

HOLDER CLAIMS – POTENTIAL CAUSES OF ACTION  
IN DELAWARE AND BEYOND?

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ESSAY

Last spring, in a widely anticipated opinion in *Citigroup Inc. v. AHW Investment Partnership*,<sup>1</sup> Chief Justice Strine, speaking for a unanimous Delaware Supreme Court, warned of the dangers of recognizing causes of action by persons who claim they were misled into holding rather than selling their securities. He pointed out the difficulties of proving such holder claims, stating that they may "compound ... complex questions of proof and damages" due to "the additional requirements of inducement."<sup>2</sup> More significantly, he identified troubling consequences for corporate governance resulting from the recognition of holder claims:

[C]oncern arises from state law holder claims more generally. When a public corporation such as Citigroup has shares in the market, it will have investors from all around the world, and certainly in virtually every state in our nation. For investors to be able to sue not only under federal law, but purport to sue under their own state's bespoke laws, subjects corporations to potential inconsistencies, inefficiencies, and unfairness[.]<sup>3</sup>

However, the Delaware Supreme Court did not address directly the legal cognizability of holder claims. As of today, no Delaware court has ever done so. This essay attempts to fill that gap by analyzing the arguments both for and against holder claims. First, the nature of holder claims are described and explored. Then, the acceptance or rejection of holder claims by various courts throughout the United States is examined. Next, the arguments in opinions that have recognizing holder claims are considered. Finally, the essay concludes that, even though some arguments in opinions rejecting holder claims are not persuasive, serious conceptual problems and equitable considerations at the core of

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<sup>1</sup>140 A.3d 1125 (Del. 2016).

<sup>2</sup>*Id.* at 1140-41.

<sup>3</sup>*Id.* at 1136.

holder claims should lead courts in Delaware and other states to rule categorically that holder claims are not legally cognizable.

### *The Nature of Holder Claims*

The factual pattern common to holder claims is that after the plaintiff investor retained, rather than sold, his securities because of material information the defendant provided to him about the issuer which was misleading or omitted material facts, the price of his securities in the market dropped substantially. The plaintiff investor thereupon claims damages because he was deprived of the opportunity to secure the earlier, higher price.<sup>4</sup> Usually the information disclosed by the defendant was more favorable about the issuer than the truth. The defendants usually but not necessarily include the issuer and its insiders.<sup>5</sup>

Holder claims are asserted as common law fraud or negligent misrepresentation causes of action. In Delaware the elements of common law fraud, which a plaintiff must prove, have been stated in different ways. Numerous opinions have listed these elements: "(1) a false representation, usually one of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or to refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance."<sup>6</sup> Some other opinions have set forth this slightly different list of what must be proved: "(i) a false representation, (ii) a defendant's knowledge or belief of its falsity or his reckless indifference to its truth, (iii) a defendant's intention to induce action, (iv) reasonable reliance, and (v) causally related damages."<sup>7</sup> The third, fourth and fifth elements in each of those lists shall be the focus of this article's analysis.

In Delaware a claim for negligent misrepresentation "is essentially a species of fraud with a lesser state of mind requirement, but with the added element that the defendant must owe a pecuniary duty to the

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<sup>4</sup>Grant Thornton LLP v. Prospect High Income Fund, 314 S.W.3d 913 (Tex. 2010); Small v. Fritz Companies, Inc., 65 P.3d 1255 (Cal. 2003).

<sup>5</sup>See, e.g., *Grant Thornton*, 314 S.W.3d 913; *Reisman v. KPMG Peat Marwick LLP*, 57 Mass. App. Ct. 100, 787 N.E.2d 1060 (Mass. App. 2003). In both cases, holder claims were asserted against accounting firms.

<sup>6</sup>*Vichi v. Koninklijke Philips Elecs. N.V.*, 85 A.3d 725, 807 (Del. Ch. 2014); *In re Wayport, Inc. Litig.*, 76 A.3d 296, 323 (Del. Ch. 2013).

<sup>7</sup>*Gaffin v. Teledyne, Inc.*, 611 A.2d 467, 472 (Del. 1992); *Johnson v. Preferred Prof'l Ins. Co.*, 91 A.3d 994, 1017 (Del. Super. 2014).

plaintiff. Specifically, to recover on a negligent misrepresentation claim, a plaintiff must demonstrate that: (1) the defendant had a pecuniary duty to provide accurate information, (2) the defendant supplied false information, (3) the defendant failed to exercise reasonable care in obtaining or communicating the information, and (4) the plaintiff suffered a pecuniary loss caused by justifiable reliance upon the false information.<sup>8</sup> In general, its differences from fraud claims are not germane to the discussion in this article about holder claims.

### *Judicial Recognition and Rejection of Holder Claims*

Holder claims have an unsettled status in Delaware and many other states. There is also no consensus on the legal viability of such claims in those states whose courts have considered them.

For many years holder claims were not widely alleged or recognized, even after a New York appellate court recognized their viability in 1922.<sup>9</sup> Then, starting in the last 15 years of the past century, some other courts began to uphold holder claims.<sup>10</sup> As of today, federal or state courts in at least eight states have expressly ruled that holder claims based on either fraudulent or negligent misrepresentations are legally cognizable.<sup>11</sup> Other courts, however, have categorically rejected holder claims under the laws of at least seven states,<sup>12</sup> especially after the

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<sup>8</sup>*Vichi*, 85 A.3d at 822; Corp. Prop. Assocs. 14 Inv. v. CHR Hldg. Corp., 2008 WL 963048, at \*8 (Del. Ch. Apr. 10, 2008).

<sup>9</sup>*Continental Insurance Co. v. Mercadante*, 222 A.D. 181, 183 (App. Div. 1927).

<sup>10</sup>*Small*, 132 Cal. Rptr. 2d at 494-502; *Gutman v. Howard Savings Bank*, 748 F.Supp. 254, 263-67 (D.N.J. 1990); *Holmes v. Grubman*, 691 S.E.2d 196, 199 (Ga. 2010); *Grant Thornton*, 314 S.W.3d at 928-30 (Tex. 2010); *Reisman*, 787 N.E.2d at 1068-69; *Rogers v. Cisco Systems, Inc.*, 268 F.Supp.2d 1305, 1313 (N.D. Fla. 2003); *In re Washington Mutual, Inc. Secs. Litig.*, 2010 U.S. Dist. LEXIS 113088, at \*19 (W.D. Wash. Oct. 25, 2010); *Ohanessian v. Pusey*, 2010 WL 728549, at \*5-6 (D. Colo. Feb. 25, 2010). It should be added that most, if not all, commentators on this topic support the recognition of holder claims. See, e.g., Lauren A. Demanovich,  *Holding Out for a Change: Why North Carolina Should Permit Holder Claims*, 92 N.C.L. REV. 988, 992 (2014); Robert W. Taylor, *Note: Re-evaluating Holder Actions: Giving Defrauded Securities Holders a Fighting Chance*, 86 NOTRE DAME L. REV. 413 (2011). None have addressed whether Delaware courts in particular should recognize holder claims as legally viable.

<sup>11</sup>California, Florida, New Jersey, Colorado, Massachusetts, Texas, Washington and Georgia.

<sup>12</sup>Mississippi, Virginia, Minnesota, Pennsylvania, Connecticut, North Carolina and South Carolina. The cases are *Crocker v. FDIC*, 826 F.2d 347, 351-52 (5th Cir. 1987); *Arnlund v. Deloitte & Touche, LLP*, 199 F.Supp. 2d 461, 489 (E.D.Va. 2002); *Arent v. Distribution Sciences, Inc.*, 975 F.2d 1370, 1374 (8th Cir. 1992); *WM High Yield Fund v. O'Hanlon*, 2005 U.S. Dist. LEXIS 33569, at \*41-42 (E.D. Pa. April 29, 2005); *Chanoff v. U.S. Surgical Corp.*, 857 F.Supp. 1011, 1018 (D.Conn.), *aff'd*, 31 F.3d 66 (2d Cir. 1984); *Rivers v. Wachovia Corp.*, 665 F.3d 610, 618-19 (4th Cir. 2011); *Harris v. Wachovia Corp.*, 2011 WL 1679625, at \*13 (N.C. Bus. Ct. Feb. 23, 2011). Judge Easterbrook, considering Illinois law,

enactment of the Uniform Standards Act of 1998.<sup>13</sup> An appellate ruling<sup>14</sup> in one other state (New York) has created uncertainty about whether that state's 1922 ruling allowing holder claims for fraud still has any validity.<sup>15</sup> Accordingly, the time is fitting for a consideration of whether any holder claim is legally cognizable in Delaware and the other states where courts have not addressed that issue.

### *The Reasoning of Holder Claims*

Opinions recognizing holder claims as legally cognizable have rested on the proposition that the holder's forbearance from selling his securities because of the defendant's misrepresentations satisfies the reliance element of common law fraud and negligent misrepresentation causes of action. They have held that a holder's inaction (*i.e.*, his retention of the security) is the equivalent of his action (*i.e.*, his sale of a security) since for purposes of proving fraud or negligent misrepresentation claims they both involve an investor's reliance on another's misstatement.<sup>16</sup> The courts have based their holdings on several arguments: (1) the statement in *Gutman, Small, and Holmes* that "Inducement is the substance of reliance; the form of reliance - action or inaction - is not critical to the actionability of fraud;"<sup>17</sup> (2) refraining from action is a basis for liability in other common law tort causes of action;<sup>18</sup> (3) §§ 525, 531, and 551 of the *Restatement (Second) of Torts* (1977) treat action and the refraining from action as equivalent bases for

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noted in *Anderson v. Aon Corp.*, 614 F.3d 361, 367 (7th Cir. 2010), that the "state judiciary has yet to make up its mind," (citing *Dloogatch v. Brincat*, 920 N.E.2d 1161 (Ill. App. 2009)). More recently, the court in *Rathje v. Horlbeck Capital Management, LLC*, 2015 Ill. App. (2d) 141176-U, 2015 WL 4732889, at \*6 (Ill. App. 2015), citing *Dloogatch*, said "Illinois has not recognized 'holder' claims," and then declined to analyze the plaintiff's claim as a holder claim.

<sup>13</sup>Pub L No. 104-67, 109 Stat 737 (1995), codified at 15 USC §§ 77a *et seq.* (1994 & Supp. 1995) (federal securities litigation intended to reduce abusive litigation and coercive settlements). See discussion in Joshua D. Ratner, *Stockholders' Holding Claim Class Actions under State Law after the Uniform Standards Act of 1998*, 68 U. CHI. L. REV. 1035, 1045 *etc.* (2001).

<sup>14</sup>*Starr Foundation v. American International Group*, 901 N.Y.S.2d 246 (1<sup>st</sup> Dept. 2010).

<sup>15</sup>See, *e.g.*, *AHW Investment Partnership v. Citigroup Inc.*, 2016 U.S. App. LEXIS 14364, at \*10 (2d Cir. Aug. 5, 2016); *Beach v. Citigroup Alternative Invs. LLC*, 2014 U.S. Dist. LEXIS 30032, at \*46-47 (S.D.N.Y. March 7, 2014) (noting how state and federal courts applying New York law have split on whether *Starr Foundation* forecloses all or only some holder claims).

<sup>16</sup>See, *e.g.*, *Small*, 132 Cal. Rptr. 2d at 495; *Gutman*, 748 F.Supp. at 264.

<sup>17</sup>*Gutman*, 748 F.Supp. at 264; *Small*, 132 Cal. Rptr. 2d at 495; *Holmes*, 691 S.E.2d at 198.

<sup>18</sup>*Small*, 132 Cal. Rptr. 2d at 495.

tort liability;<sup>19</sup> (4) remarks by the United States Supreme Court in *Blue Chip Stamps v. Manor Drug Store*<sup>20</sup> suggesting that investors had protection at common law from fraudulent inducements to retain their securities; and (5) the beliefs that the fraudulent inducement of an investor to retain his security is no more "commercially moral" than the fraudulent inducement of an investor to buy or sell a security and that "the purpose of the law is, wherever possible, to afford a remedy to defeat fraud," even where proof of the claim is difficult and there is a risk of abusive litigation.<sup>21</sup>

Most of those courts, aware that they are creating a new tort liability, have hedged their rulings. In recognition of the potential abuse a holder cause of action might invite, they have invariably imposed additional requirements for the pleading and proof of holder claims beyond the allegations showing the elements of fraudulent and negligent misrepresentation causes of action. In particular, the holder has to allege and prove that the challenged misstatements were made in "direct" communications to him from the defendant; several courts have said that the communications cannot be in publicly available documents.<sup>22</sup> Some courts have also required that the plaintiff holder set forth specific acts and concrete plans showing when he would have bought or sold a specific amount of a security but for the alleged misstatement.<sup>23</sup> While they dismissed complaints without prejudice because they did not allege

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<sup>19</sup>*Small*, 132 Cal. Rptr. 2d at 494-95; *Holmes*, 691 S.E. 2d at 198; *Gutman*, 748 F.Supp. at 264; *Rogers*, 268 F.Supp.2d at 1313. For example, § 525 states:

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. (emphasis added)

<sup>20</sup>421 U.S. 723, 738, 739 n.9, 744 (1978).

<sup>21</sup>*Continental Insurance Co.*, 222 App. Div. at 183-84; *Small*, 132 Cal. Rptr. 2d at 500-02; *Gutman*, 748 F.Supp. at 264, 265-66; *Holmes*, 691 S.E. 2d at 199.

<sup>22</sup>*Grant Thornton*, 314 S.W. 3d at 199; *Gutman*, 748 F.Supp. at 266; *Goldin v. Salomon Smith Barney, Inc.*, 994 So.2d 517, 520 (Fla. App. 2008); *Holmes*, 691 S.E.2d at 199; *Small*, 132 Cal. Rptr. at 496; *Ohanessian*, 2010 U.S. Dist. LEXIS 16847, at \*6. Without discussion, the court in *In re Washington Mutual, Inc. Secs. Litig.*, 2010 U.S. Dist. LEXIS 113088, at \*17-18, upheld a holder claim based on an allegedly misleading SEC filing. It is noteworthy that the Supreme Court of California expressly rejected the requirement that the misleading statement be made in a "personal" communications from defendants. *Small*, 132 Cal. Rptr. 2d at 496. At least one court has rejected the requirement that the plaintiff allege and prove that he had taken "preparatory" actions which showed that he would have sold his securities but for the misleading statements. *Gutman*, 748 F.Supp. at 267.

<sup>23</sup>See, e.g., *Rogers*, 268 F.Supp.2d at 1314; *Small*, 132 Cal. Rptr. 2d at 502-03. Those opinions even used the term "action" to describe such conduct of the holder. *Id.* That language only highlights the absence in a holder claim of the essential action in a fraud claim: a transaction. See *Starr Foundation*, 901 N.Y.S.2d at 249-50.

those specific details,<sup>24</sup> those courts have emphatically recognized the legal cognizability of holder claims.

### *Reasons to Reject Holder Claims*

The arguments for holder claims have substantial irremediable flaws. They ignore the actual economic loss requirement for a fraud claim. They *sub silentio* reduce the scope of liability for a fraudulent misrepresentation to a holder. They also rest on a mistaken as well as incomplete account of the causal relationship between the alleged misconduct of the defendant and any resultant damages. Each of these flaws is sufficient for a court to rule that a holder claim is not legally cognizable. For further support a court's rejection of holder claims can also rest on equitable considerations, but some of the arguments used to date by courts to dismiss holder claims should not be adopted.

#### 1. Actual Loss

Actual loss is a well-established requirement for a common law fraud claim.<sup>25</sup> Holder claims, on the other hand, are predicated on the fact that there was no actual economic loss since no actual transaction by the holder was linked to the alleged wrongdoing. The suggestion in several opinions that the loss of an opportunity to make a particular securities transaction constitutes an actual loss is misguided. First, the loss of an opportunity to sell a security for a certain possibly inflated price is not the same as the loss of funds in a completed transaction. In the latter there is a certitude that does not exist in the former; the former involves only a potential transaction where the investor alleges that he would have received the monies he actually did not obtain. As Judge Posner has observed, in tort law "[t]he near miss is not actionable." The imposition of additional pleading requirements (*e.g.*, details on plans for transactions allegedly abandoned because of a misstatement) in those opinions does not transform the nature of a retention or render it the equivalent of a sale.

Second, the so-called "forfeited opportunity"<sup>26</sup> or "lost profit opportunity"<sup>27</sup> which a holder claim seeks to monetize in no way

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<sup>24</sup>See, *e.g.*, *Small*, 132 Cal. Rptr. 2d at 503; *Rogers*, 268 F.Supp.2d at 1311-12, 1314.

<sup>25</sup>*Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 344 (2005); *Clarkson v. Goldstein*, 2005 Del. Super. LEXIS 191, at \*10-11, 25-26 (Del. Sup. May 31, 2005); *Kosachuk v. Harper*, 2002 Del. Ch. LEXIS 96, at \*35 (Del. Ch. July 25, 2002).

<sup>26</sup>*Grant Thornton*, 314 S.W.3d at 926.

involves an actual loss or, in most instances, a legal "opportunity." As Judge Easterbrook stated in *Anderson v. Aon Corp.*, such hypothetical, often insider, sales would not occur as legitimate transactions—not to mention ever achieve a legal profit or legally avoid the inevitable loss:<sup>28</sup>

Anderson can show injury only if he would have sold his shares ahead of the decline. Yet public announcement of the truth would have made it impossible for Anderson to avoid the loss. Although a private revelation to Anderson could have enabled him to sell before the decline, trading on the basis of material nonpublic information revealed in confidence by the issuer violates federal securities laws. Anderson can't use hypothetical inside trading as the basis of his recovery.<sup>29</sup>

This conclusion, that a holder claim does not involve an actual loss, is echoed by *Starr Foundation v. American International Group*, which is a 2010 ruling by a New York appellate court that a holder claim of the plaintiff investor was not legally cognizable. The court pointed out that the investor plaintiff in a holder claim has not "lost . . . any value" because the investor, which claimed that its forbearance from selling its AIG stock had resulted in the loss of a profit opportunity, "did not lose or give up any value" as it "did not allege any transaction in which it gave up anything in exchange for anything else."<sup>30</sup>

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<sup>27</sup>*Harris*, 2011 WL 1679625, at \*10.

<sup>28</sup>614 F.3d at 361. The Fifth Circuit in *Crocker* likewise concluded that under scrutiny a holder's "envisioned 'profit opportunity' evaporates into hardly more than an illusion." 826 F.2d at 351. See also the discussion in *Arent*, 975 F.2d at 1374, which notes that the material information underlying a holder claim will regularly be non-public and preclude a shareholder from selling his securities.

<sup>29</sup>The customary caution of Delaware courts addressing a motion to dismiss a tort claim at the outset of litigation should not restrain them from granting a motion to dismiss a holder claim. Under Delaware law, a claim is allowed to proceed provided that it states a cognizable claim under any "reasonably conceivable set of circumstances inferable from the alleged facts." *Winshall v. Viacom Int'l Inc.*, 76 A.3d 808, 813 n.11 (Del. 2013). The core point about a standard holder claim is that it does *not* allege such a "reasonably conceivable" set of circumstances. At its center usually is an *inconceivable* event: the legal sale of securities at a price that reflects the true rather than inflated value of the security at the time when the holder received and relied on the allegedly misleading information. Given that the federal pleading standard of plausibility, which the Supreme Court established in *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009), is less demanding than Delaware's pleading standard, it follows that a holder claim should be dismissed also in federal and other courts which follow the plausibility standard. *Winshall*, 76 A.3d at 813.

<sup>30</sup>*Starr*, 901 N.Y.S 2d at 249-50. See also *AHW Investment Partnership*, 2016 U.S. App. LEXIS 14364, at \*7-9. Several opinions rejecting holder claims have stated that the alleged damages either did not amount to an actual loss or were too speculative. See, e.g., *Chanoff*, 857 F.Supp. at 1019; *Harris*, 2011 WL 167925, at \*13.

## 2. Scope of Liability

The requirement that the allegedly false communication by a defendant be directed at the holder plaintiff effectively changes the substantive elements of a fraud claim. For decades courts have allowed fraudulent misrepresentation claims where the maker of the falsehood "intended or had reason to expect" the plaintiff to rely on the alleged misstatement. They have rejected the old rule that only a particular person or class of persons to whom the misrepresentation was directed by the defendant could assert a fraudulent misrepresentation claim.<sup>31</sup> The new requirement for holder claims amounts to a retreat from the broader scope of liability adopted by the *Restatement (Second) of Torts* (1977) and the courts.<sup>32</sup> Whatever the substantive validity of that modification for fraud claims by holders, it is quite clear that the courts recognizing holder claims did not directly address this change and that therefore the reliability of their opinions is suspect.<sup>33</sup>

## 3. Causation: Inaction is not Equivalent to Action

Equally serious problems undercut the reasons proffered to sustain the allegation and proof of any requisite causation elements of holder claims. Those causation problems begin with the contention that forbearance satisfies the reliance element of a fraudulent misrepresentation cause of action. In Delaware no court has so ruled. Moreover, as noted above,<sup>34</sup> the Delaware courts' formulaic statements of

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<sup>31</sup>*Restatement (Second) of Torts* §531. See also *Vichi*, 85 A.3d at 811; *Powers v. Ostreicher*, 824 F.Supp. 372, 376-77 (S.D.N.Y. 1993); *Globe Communications Corp. v. R.C.S. Rizzoli Periodici, S.p.A.*, 729 F.Supp. 973, 977 (S.D.N.Y. 1990); *Wey v. New York Stock Exchange, Inc.*, 841 N.Y.S.2d 222 (Sup. Ct. N.Y. Co. 2007), *appeal withdrawn*, 859 N.Y.S.2d 370 (1<sup>st</sup> Dept. 2008). For further details on the courts' adoption of the "reason to expect" standard and the different interpretations of that standard, see Andrew R. Simank, *Deliberately Defrauding Investors: The Scope of Liability*, 42 ST. MARY'S L.J. 253, 257-59 (2010).

<sup>32</sup>*Powers*, 824 F.Supp. at 376-77. Compare *Restatement (First) of Torts* §§525, 531 and 533 cmt. b (1938) with *Restatement (Second) of Torts* §531 (1977).

<sup>33</sup>Several courts, perhaps implicitly acknowledging that a directed communication is not required under the established test for a fraudulent misrepresentation claim, have erroneously declared that its requirement was "a logically necessary sub-element of justifiable reliance." *Holmes*, 691 S.E.2d at 199; *Goldin*, 994 So.2d at 520. No explanation of that "logical necessity" has been offered for that declaration. Nor can there be a satisfactory explanation. The justifiable reliance element focuses on the conduct of the investor; the requirement of a directed communication not only reduces the scope of liability but also relates directly to the requisite state of mind of the maker of the misrepresentation. See, e.g., *Globe Communications Corp.*, 729 F.Supp. at 977.

<sup>34</sup>See *supra* notes 6 and 7.



the elements of a fraud claim do not uniformly state that an investor's forbearance is the equivalent of an actual purchase or sale for determining the viability of a fraud claim. Some courts have used the phrase "action or inaction taken in justifiable reliance" on the alleged misrepresentation to describe an element of a claim for fraudulent misrepresentation. Others have not. Furthermore, one Delaware court has ruled that refraining from action is not the legal equivalent of action in the analogous claim for a fraudulent inducement not to enforce a debt.<sup>35</sup>

Thus, it is appropriate at this juncture to scrutinize each of the reasons offered by courts to treat "action" and "inaction" as equivalent forms of reliance in order to determine whether Delaware courts should recognize holder claims as legally cognizable.

First, contrary to the courts in *Gutman*, *Small*, and *Holmes*, their statement that "inducement is the substance of reliance" is simply mistaken. The proof of inducement focuses on the conduct of the wrongdoer who persuaded the investor to act or not act.<sup>36</sup> In contrast, the proof of justifiable reliance focuses on the conduct of the allegedly wronged investor.<sup>37</sup>

Second, a person's refraining from action may be recognized as the equal of acting for some claims, but in Delaware and elsewhere it is also a bar to a recovery on certain fraud claims. As just noted, one such claim is for fraudulently inducing a lender not to enforce a credit agreement so as to collect a debt.<sup>38</sup> Thus, the recognition of forbearance as the equivalent of action for certain tort claims at common law or in the Restatement (Second) of Torts does not justify an unblinking holding that forbearance satisfies the reliance element for a fraudulent misrepresentation claim involving securities.<sup>39</sup> Accepting forbearance for the satisfaction of that claim must be justified on its own merits.

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<sup>35</sup>*Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1177-78 (Del.Ch. 2006), and cases cited therein. See also 37 *C.J.S. Fraud* §53 (1997) ("recovery . . . cannot be had for fraudulent representation inducing a creditor merely to refrain from taking steps to collect a debt until collection has become impossible . . .").

<sup>36</sup>Black's Law Dictionary (10<sup>th</sup> ed. 2014) defines "inducement" as "the act or process of enticing or persuading another person to take a certain course of action." See *E.I. DuPont de Nemours & Co. v. Florida Evergreen Foliage*, 744 A.2d 457, 463 (Del. 1999), for a typical discussion of the defendant's alleged inducement of the plaintiff in a fraud claim.

<sup>37</sup>See, e.g., *Universal Enter. Group, L.P. v. Duncan Petroleum Corp.*, 2013 Del. Ch. LEXIS 162, \*\*at 42-43 (Del. Ch. July 1, 2013); *Kosachuk v. Harper*, 2002 Del. Ch. LEXIS 96, at \*23 (Del. Ch. July 25, 2002).

<sup>38</sup>*Big Lots Stores, Inc.*, 922 A.2d at 1177-78.

<sup>39</sup>The reliance on §525 of the *Restatement (Second) of Torts* to deem holder claims legally cognizable has not been sufficiently skeptical. Courts have not considered the logical implication of applying §525 to support holder claims—namely, the recognition of a new parallel set of claims by persons who would have but did *not purchase* securities because of

Third, the remarks forty years ago in *Blue Chip Stamps*, a ruling on standing under §10(b) of the Securities Exchange Act, were merely dicta.<sup>40</sup> Moreover, they are now overshadowed by Justice Breyer's more recent dicta in *Dura Pharmaceuticals, Inc. v. Broudo* that it was a long established requirement for a common law fraud claim that the plaintiff show that "had he known the truth he would not have acted"<sup>41</sup> as he did. Not a word was said in *Dura Pharmaceuticals* about refraining from action.

Fourth, "commercial morality" is not a sufficient touchstone for common law liability. Numerous unethical practices have long escaped the remedies provided at common law. Relief from such practices has been provided primarily by legislation.<sup>42</sup>

In sum, the equation by certain courts of retaining and selling securities to justify the upholding of a holder claim is misguided and unconvincing.

#### 4. Causation: Proximate Causation

No less a flaw in the opinions upholding holder claims is their incomplete account of the causal relationship between the defendant's misconduct and the allegedly resultant damages. Most of those cases implicitly accept without discussion the proposition that once the justifiable reliance element of a fraud claim is shown, the causation element in holder's fraudulent misrepresentation claim is properly pleaded.<sup>43</sup> They do not consider directly what has long been a

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another person's misrepresentation. After all, that potential purchaser, like a holder, allegedly refrained from taking action as a result of a misstatement. He too may someday assert a claim. That consequence—a claim with the same defects inherent in holder claims—may not be what those courts had in mind when they recognized holder claims as legally cognizable. But, their own thinking may make that outcome difficult to avoid. The courts' unexplained reliance on *Restatement (Second) of Torts §531* is especially unpersuasive since they regularly reject a central new guideline proposed in the same section of the *Restatement (Second)*, namely, the expansion of a wrongdoer's liability for a holder claim to persons beyond those particular individuals to whom the misrepresentation was directed. See n. 31 and 32 and associated text.

<sup>40</sup> *Anderson*, 614 F.3d at 366.

<sup>41</sup> 544 U.S. 336, 343-44 (2005) (emphasis added).

<sup>42</sup> Prime examples are the federal securities laws. See *Blue Chip Stamps*, 421 U.S. at 750-53 and 756 n.4.

<sup>43</sup> For example, *Holmes* refers to only a "fraud, accompanied by damage to the party." 691 S.E. 2d at 198. *Grant Thornton*, in turn, noted that the plaintiff's claimed damages were the "diminished value of the stock or the value of the forfeited opportunity, allegedly caused by defendants' misrepresentations." 314 S.W.3d at 926.

requirement in most fraud cases, namely, "proximate causation."<sup>44</sup> The explication of causation in the one opinion, *Reisman v. KPMG Peat Marwick LLP*, which discusses a supposed causal link between the misconduct and damages, is seriously deficient. That court allowed a holder claim where, the plaintiffs alleged merely that "false statements were a substantial factor in the [plaintiffs'] decision [to retain their investment] and that their pecuniary losses flowed naturally from them" and the plaintiff's loss "occurred as a result of . . . inaction taken in reliance of a false representation where the inaction was the direct natural and intended result of the false representations."<sup>45</sup> That vague statement of the causal relationship between the wrongdoing and the resulting damage breeds confusion.

Not surprisingly, the attempt in *Reisman* to explain that test led to confusion or worse. *Reisman* determined that the defendant, by making a misrepresentation which was "an operating factor" in the holders' decision not to sell their securities, assumed all the risk of all the losses of the holders after the time of the misrepresentation through the "time the misrepresentation had been discovered"—"without an attempt to separate out general market conditions or other factors in the market that may also have contributed to a decline in price."<sup>46</sup> Thus, the maker of a misrepresentation was to be responsible for the entire price decline, including the losses that did not "flow naturally." In fact, the *Reisman* test as applied would not require a plaintiff to prove any causal link between the misrepresentation and the investment loss other than justifiable reliance on a material misrepresentation. The mere fact that the market price had declined "at the time the misrepresentation had been discovered" is sufficient to make the defendant pay for all those losses.<sup>47</sup>

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<sup>44</sup>*Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683 (7<sup>th</sup> Cir. 1990) (Posner, J.) ("Indeed what securities lawyers call 'loss causation' is the standard common law fraud rule (on which see Prosser and Keeton on the Law of Torts §110, at p. 767 (5<sup>th</sup> ed. 1984), merely borrowed for use in federal securities fraud cases.").

<sup>45</sup>787 N.E.2d at 1068.

<sup>46</sup>*Id.* at 1070. As recognized in *Prosser*, Law of Torts §110, at 732 (4<sup>th</sup> ed. 1971), this imposition of total liability conflicts with the general rule which restricts "recovery to those damages which might foreseeably be expected to follow from the character of the misrepresentation itself." See *International Totalizing Systems, Inc. v. PepsiCo., Inc.*, 560 N.E. 2d 749, 754 n.13 (Mass. App. 1990).

<sup>47</sup>The reasoning for the *Reisman* test was conclusory and flawed. First, it said that the "purpose" of its rule was "to make the plaintiff whole for any loss suffered." (787 N.E.2d at 1070). That comment may describe the result of the test but it does not justify the alleged "purpose" or result, especially since the *Reisman* holding imposes liability on a person who did not necessarily have any responsibility for falsehoods relating to the reasons for the price decline.

*Reisman's* other rationales for its test are no better. They orate or speculate rather than reason to a conclusion. The declaration that "it is thought to be fairer that the maker of the false representation bear the loss rather than the person deceived" again provides no

In any event, the test in *Reisman* makes little sense in the context of a holder's fraud cause of action. The investment loss in a common law securities fraud claim does not "flow" or "result" from the misrepresentations themselves or, indeed, from just the reliance on them. Rather, as the Second Circuit noted in its discussion of causation in the analogous context of a federal securities action:

[I]t cannot ordinarily be said that a drop in the value of a security is caused by the misstatements or omissions made about it, as opposed to the underlying circumstance that is concealed or misstated . . . Thus to establish loss causation, a plaintiff must allege . . . that the *subject* of the fraudulent statement or omission was the cause of the actual loss suffered, i.e., that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security.<sup>48</sup>

## 5. Equitable Considerations

In addition to the policy considerations Chief Justice Strine noted in *Citigroup Inc.*,<sup>49</sup> several equitable considerations support the conclusion that holder claims are not legally cognizable. If the holder were not to bear the risk of the economic downturn (and possible wrongdoing) which occurred during the time he held the stock and accepted the potential benefits of securities ownership (such as dividends), then he would have likely passed the loss to others, such as creditors and shareholders including the new investors who had not

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explanation. 787 N.E.2d at 1070. It also leaves unanswered the possibility that the price decline was due to the disclosure of another misrepresentation by another person and that the defendant would be deemed responsible for losses linked to misconduct of only another wrongdoer. Left unexplained is how that result would be fair. The remaining rationales in *Reisman*—"the fact that the condition of a company is less good than represented *may* also cause the company to be less able to withstand" an economic downturn and the difficulty of distinguishing the effects of the misrepresentation and "general market conditions"—are meritless. *Id.* (emphasis added). The former is downright speculation and the latter is an unpersuasive rationale since courts deeming a holder claim legally cognizable have ignored or minimized any concerns that proving the reliance and damages elements of a holder claim would be difficult and invite abusive litigation. *See, e.g., Gutman*, 748 F.Supp. at 266; *Small*, 132 Cal. Rptr. 2d at 499-500.

<sup>48</sup>*Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 173 (2d Cir. 2006) (emphasis added) (internal quotation marks and citations removed). *See also In re Vivendi, S.A. Secs. Litig.*, Nos. 15-180-cv(L), 15-208-cv (XAP), at pp. 79-80 (2d Cir. Sept. 27, 2016).

<sup>49</sup>*See supra* text accompanying notes 1-3.

knowingly borne the risk or obtained any benefits during the time when that possible wrongdoing occurred.<sup>50</sup>

Furthermore, upholding holder claims would likely give some investors an unfair "windfall profit." As the Fifth Circuit observed in *Crocker v. FDIC*:

We cannot help but observe the troublesome paradox presented by the Crockers' theory: on the one hand, they claim the defendants' scheme caused their injury; yet, on the other hand, without the scheme, the minority shareholders could never have realized the artificially high profit that they claim to have unjustly lost. In sum, the Crockers complain that the scheme that harmed the minority shareholders also presented a unique profit opportunity, which the plaintiff class unfortunately missed.<sup>51</sup>

That "windfall profit," where it is secured through a claim against the corporation, would likely be at the expense of innocent creditors and shareholders. Assuming the holder retained his shares throughout his lawsuit, a damages award would also involve shifting wealth from one of his pockets to another, minus the costs of litigation.<sup>52</sup> Both of those consequences would be difficult to justify.

Those considerations override the contention that often holders are simply seeking a benefit which other innocent former shareholders obtained when they sold their securities during the time of the fraud and that they would have secured the same benefit but for the wrongdoer's inducement of them to refrain from selling. It may be noteworthy that no court or regulator has ordered those former shareholders to return their profits. Simply put, they contend that they are innocent investors who in many instances sought information to become informed shareholders (as encouraged by state policy) and defendant should pay them what they would have received but for defendant's wrongdoing.

In any event, there is a direct three-fold answer to that argument. First, the fact that some shareholders benefitted from an uninformed or

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<sup>50</sup>See, e.g., *Kagan*, 907 F.2d at 692. Of course, the new investor might be able to sue wrongdoers but the same could be said for the holder if such a claim existed. More importantly, the issue here is which investor should bear the risk and loss—not who should be entitled to prosecute a claim in costly litigation and thereby incur further costs. Indeed, the new investor might not be entitled to bring a claim for a wrong to the company since the wrongdoing did not occur while he was a shareholder and bearing the risk. See, e.g., *Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984); 8 Del. C. § 327.

<sup>51</sup>826 F.2d at 352.

<sup>52</sup>See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action*, 106 COL. L. REV. 1534, 1559 (2006).

misinformed marketplace is not justification for allowing any other shareholder to do so. Further, as shown above, the investor would often not have received anything but for mismanagement or other wrongdoing directed at the issuer. In many instances he would not be allowed to sell his securities because he had sought and obtained non-public information.

Second, holders in most, if not all, circumstances will have a legal remedy. The underlying circumstances, which were concealed from the holder, often entail mismanagement or other misconduct of insiders in breach of their fiduciary duties to the company. In those situations, the holder will have the right to initiate derivative litigation against the wrongdoers.<sup>53</sup>

Third, in Delaware corporations, holders would have a direct breach of fiduciary duty claim against any director who made a misleading statement to them.<sup>54</sup> Though this claim has been circumscribed, it still remains a right of shareholders in Delaware corporations.<sup>55</sup>

## 6. Arguments to Not Adopt

Finally, it should be acknowledged that some appellate rulings rejecting holder claims have relied on inexact and unpersuasive reasoning, including arguments on the causation element, which should not be followed in the future. For example, one group of opinions has dismissed holder claims on the ground that the "loss derives not from the fraud *per se*, but from the disclosure of the misrepresentations and the

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<sup>53</sup>See, e.g., *Kagan v. Edison Bros. Stores, Inc.*, 907 F.2d 690, 692 (7<sup>th</sup> Cir. 1990); *Arent*, 975 F.2d at 1374; *Rivers*, 655 F.3d at 618-19; *Crocker*, 826 F.2d at 352. Derivative claims face hurdles not found in direct litigation (e.g., the demonstration that a demand on the board to assert the claim would have been futile). Del. Ct. Ch. Rule 23.1. See also *In re Dow Chemical Co. Derivative Litig.*, 2010 Del. Ch. LEXIS 2, at \*2-3 (Del. Ch. Jan. 11, 2010); *In re The Limited, Inc. Shareholders Litig.*, 2002 Del. Ch. LEXIS 28, at \*10-11 (Del. Ch. March 27, 2002). Nonetheless, holders do have possible claims to protect their financial interests through derivative litigation.

<sup>54</sup>*Malone v. Brincat*, 722 A.2d 5 (Del. 1998); see also *Citigroup Inc.*, 140 A.3d at 1140 n.75, discussing such possible claims. The Delaware courts' recent allowance of expanded pre-litigation discovery under Del. Code Annot. tit. 8, §220 would increase the threat of both such a claim and derivative litigation. See, e.g., *Wal-Mart Stores, Inc. v. Indiana Elec. Workers Pension Trust Fund IBEW*, 95 A.3d 1264 (Del. 2014); *Chammas v. NavLink, Inc.*, 2016 Del. Ch. LEXIS 22 (Del. Ch. Feb. 1, 2016).

<sup>55</sup>See, e.g., *Dubroff v. Wren Holdings, LLC*, 2010 Del. Ch. LEXIS 178, at \*19-21 (Del. Ch. Aug. 20, 2010).

subsequent correction in the market price of the stock."<sup>56</sup> Reliance on that tort dichotomy is misguided. As noted above, the Second Circuit in *Lentell v. Merrill Lynch & Co., Inc.*, showed that it is inaccurate to say that the misrepresentation itself "caused" the loss; rather, "the subject of the fraudulent statement or omission was the cause of the loss which was materialized when the falsity of that misstatement was disclosed."<sup>57</sup> Similarly, the significance of the disclosure correcting the fraud is that it may provide an initial framework for both measuring a decline in the true value of the securities,<sup>58</sup> and calculating the actual monetary damages. It is not the event from which the holder's loss is derived; that is the misconduct of the person who made the misrepresentation.<sup>59</sup>

Again, contrary to the views of several courts,<sup>60</sup> the difficulties of proving an element of a fraud claim, be it reliance or damages, may or may not be surmountable. Those courts note the difficulties of proving reliance or calculating damages because of the uncertain data that must be proven for any recovery (e.g., the date(s) and amount(s) of the hypothetical sale(s) which never took place). Yet, as noted above,<sup>61</sup> other courts have ruled that those difficulties of litigating a holder claim did not undercut its validity. In truth, a universal ironclad appraisal of those difficulties is frequently difficult to make. As a result, the difficulty of proving a holder's claim—if such a claim is deemed legally cognizable—remains a highly subjective, case-intensive criterion with uncertainty about its future applicability.

### Conclusion

Nationwide the judicial treatment of holder claims has been inconsistent. Courts in some states have recognized them as legally cognizable. Others have rejected them. Over the decades the courts

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<sup>56</sup>*Dloogatch v. Brincat*, 920 N.E. 2d 1161, 1170 (Ill. App. 2009); *Arnlund*, 199 F.Supp. 2d at 487.

<sup>57</sup>*Lentell*, 396 F.3d at 173.

<sup>58</sup>See *Dura Pharmaceuticals, Inc.*, 544 U.S. at 344, and the discussion by Allen Ferrell & Atanu Saha, *Forward-Casting 10b-5 Damages: A Comparison to Other Methods*, 37 J. CORP. L. 365 (2012).

<sup>59</sup>Some opinions rejecting holder claims also use an unduly vague proximate cause guideline. See, e.g., *Chanoff*, 857 F. Supp. at 1018. The Connecticut Supreme Court has explained that "those results are proximate which must be presumed to have been within the contemplation of the defendants as the probable consequence of his fraudulent representations." *Kilduff v. Adams*, 219 Conn. 314 at 323-24 (1991). See also *Holmes v. Sec. Inv'r Prot. Corp.*, 503 U.S. 258, 268 (1992) ("the notion of proximate cause reflects 'ideas of what justice demands, or of what is administratively possible and convenient.'" (internal citations omitted)).

<sup>60</sup>See, e.g., *supra* note 12.

<sup>61</sup>See, e.g., *supra* note 21.

ruling one way or the other have often not addressed explicitly the rationales of the opposing viewpoint except in conclusory terms. This article has attempted to conduct that analysis, and thereby help sharpen the reasoning in future judicial rulings.

To date, the courts in Delaware and numerous other states have not had occasion to rule on the legal viability of holder claims. This article, while finding unconvincing some arguments supporting the rejection of holder claims, has identified critical flaws in holder claims and in the opinions recognizing them. In the future courts should recognize those flaws and conclude that holder claims inherently lack essential elements of fraudulent and negligent misrepresentation claims and thus are categorically without merit.

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