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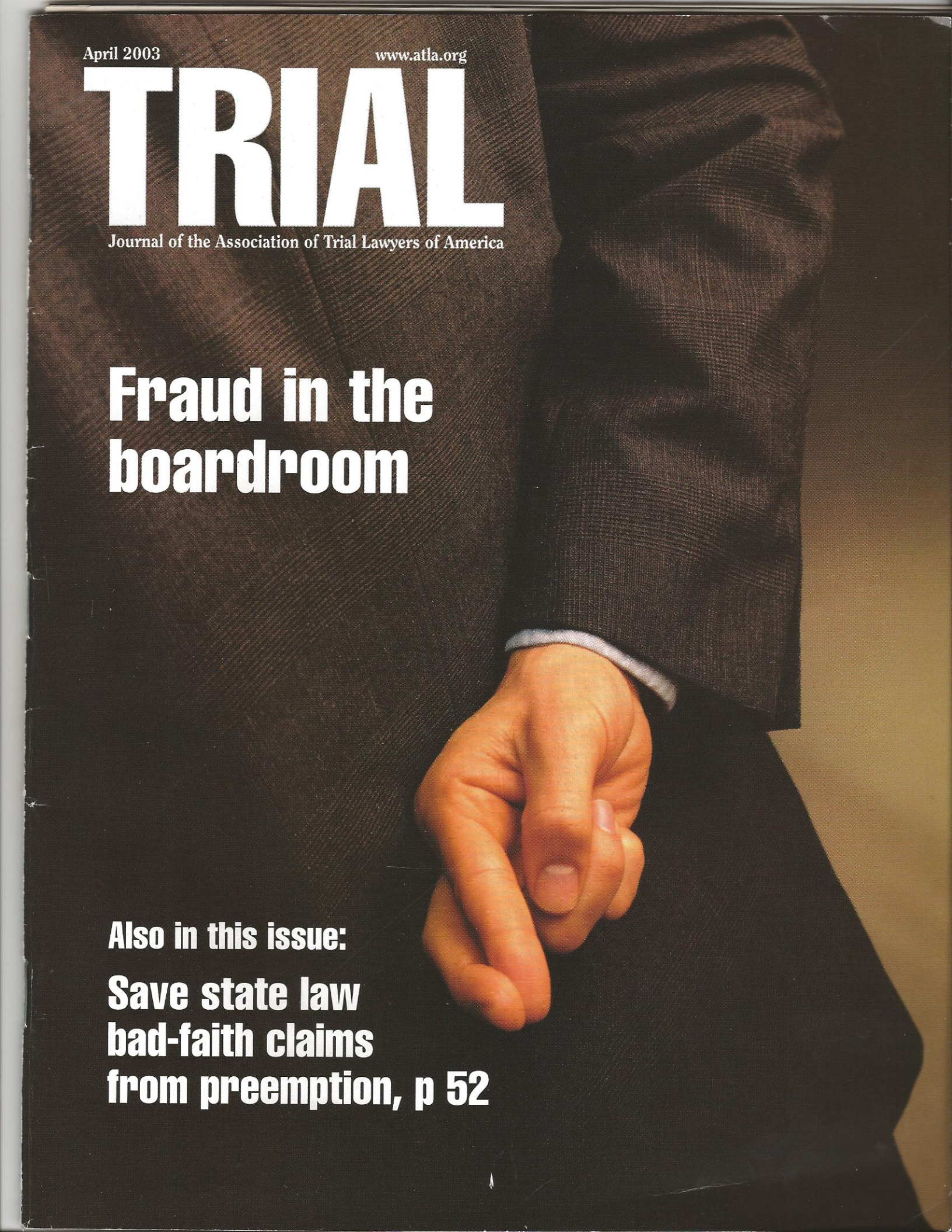

Fraud in the boardroom

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Remedies for wronged investors

Howard L. Nations

Recent federal laws and court decisions have diminished the rights of investors to recover for fraud and other wrongful conduct in securities transactions. But it can be done.

Until the mid-1990s, plaintiffs seeking recourse for securities-related corporate fraud often turned to §10(b) of the 1934 Securities Exchange Act[1] and Rule 10b-5—which was promulgated under the act[2]—and §12(2) of the 1933 Securities Act.[3] State common law and statutory remedies played a secondary role.

Congressional passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) materially reduced the federal rights and remedies of investors seeking redress against corporate wrongdoers, forcing plaintiffs to pursue state law remedies in state courts.[4] Although then-President Bill Clinton vetoed the act, saying he was "not . . . willing to sign legislation that [would] have the effect of closing the courthouse door on investors who have legitimate claims,"[5] Congress overrode the veto.

Since then, as Clinton predicted, many citizens seeking redress for losses as a result of negligent or intentional misrepresentation, fraud, breach of fiduciary duty, or other misconduct in the purchase, sale, or offer for purchase or sale of securities have found their federal rights substantially reduced and have been forced to seek redress under state rather than federal law.

The PSLRA provided protection for corporate wrongdoing by creating a "safe harbor" for inaccurate forward-looking corporate statements about expected profits that contain a disclaimer that the projections are "uncertain" and will not necessarily comport with actual profits.[6] And it substantially increased an investor's burden of pleading and proof by providing that fraud must be pleaded with sufficient specificity to overcome a motion to dismiss, despite a stay of discovery.[7]

The act capped damages recoverable in cases alleging a material misstatement or omission in a prospectus or oral communication, or some other act or omission actionable under §10(b) of the 1934 Securities Exchange Act or Rule 10b-5.[8] And Congress substituted proportionate liability for joint and several liability unless the plaintiff can prove that the defendant knowingly committed a violation of §10(b) or Rule 10b-5.[9]

"All this shows that [the law was] meant to erect a higher barrier to bringing suit than any now existing—one so high that even the most aggrieved investors with the most painful losses may get tossed out of court before they have a chance to prove their case," Clinton noted in his veto message.[10]

When these changes started to drive investors to seek redress under state laws, Congress again reduced remedies available by passing the Securities Litigation Uniform Standards Act of 1998 (SLUSA).[11] This law is predicated on a congressional finding that enactment of the PSLRA merely shifted securities class actions from federal to state courts, which had the effect of defeating the objectives of that law.[12]

The SLUSA created "national standards for securities class-action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of state securities regulators and not changing the current treatment of individual lawsuits."[13] Thus, individual securities actions in state courts survived unscathed.

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Even before Congress passed these laws, the U.S. Supreme Court had issued decisions that diminished investor rights in securities actions brought in federal court. In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Court reversed well-established precedent when it held that neither §10(b) of the 1934 Securities Exchange Act nor Rule 10b-5 creates an implied private cause of action for aiding and abetting securities fraud.[14]

The Court further diminished rights of investors who buy securities in initial private offerings or on the secondary market by holding in *Gustafson v. Alloyd Co.* that §12(2) of the 1933 Securities Act—one of the most powerful antifraud provisions under federal securities laws—does not apply to such offerings.[15] The Court's denial of this remedy to shareholders in initial private or secondary-market offerings left §10(b) of the 1934 Securities Exchange Act as the primary federal remedy for private litigants.

Typical state common law rights and remedies

Common law claims will vary from state to state depending on each jurisdiction's laws and procedural requirements. Nevertheless, most state actions will be based on similar allegations—negligent misrepresentation, common law fraud, and breach of fiduciary duty.

Negligent misrepresentation. Section 552 of the *Restatement (Second) of Torts* provides that

> one who, in the course of his business, profession, or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.[16]

To prove negligent misrepresentation, most states require a plaintiff to show that:

- the defendant made a representation in the course of business or in a transaction in which the defendant has a pecuniary interest
- the defendant provided false information for the guidance of others in their business
- the defendant failed to exercise reasonable care or competence in obtaining or communicating the information
- the defendant's misrepresentation proximately caused the plaintiff's injury
- the plaintiff suffered pecuniary loss by justifiably relying on the defendant's misrepresentation.[17]

State common law remedies and securities statutes are viable options for investors who are seeking compensation for securities-related losses.

Common law fraud. Section 525 of the *Restatement (Second) of Torts* provides the general rule for fraudulent misrepresentation: "One who fraudulently makes a misrepresentation of fact, opinion, intention, or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation."[18]

To prove common law fraud in most states, the plaintiff must show that

- the defendant made a material false representation or failed to communicate a material fact, which had the effect of falsifying statements actually made
- the defendant did this intentionally (the defendant knew that the representation or omission constituted a falsehood) or recklessly (the defendant made the representation without regard to whether it was true or false)
- the defendant intended that the plaintiff act on it
- the plaintiff did, in fact, rely on the representation or omission to his or her detriment.[19]

A representation is material if either a substantial likelihood exists that a reasonable person would attach importance to it in making a decision or the person who made the representation has reason to know that the plaintiff is likely to regard it as important in making a decision, even though a reasonable person would not so regard it.[20]

Fraudulent misrepresentation by omission may be actionable if the defendant has a duty to the plaintiff to disclose material facts and fails to do so, and if this failure results in a false impression being conveyed to the plaintiff. A defendant can also be liable for failing to disclose new information that makes previously disclosed information misleading.[21]

To be actionable, a fraudulent misrepresentation generally must concern fact rather than mere opinion, judgment, expectation, or probability. However, a fraud case can be based on a representation of opinion when one or more of the following occurred:

- the defendant knew that the facts on which the opinion was based were false
- the defendant knew that the opinion was false
- the opinion was based on the defendant's special knowledge of information contained in it and the defendant knew that the plaintiff was justified in relying on this special knowledge
- the defendant claimed to have special knowledge of facts that would occur in the future
- the defendant had special knowledge superior to that of the plaintiff about value.[22]

Remedies. A plaintiff injured by a defendant's common law fraud or negligent misrepresentation may file suit to recover compensatory damages for economic injury, exemplary damages (in limited circumstances), and prejudgment interest.

Ordinarily, compensatory damages arising from fraud or negligent misrepresentation are measured as either out-of-pocket or benefit-of-the-bargain damages. Out-of-pocket damages measure the difference between the amount the buyer paid and the value the buyer received at the time of sale. Benefit-of-the-bargain damages mea-

It is not necessary for the plaintiff to prove causation to prevail on claims of certain breaches of fiduciary duty. It is the agent's disloyalty that violates the fiduciary relationship.

sure the difference between the value as represented by the seller and the value received by the buyer.[23]

In circumstances where there is no adequate remedy at law, a defrauded party can seek the equitable remedies of rescission, specific performance, or reformation.

Affirmative defenses

The investor prosecuting a securities case on the common law theories of negligent misrepresentation or fraud may be confronted with a number of affirmative common law defenses. In most jurisdictions, the following affirmative defenses must be specially pleaded.

Statutes of limitations. The statute of limitations for common law fraud claims is generally four years. Claims of negligent misrepresentation are usually governed by a state's limitations on negligence claims—usually one or two years.

The limitations statute for a cause of action for fraud or negligent misrepresentation begins running when the conduct occurs, unless the defendant has concealed it from the plaintiff. Then, in most jurisdictions, the statute of limitations is tolled until the plaintiff either discovers the wrongful conduct or, through the exercise of reasonable diligence, should have discovered it.

Plaintiff as a sophisticated investor. Defendants in securities fraud cases often try to avoid liability by claiming the plaintiff knew more about investing or about the specific investment at issue than the defendant did and therefore could not have reasonably relied on the advice of the defendant. Generally, this defense will not preclude recovery by the investor as a matter of law, but it may be considered by the jury in deciding whether the plaintiff's reliance was reasonable or justifiable.

Lack of causation. The defendant may assert the lack of proximate causation—that the actions of a third party are the sole proximate or independent intervening causes of the plaintiff's damages. However, if the defendant could have reasonably foreseen the intervening cause, the chain of causation between the defendant's negligence and the alleged damages is not broken, and the defendant is not relieved of liability for the plaintiff's losses.[24]

Disclaimer. The defendant may argue that the transaction included a disclaimer that protects it from liability. Typical disclaimers include an assertion that the seller (or defendant) relies solely on third parties for the truth and completeness of the representations made to the investor. But these disclaimers protect the seller only to the extent that the information is true. They will not protect the seller if it knows that the third-party statements are false, because the seller is then a party to the fraud.

Equitable defenses. The plaintiff must come into court with "clean hands" to assert equitable remedies. The defendant, too, must have clean hands to assert the equitable defenses of estoppel, laches, and *in pari delicto*.

Ratification. Ratification is the adoption or confirmation, by a party with knowledge of all material facts, of an earlier act that did not at the time legally bind that party and that the party, therefore, had a right to repudiate before the ratification. To prove the plaintiff did this, a defendant must show that the plaintiff had full knowledge of the defendant's allegedly fraudulent or negligent acts at the time of ratification and nevertheless intentionally chose to ratify those acts in spite of the alleged fraud or negligence.[25]

Other liability theories

Investors are not necessarily limited to federal remedies or the state common law theories of fraud and negligent misrepresentation. Investors' lawyers should also consider bringing actions based on breach of fiduciary duty or on state statutes.

Breach of fiduciary duty. The duties imposed by law on fiduciary relationships render those who owe fiduciary duties to investors viable targets in corporate-misconduct cases. Recent high-profile corporate-fraud cases, which have been accompanied by America's largest bankruptcies, have spawned a search for defendants other than the now-bankrupt securities sellers or corporations at the center of these cases. Potential defendants include corporate officers and directors, trustees, accountants, attorneys, brokers and brokerage houses, underwriters, investment bankers, appraisers, and market makers.

To prove this tort, a plaintiff must show that he or she and the defendant had a fiduciary relationship, that the defendant breached its fiduciary duty to the plaintiff, and that this resulted in an injury to the plaintiff or a benefit to the defendant.[26] Generally, corporate officers owe a fiduciary duty only to the corporations they serve.[27] They do not owe a fiduciary duty to individual shareholders unless one has been created by contract or the existence of a special relationship.[28]

Specific fiduciary duties that would apply to corporate officers and directors include the following

- the duty not to usurp corporate opportunities for personal gain
- the duty to use utmost good faith in relations with the corporation
- the duty to make full disclosure of all pertinent information relating to the subject matter of any contract the officer or director negotiates with the corporation in which he or she has a personal interest
- the duty of loyalty to the corporation.[29]

Securities brokers owe a fiduciary duty to their customers in matters within the scope of their agency. This is determined by the nature and scope of the relationship between them.[30]

In several types of securities transactions, such as those involving bonds, fidu-

ciaries owe specific duties that, when breached, can form the basis of a claim. These fiduciary duties mirror both general and specific duties imposed by the common law on trustees regarding management and investment of trust assets.

The fundamental duties of a trustee include loyalty to the beneficiaries of the trust[31] and use of the skill and prudence that an ordinary, capable, and careful person would use in the conduct of his or her affairs.[32] Other duties that trustees owe their beneficiaries include

- the duty of good faith and fair dealing in handling the affairs of the trust and its principal[33]
- the duty to preserve the assets while making them productive[34]
- the duty to disclose all material facts known to the trustee that might affect the beneficiaries' rights[35]
- the duty to fully account for all trust transactions[36]
- the duty to properly manage, supervise, and safeguard trust funds[37]
- the duty to keep trust property separate from other assets.[38]

To prove an action for breach of fiduciary duty, the plaintiff must establish that the defendant's breach resulted in injury to the plaintiff or benefit to the defendant. It is not necessary for the plaintiff to prove causation to prevail on claims of certain breaches of fiduciary duty.[39] It is the agent's disloyalty, not any resulting harm, that violates the fiduciary relationship.[40]

State statutory remedies. The National Conference of Commissioners on Uniform Laws (NCCUL) promulgated the Uniform Securities Act of 1956, which has been adopted at one time or another, in whole or in part, by 37 jurisdictions. The Revised Uniform Securities Act of 1985 has been adopted in only a few states. Each version of the Uniform Securities Act has been preempted in part by the National Securities Markets Improvement Act of 1996[41] and the Securities Litigation Uniform Standards Act of 1998.[42]

In 2002, a combination of federal preemptive legislation, significant changes in the technologies of securities trading and regulation, and substantial increases in the interstate and international aspects of

securities prompted the NCCUL to promulgate the modernized Uniform Securities Act (2002).

Seminal points of research for lawyers prosecuting securities cases in state court are state securities statutes and the business and commerce codes, which are often more investor-friendly than either federal securities law or common law remedies. Consider Texas:

- The Texas Securities Act, §33A(2), establishes an easier burden of proof than Rule 10b-5, common law fraudulent misrepresentation, or common law negligent misrepresentation, in that it does not require a showing of either the plaintiff's reliance on the misinformation or proof that the defendant knew the misrepresentation was false or made without regard to its truth or falsity.[43]
- The Texas Business and Commerce Code, §27.01, provides that liability can be established by showing that the defendant made either a false representation of a past or existing material fact or a false promise to perform some material act, with the intention not to fulfill it, to induce a person to enter into a contract or to purchase stock, and that the plaintiff relied on the false statement in deciding to enter into the contract or to purchase stock.[44]
- As in most states, Texas trust statutes set out general and specific fiduciary duties,[45] and the Texas Deceptive Trade Practices-Consumer Protection Act provides for recovery of punitive damages and attorney fees if certain criteria are met.[46]

Choosing carefully

Corporate America is experiencing a meltdown in public trust with the result that there are unparalleled opportunities for victims of corporate wrongdoing to seek redress from jurors. However, as with any claim, the starting point of a lawsuit brought by an investor seeking compensation for wrongful conduct in securities transactions is a careful analysis of all applicable laws. Only after carefully comparing statutory and common law remedies, as well as state and federal laws, can a lawyer properly advise the plaintiff regarding the forum and body of law that should control the case.[47] ❐

Notes

1. Securities Exchange Act of 1934, 15 U.S.C. §78a (2002).
2. 17 C.F.R. §240.10b-5 (2003).
3. Securities Act of 1933, 15 U.S.C. §77a (2002).
4. 15 U.S.C. §78j (2002).
5. 141 Cong. Rec. H15214-06, *H15214 (1995).
6. 15 U.S.C. §77z-2(c)(1) (2002).
7. *Id.*
8. 15 U.S.C. §78u-4(e)(1) (2002).
9. 15 U.S.C. §78u-4(f)(2)(A) & (B).
10. 141 Cong. Rec. H15214-06, *H15214.
11. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998).
12. *Id.* §2(2) and (3).
13. *Id.* §2 (5).
14. 511 U.S. 164, 192 n.1 (1994) (Stevens, J., dissenting).

15. 513 U.S. 561 (1995).
16. RESTATEMENT (SECOND) OF TORTS §552(1) (1977).
17. *See, e.g.*, McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791 (Tex. 1999).
18. RESTATEMENT (SECOND) OF TORTS §525 (1977).
19. *See* Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 674 (Tex. 1998).
20. RESTATEMENT (SECOND) OF TORTS §538 (1977).
21. *Id.* §551.
22. *Id.* §542.
23. *Id.* §§549, 552.
24. RESTATEMENT (SECOND) OF TORTS §448 (1965).
25. Texarcadian Fuels, Inc. v. Lone Star Energy Storage, Inc., 896 S.W.2d 233, 237 (Tex. Ct. App. 1995), *vacated on other grounds*, 922 S.W.2d 549 (Tex. 1996).
26. *See* Kinzbach Tool Co. v. Corbett-Wallace Corp., 160 S.W.2d 509, 513 (Tex. 1942).
27. Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963).
28. Faour v. Faour, 789 S.W.2d 620, 621-22 (Tex. Ct. App. 1990).
29. RESTATEMENT (SECOND) OF AGENCY §§377-98 (1958).
30. *See* Hand v. Dean Witter Reynolds, Inc., 889 S.W.2d 483, 493 n.5 (Tex. Ct. App. 1994).
31. RESTATEMENT (SECOND) OF TRUSTS §170 (1959).
32. RESTATEMENT (THIRD) OF TRUSTS, P.I.R. §227 (1992).
33. RESTATEMENT (SECOND) OF TRUSTS §170 (1959).
34. *Id.* §§176, 181.
35. *Id.* §170(2).
36. *Id.* §§172, 173.
37. *See, e.g.*, Hoenig v. Texas Commerce Bank, N.A., 939 S.W.2d 656, 661 (Tex. Ct. App. 1996).
38. RESTATEMENT (SECOND) OF TRUSTS §179 (1959).
39. *See, e.g.*, Upchurch v. Albear, 5 S.W.3d 274, 283 (Tex. Ct. App. 1999).
40. *See, e.g.*, Burrow v. Arce, 977 S.W.2d 229, 238 (Tex. 1999).
41. National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).
42. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998).
43. TEX. REV. CIV. STAT. ANN. art. 581-33A(2) (West 2003).
44. TEX. BUS. & COM. CODE ANN. §27.01 (West 2003).
45. TEX PROP. CODE ANN. §113.051-113.060 (West 2003).
46. TEX. BUS. & COM. CODE ANN. §17.41-.63 (West 2003).
47. There has been considerable activity at the federal level, including passage of the Sarbanes-Oxley Act (Pub. L. No. 107-204, 116 Stat. 745 (2002)) and rules changes by the Securities and Exchange Commission, which are beyond the scope of this article.