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SECOND CIRCUIT REVIEW

FEDERAL SECURITIES LAW: LOSS CAUSATION, 'BENEFICIAL OWNERSHIP'

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In this month's column, we review two significant securities law decisions issued by the U.S. Court of Appeals for the Second Circuit earlier this month. In the first, the Second Circuit comprehensively examined the issue of loss causation in the context of a securities fraud claim, and attempted to reconcile several seemingly inconsistent rulings it has issued on the subject over the past two decades.

In the second decision, the court addressed the issue of "beneficial ownership" and analyzed whether a shareholder who individually owned less than 10 percent of a company's stock nevertheless could be deemed a beneficial owner of more than 10 percent of stock for the purposes of § 16(b) of the Securities Exchange Act by virtue of his relationship with two other shareholders.

Loss Causation

In *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*,[1] the Second Circuit, in an opinion written by Judge Richard J. Cardamone and joined by Chief Judge John M. Walker and Judge Roger J. Miner, reversed the district court's dismissal of a securities fraud action for failure to allege loss causation, holding that defendants' deliberate concealment of the financial problems of the principal executive of an enterprise could foreseeably cause investors to suffer financial harm by leading them to arrive at an inaccurate valuation of the enterprise's securities.

Defendant Toronto-Dominion Bank (T-D Bank), through its affiliates, held a large financial stake in SAM Group, a health care financing enterprise. In October 1996, Toronto-Dominion Capital (T-D Capital), a subsidiary of T-D Bank, proposed that plaintiffs Suez Equity Investors L.P. (Suez) and SEI Associates (SEI) invest in SAM Group.

In determining whether to make such an investment, Suez and SEI requested a background report on SAM's founder, principal executive and controlling shareholder, J. Christopher Mallick. Philip DeRoziere, an employee of T-D Bank, furnished plaintiffs with an outdated background report on Mallick and purposefully omitted significant negative events in Mallick's financial history, including the filing of an involuntary Chapter 7 bankruptcy, three personal tax liens, several adverse judgments and delinquent credit accounts. In addition, DeRoziere falsely misrepresented to plaintiffs that he received only positive feedback during his own due diligence of Mallick.

Allegedly based on these representations, Suez and SEI invested in SAM Group and purchased $3 million of its debt and equity securities. Less than two months later, SAM Group filed for bankruptcy.

Plaintiffs sued T-D Bank and its affiliates and subsidiaries as well as DeRoziere and Eric Rindahl, an employee of T-D Capital, in the U.S. District Court for the Southern District of New York. Plaintiffs alleged federal securities law violations (§ 10(b); Rule 10(b)(5); § 20) and asserted claims for common law fraud and negligent misrepresentation.

The district court granted defendants' motion to dismiss the complaint pursuant to Fed. R. Civ. P. 12(b)(6) and 9(b) on the grounds that plaintiffs failed adequately to allege loss causation and scienter, failed adequately to allege the "special relationship" required to state a negligent misrepresentation claim, and failed adequately to allege proximate causation, which is an essential element of common law fraud. Specifically, in dismissing the federal securities fraud claims, the district court ruled that plaintiffs failed to allege loss causation because they failed to show that the alleged inaccurate background report caused their financial losses.

Suez and SEI appealed to the Second Circuit, which reversed and remanded the district court's dismissal of the § 10(b) and common law fraud claims as to T-D Bank and certain of its affiliates and subsidiaries. The court also vacated the district court's dismissal of the § 20 claims as against T-D Bank and the negligent misrepresentation claim as against T-D Bank, certain of its affiliates, DeRoziere and Rindahl.

Writing for the panel, Judge Cardamone ruled that plaintiffs adequately alleged loss causation for purposes of a Rule 10b-5 claim. At the outset of the opinion, the court noted that a plaintiff must allege both transaction causation and loss causation. "Transaction causation is based upon the plaintiff's reliance upon the defendant's deceptive statements or omissions; that is, but for such conduct by the defendant, the plaintiff would not have acted to his detriment."[2] Loss causation is analogous to the tort concept of proximate cause, "meaning that in order for the plaintiff to recover, it must prove the damages it suffered were a foreseeable consequence of the misrepresentation."[3] To state a securities fraud claim in the Second Circuit, a plaintiff must demonstrate that the fraud both caused the plaintiff to engage in the transaction and that it also caused the harm actually suffered.

The court concluded that Suez and SEI adequately alleged that the omissions in Mallick's background check were the proximate cause of the harm they suffered because defendants' concealment "gave plaintiffs an inaccurate perspective from which to value the Group securities."[4] Moreover, the court ruled that defendants could have foreseen that the negative facts omitted in the background report would have demonstrated to plaintiffs that Mallick was ill-equipped to head the company and that, with him at the helm, the company likely would suffer a financial downfall.[5]

The 'Marbury Management' Case

The panel relied on the Second Circuit's 1980 decision in *Marbury Management, Inc.* v. *Kohn*[6] to support its holding that plaintiffs' loss causation allegations were adequate. In *Marbury Management*, a trainee at a brokerage firm persuaded clients to invest in certain stocks by misrepresenting that he was a portfolio management specialist and stockbroker. In that case, the Second Circuit upheld a jury verdict for plaintiffs on the ground that the misrepresentation regarding the reliability of the trainee's valuation was directly related to the value of the shares. The panel explained that just as a "reasonable investor would accord less deference to a trainee than it would to a broker when valuing a recommended stock,"[7] plaintiffs Suez and SEI may well have arrived at a different valuation of SAM Group's securities had they known about its leader's spotty background and prior financial failures. Therefore, defendants' omissions may well have caused plaintiffs to attribute a higher value to SAM Group's securities than they otherwise would have, thereby proximately causing plaintiffs' financial harm.

The panel's opinion went out of its way to distinguish misrepresentations that are related to the value of the securities from those that are extrinsic to the value of the securities — and stressed that only the former may be held to satisfy loss causation. To illustrate this distinction, the panel cited the Second Circuit's 1985 decision in *Bennett* v. *United States Trust Co.*[8] There, "the defendants had misrepresented to the plaintiffs that the Federal Reserve's margin rules did not apply to public utility shares pledged to a bank as collateral."[9] The Second Circuit upheld the district court's dismissal of the complaint for failure to state loss causation because the margin rules were extrinsic to the decline in the stock's value.

In the present case, by contrast, the court reasoned that the competency of the company's leader was essential to its financial success, making it foreseeable that misrepresentations about his competency would directly affect the value of the company's securities. Thus, it was sufficient for plaintiffs to allege that the deliberate concealment of the financial and business problems of the leader of SAM Group gave plaintiffs an inaccurate perspective from which to value the company's securities. If defendants had provided plaintiffs with an accurate background report, then plaintiffs could have learned of Mallick's inability to run the company and could have forecast the company's financial problems.

Foreseeable Disparity

In the end, the court ruled that, to allege loss causation, a plaintiff must demonstrate that "defendants' misrepresentations induced a disparity between the transaction price and the true investment quality of the securities at the time of transaction," and that such a "disparity" would have been foreseeable to defendants. The court adopted this standard in an attempt to reconcile the divergent loss-causation approaches it took in *Marbury Management, Bennett, Drysdale Securities, Wittcoff* and *Gelt Funding*.[10]

Interestingly, the court noted that, but for its several (albeit inconsistent) precedents in this area, it would have preferred to adopt the Seventh Circuit's approach to loss causation: whether the loss at issue was caused by the materialization of a risk that was not disclosed because of the defendant's fraud.[11]

Beneficial Ownership

In *Morales* v. *Quintel Entertainment Inc.*,[12] the Second Circuit, in another opinion written by Judge Richard J. Cardamone and joined by Judges Dennis Jacobs and Robert D. Sack, vacated the district court's entry of summary judgment in favor of defendant and ruled that a jury could find that a holder of less than 10 percent of a corporation's shares may be a "beneficial owner" under § 16(b) of the Securities Exchange Act because of his coordinated actions with other stockholders.

Defendant Peter Stolz was the minority shareholder of Psychic Reader's Network Corp. (Psychic) and owned 11 percent of its shares. The two controlling shareholders of Psychic were Thomas H. Lindsey and Steven L. Feder, who each owned half of the remaining 89 percent of the stock. In 1995, another corporation, Quintel Entertainment Inc. (Quintel), approached Feder, with a proposal to purchase Psychic's 50 percent interest in a corporation named New Lauderdale LLC in exchange for Quintel stock. Mr. Feder agreed, and Mr. Stolz and Mr. Lindsey played no role in the sales negotiation. Pursuant to the sales agreement executed in September 1996, Mr. Feder and Mr. Lindsey each received Quintel shares in proportion to their 89 percent interest in Psychic and Mr. Stolz received Quintel stock in proportion to his 11 percent interest in Psychic. Although Mr. Stolz individually owned less than 2.5 percent of Quintel common stock, he owned 18 percent if his holdings were grouped with those of Mr. Feder and Mr. Lindsey. The sales agreement contained "lock up" provisions, prohibiting Mr. Stolz, Mr. Feder and Mr. Lindsey from selling their Quintel stock for two years.

In December 1996, the three men jointly executed and filed a single Schedule 13D with the Securities and Exchange Commission, in which they disclaimed any beneficial ownership of one another's stock. The Schedule 13D also indicated that Mr. Stolz was a member of a "group" under § 13(d) of the Exchange Act, which owned more than 10 percent of Quintel stock. According to Mr. Stolz, the Schedule 13D and various Form 4s and 5s filed with the SEC were prepared by his attorney and were not reviewed by him.

Within three months of the September 1996 execution of the sales agreement, Mr. Stolz began to purchase and sell shares of Quintel common stock, and continued to do so over the following two years.

In October 1998, Richard Morales, a Quintel shareholder, filed a shareholder derivative suit under § 16(b) of the Securities Exchange Act to compel Mr. Stolz to disgorge the profits realized from his short-swing trades in Quintel stock. Mr. Morales and Mr. Stolz filed cross-motions for summary judgment. The district court granted Mr. Stolz's summary judgment motion. The court ruled that Mr. Stolz did not satisfy the 10 percent threshold required to trigger liability under § 16(b), because he individually owned only 2.5 percent of Quintel stock and was not a beneficial owner of the stock of Mr. Feder and Mr. Lindsey.

Mr. Morales appealed, and the Second Circuit vacated the district court's award of summary judgment. The court ruled that a jury could find that, because of his association with the other two shareholders, Mr. Stolz was a beneficial owner of more than 10 percent of the Quintel stock and therefore strictly liable for engaging in short-swing trading.

A 'Beneficial Owner'?

The dispositive issue on appeal was whether Mr. Stolz was a "beneficial owner" under § 16(b) of the Securities Exchange Act. The panel began its analysis with the SEC's definition of "beneficial owner," as set forth in § 13(d). In 1991, the SEC promulgated Rule 16a-1, which stated that the term "beneficial owner" shall mean any person who is deemed a beneficial owner under § 13(d). Pursuant to § 13(d), a group of stockholders may be deemed to be a beneficial owner if they "agree to act together for the purpose of acquiring, holding, voting, or disposing of" stock.[13] According to the panel, the "agreement" may be formal or informal and may be proved by direct or indirect evidence. What is more, the stockholders need not have formed an agreement to "gain corporate control or to influence corporate affairs,"[14] but "need only have combined to further a common objective regarding"[15] acquiring, holding, voting or disposing of equity securities. Requiring a "control" objective would undermine the purpose of § 13(d), which is to "alert the market to large acquisitions that threaten *potential* shifts in corporate control."[16]

The Second Circuit disagreed with the district court's finding that, because the main objective of the stockholders of Psychic was to "sell" their holdings in their subsidiary, New Lauderdale, rather than to "acquire control" of Quintel, they could not be deemed a group beneficial owner of Quintel's stock for purposes of § 13(d). The panel viewed the difference between these two objectives as "six of one, rather than half-a-dozen of the other"[17] because "virtually any acquisition of securities involves the exchange of some consideration in return for the receipt of securities."[18] Therefore, acquiring stock always is an objective.

Panel's Reasons

The panel also rejected Mr. Stolz's argument that he never agreed to acquire Quintel stock because he was merely a minority shareholder and played no role in negotiating the sales agreement. The court noted that Mr. Stolz, although he was a minority shareholder, was a minority shareholder of a "closely held corporation with only [two others] as coshareholders."[19] The court thus distinguished this case from that in "which the assertion of existing shareholder rights or mere business relationship is alleged as a basis for group membership."[20]

The panel pointed to several additional factors that support the existence of an agreement. It stated that although Mr. Stolz may have played no role in negotiating the sales agreement, he did sign its lock-up provisions that remained in effect for two years. Also, Mr. Stolz and his coshareholders deposited their Quintel stock in identical trusts, naming the same person as trustee. Finally, Quintel redeemed the holdings of Mr. Stolz, Mr. Feder and Mr. Lindsey at the same time. The court found that "such evidence of coordinated action may indicate the existence of a group, even in the absence of a formal agreement."[21]

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ENDNOTES

[1] *Suez Equity Investors, L.P.* v. *Toronto-Dominion Bank*, No. 99-9042 (2d Cir. May 8, 2001).

[2] Id. at 8195.

[3] Id.

[4] Id. at 8196.

[5] Id. at 8197.

[6] *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir. 1980).

[7] Id.

[8] *Bennett* v. *United States Trust Co.*, 770 F.2d 308 (2d Cir. 1985).

[9] *Suez*, slip op. at 8197.

[10] *Marbury Management, Inc.* v. *Kohn*, 629 F.2d 705 (2d Cir. 1980); *Bennett* v. *United States Trust Co.*, 770 F.2d 308 (2d Cir. 1985); *Manufacturers Hanover Trust Co.* v. *Drysdale Secs. Corp.*, 801 F.2d 13 (2d Cir. 1986); *Weiss* v. *Witcoff*, 966 F.2d 109 (2d Cir. 1992); *First Nationwide Bank* v. *Gelt Funding Co.*, 27 F.2d 763 (2d Cir. 1994).

[11] *Bastian* v. *Petren Res. Corp.*, 892 F.2d 680, 685-86 (7th Cir. 1990).

[12] *Morales* v. *Quintel Entertainment, Inc.*, No. 99-9374 (2d Cir. May 2, 2001).

[13] Id. at 2887.

[14] Id. at 2888.

[15] Id. at 2887.

[16] Id. at 2889.

[17] Id.

[18] Id. at 2890.

[19] Id.

[20] Id.

[21] Id. at 2893.