impact on securities *class action* litigation. Nonetheless, the decision is still important and presents potential hazards to companies, their officers, and investor relations contacts, for three reasons. First, institutional investors that make periodic and deliberative decisions on retaining stocks in their portfolios may allege that they decided to hold onto a particular company's stock based on the company's public disclosures. These persons may assert very large damages claims if the company's stock price declines. Second, the sensitivity of one-on-one contacts with shareholders will be increased, as such shareholders have a greater probability of asserting actual reliance on a company's statements than do other shareholders. As a result, companies should be more cautious than ever in these communications, including continuing to heed the dictate of Regulation FD that material nonpublic information may not be disclosed other than on a public-wide basis. Third, a claim for negligent misrepresentation is easier to plead and prove than a fraud claim, although the Court enunciated a relatively high standard for negligent misrepresentation (that a statement have no reasonable basis).

Finally, there is a powerful limitation to the negligent misrepresentation claim recognized in *Small* that the Court did not consider. The foundation of the decision is that liability, even for mere negligence, in this context is consistent with the common law because officers and directors owe fiduciary duties to the shareholders. However, the corporate law of most States does not allow officers or directors to be liable for the breach of fiduciary duty to the shareholders unless their conduct amounts to *gross* negligence. Moreover, many States allow corporations to adopt provisions that restrict directors' and officers' liability to *intentional* misconduct on their part. These corporate law principles (which often have a statutory basis) should preclude liability predicated on mere negligence.

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