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Ga.'s Take On Holmes V. Grubman

Law360, New York (March 09, 2010) -- On Feb. 8, 2010, the Georgia Supreme Court issued an opinion in response to three certified questions submitted by the U.S. Court of Appeals for the Second Circuit, holding that, under Georgia common law:

1) “holder” claims are actionable;

2) plaintiffs in misrepresentation or omission claims involving publicly traded securities must prove loss causation; and

3) a limited fiduciary relationship exists between registered representatives and clients, even in nondiscretionary accounts.[1]

The court’s opinion represents a significant departure from existing law and is described further below.

The case’s procedural history was winding, making stops in the U.S. Bankruptcy Court for the Middle District of Georgia; the U.S. District Court for the Southern District of New York, as part of the multidistrict WorldCom Securities Litigation; and the Second Circuit before ultimately landing in the Georgia Supreme Court.

The underlying dispute was not as complex. William K. Holmes alleged that Salomon Smith Barney & Co. Inc. (“SSB”) and its financial analyst, Jack Grubman, convinced him not to sell his 2.1 million shares in WorldCom in 1999 after he verbally ordered his broker at SSB to sell his WorldCom shares.

Instead of selling, Holmes purchased additional shares of WorldCom as the stock price declined. In 2000, Holmes was forced to sell all of his WorldCom shares in order to meet margin calls, resulting in alleged losses of nearly $200 million.

After finding his way to the Southern District of New York, Holmes’ third amended complaint, which included claims of fraud, negligent misrepresentation, negligence in making disclosures, and breach of fiduciary duty, was dismissed, prompting Holmes’ appeal to the Second Circuit and that court’s certification of three questions to the Georgia Supreme Court.

“Holder” Claims are Actionable Under Georgia Common Law

The first question certified to the Georgia Supreme Court was whether Georgia common law recognizes fraud claims based on forbearance in the sale of publicly traded securities (commonly known as “holder” claims).

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The court had no trouble finding that Georgia common law does indeed recognize “holder” claims. A unanimous court noted that “it is well settled that one of the elements of the tort of fraud in Georgia is an ‘intention to induce the plaintiff to act or refrain from acting.’”[2]

Georgia’s well-settled element of fraud claims, the court continued, is consistent with both the Restatement (Second) of Torts § 525 and the general rule that “‘induced forbearance can be the basis for tort liability.’”[3]

The court found further support for its holding in Blue Chip Stamps v. Manor Drug Stores, a case in which the U.S. Supreme Court held that “holder” claims were not available under Rule 10(b)(5), promulgated by the U.S. Securities and Exchange Commission under § 10(b) of the Securities Exchange Act of 1934, but also noted that “holder” claims may be available under state law.[4]

The court also noted that the Georgia Court of Appeals had previously acknowledged that “evidence of fraud ... includes evidence which supported the conclusion that [the plaintiffs] were fraudulently induced into making and keeping their investments.”[5]

After finding that “holder” claims exist under Georgia law, the Court 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 at them to their injury.’”[6]

The “specific reliance” limitation requires that plaintiffs “‘allege actions, as distinguished from unspoken or unrecorded thoughts and decisions, that would indicate that the plaintiff actually relied on the misrepresentations.’”[7]

Finally, though the Second Circuit’s certified question related only to fraud claims, the court held that negligent misrepresentation claims, subject to the same limitations, can also be based on forbearance in the sale of publicly traded securities.[8]

Georgia joins a handful of other states that have recognized “holder” claims, including Massachusetts, New York, Wisconsin, New Hampshire and New Jersey.[9] At least one federal court, the District of Connecticut, has expressed doubt with the approach taken by Georgia and these other courts, noting that claims for damages under “holder” claims have several inherent problems.[10]

According to the District of Connecticut, among the hurdles faced by plaintiffs bringing “holder” claims are difficulties proving damages with certainty and proving causation.[11] These are bedrock principles of contract law that plaintiffs bringing “holder” claims will unquestionably face and which may be insuperable, thus rendering “holder” claims a theoretical possibility, but a practical impossibility.

Georgia Law Requires Plaintiffs to Establish Loss Causation for Misrepresentation or Omission Claims Relating to Publicly Traded Securities

The second certified question is whether, with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities, proximate cause is adequately pleaded under Georgia law when a plaintiff alleges that his injury was a reasonably foreseeable result of the defendant’s false or misleading statements but does not allege that the concealed fact caused a drop in the price of the security.

In response, after recognizing that it was not authorized to determine what allegations are necessary for a pleading to be adequate in a federal diversity action, the court addressed the burden placed on a plaintiff at trial to prove proximate cause with respect to a tort claim based on misrepresentations or omissions concerning publicly traded securities.

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The court began its analysis by noting that it has long been the law in Georgia that “in order to recover in tort for fraud, the plaintiff must prove that he sustained loss or damage as the proximate result of the alleged misrepresentations.”[12]

The court then noted that, unlike “holder” claims, Georgia’s common law requirement that plaintiffs prove proximate causation is in accord with Supreme Court precedent.

In Dura Pharmaceuticals v. Broudo, 544 U.S. 336, 343-44 (2005), the U.S. Supreme Court adopted common law causation requirements for fraud claims in harmony with those already extant in Georgia.[13]

According to the court, “‘Dura requires that a plaintiff show that it was th[e] revelation [of the concealed truth] that caused the loss and not one of the “tangle of factors” that affect price.’”[14]

Brokers May Owe a Limited Fiduciary Duty to Clients Holding Nondiscretionary Accounts

The final question is whether a fiduciary duty exists under Georgia law between a brokerage firm and a customer with a nondiscretionary account.[15]

The court recognized the limited scope of the fiduciary duty that a broker owes to a client holding a nondiscretionary account and recognized circumstances when a broker would owe a “heightened” duty to clients holding nondiscretionary accounts.

Typically, a broker owes a limited duty to nondiscretionary clients, “‘including the duty to transact business only after receiving prior authorization from the client and the duty not to misrepresent any fact material to the transaction.’”[16]

The court approved of this standard and noted that brokers “generally have a heightened duty, even to the holder of a non-discretionary account, when recommending an investment which the holder has previously rejected or as to which the broker has a conflict of interest.”[17]

While the Georgia Supreme Court purports to recognize a fiduciary duty owing from a broker to clients holding nondiscretionary accounts, the contours of that duty are not clear.

The examples of the limited scope of the fiduciary duty which brokers owe to their nondiscretionary clients — to transact business only after receiving prior authorization from the client and the duty not to misrepresent any fact material to the transaction — amount to little more than a statement that brokers should not act beyond the scope of their agency or lie to their clients.

These “fiduciary duties” are obligations that run from brokers to all of their clients, regardless of whether a fiduciary duty exists.

--By S. Lawrence Polk (pictured) and Kurt Lentz, Sutherland Asbill & Brennan LLP

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[1] Holmes v. Grubman, SO9Q1585, 2010 WL 424225 (Ga. Feb. 8, 2010).

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[2] Holmes v. Grubman, 2010 WL 424225 (quoting Stiefel v. Schick, 260 Ga. 638, 639 (1990)).

[3] Id. (quoting Small v. Fritz Cos., 65 P.3d 1255, 1259 (Cal. 2003)).

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

[5] Holmes v. Grubman, 2010 WL 424225 (quoting Argentum Int'l v. Woods, 280 Ga. App. 440, 445 (2006)).

[6] Id. (quoting Gutman v. Howard Savings Bank, 748 F. Supp. 254, 265 (D.N.J. 1990)).

[7] Id. (quoting Small v. Fritz Cos., 65 P.3d at 1265).

[8] Id.

[9] Small v. Fritz Companies Inc., 65 P.3d 1255, 1259 (Cal. 2003) (collecting cases).

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

[11] Id. at 1018-19. The problem, as described by the court, is that these "claim[s] for damages [are] further attenuated as plaintiffs allege a separate damages claim for shares, neither bought nor sold, but merely retained."

[12] Id.

[13] Id.

[14] Id. (quoting In re Williams Secs. Litig. — WCG Subclass, 558 F.3d 1130, 1138 (10th Cir. 2009)).

[15] Holmes v. Grubman, 568 F.3d 329, 340-41 (2d Cir. 2009).

[16] Id. (quoting Glisson v. Freeman, 243 Ga. App. 92, 99 (2000)).

[17] Id. (citing Leib v. Merrill Lynch, Pierce, Fenner & Smith, 461 F. Supp. 951, 953 (E.D. Mich. 1978)).

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