

FRAUD—RELIANCE—FRAUD-ON-THE-MARKET THEORY MAY NOT SATISFY RELIANCE REQUIREMENT IN CLAIMS OF COMMON LAW FRAUD OR NEGLIGENT MISREPRESENTATION—*Kaufman v. I-Stat Corp.*, 165 N.J. 94, 754 A.2d 1188 (2000).

The defendant, i-Stat Corporation (i-Stat), allegedly overstated the sales and demand of its products in public announcements. *Kaufman v. I-Stat Corp.*, 165 N.J. 94, 98-99, 754 A.2d 1188, 1190 (2000). i-Stat, a publicly traded corporation, experienced a decline in its stock value and heavy trading after its sales procedures were discovered and publicized.

The plaintiff, Susan Kaufman, who brought suit on behalf of a putative class, was a shareholder of i-Stat during the alleged period of misrepresentation. *Id.* at 99, 754 A.2d at 1190. When purchasing her stock, Ms. Kaufman relied solely on the market price of i-Stat, and not on i-Stat's misrepresentations. *Id.* at 100, 754 A.2d at 1191. Ms. Kaufman brought suit against i-Stat, and other named defendants, alleging, among other things, common law fraud and negligent misrepresentation. *Id.*, 754 A.2d at 1190. Ms. Kaufman claimed i-Stat's misrepresentations of its sales inflated its stock price during the named period. Because Ms. Kaufman did not rely on any alleged misrepresentations of i-Stat when purchasing her stock, the plaintiff depended upon the fraud-on-the-market theory to satisfy the reliance element of common law fraud and negligent misrepresentation. *Id.*, 754 A.2d at 1191. The fraud-on-the-market theory creates a rebuttable presumption of reliance based upon an efficient market's incorporation of misrepresentations and omissions into a stock's price. *Id.* at 97, 101, 754 A.2d at 1189, 1191 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)).

The Superior Court, Law Division, granted summary judgment in favor of i-Stat, holding that the fraud-on-the-market theory may not satisfy reliance in claims of common law fraud or negligent misrepresentation under New Jersey law. *Id.* at 100, 754 A.2d at 1191. The appellate division affirmed the dismissal of the plaintiff's complaint regarding negligent misrepresentation, but reversed the dismissal of the common law fraud claim. *Id.* The appellate division reasoned that the fraud-on-the-market theory could satisfy the reliance element of a common law fraud claim, but not a claim of negligent misrepresentation. *Id.* at 101, 754 A.2d at 1191.

The New Jersey Supreme Court granted certification to determine whether the fraud-on-the-market theory may satisfy the reliance element of

common law fraud. *Id.* at 103, 754 A.2d at 1192. Justice LaVecchia, writing for a majority of four justices, held that the fraud-on-the-market theory does not satisfy the reliance element of common law fraud or negligent misrepresentation. *Id.* at 118, 754 A.2d at 1201.

The majority began the analysis with a discussion of the relevant federal security laws, noting that Rule 10b-5 of the Securities Exchange Act of 1934 prohibits defendant's alleged acts and entitles plaintiff to damages. *Id.* at 103, 754 A.2d at 1192-93. The court observed, however, that the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA) has restricted a plaintiff's ability to recover. *Id.* at 104, 754 A.2d at 1193. Justice LaVecchia noted that the PSLRA imposes several restrictions upon a plaintiff alleging claims under the federal securities laws. *Id.* at 104, 754 A.2d at 1193. The majority explained that plaintiffs have been filing weaker securities claims in state courts to avoid the strictures of the PSLRA. *Id.* at 105, 754 A.2d at 1193. The court observed that upon the filing of these substitute Rule 10b-5 actions under state law, plaintiffs attempt to have the presiding court incorporate the fraud-on-the-market theory into that state's common law. *Id.*

Justice LaVecchia asserted that Congress enacted the SLUSA in response to the circumvention of the PSLRA through substitute state law claims. *Id.* at 106, 754 A.2d at 1194. The court clarified that the SLUSA restricts the ability of plaintiffs to bring federal securities actions in state courts. *Id.* at 107, 754 A.2d at 1194. The majority cautioned, however, that excepted plaintiffs under the SLUSA can still bring substitute Rule 10b-5 actions in state court. *Id.* Justice LaVecchia forewarned that if New Jersey incorporated the fraud-on-the-market theory into its common law, these excepted plaintiffs could forum shop, bringing substitute Rule 10b-5 actions under New Jersey common law. *Id.*

The court next analyzed the current reliance requirement under common law fraud and negligent misrepresentation. *Id.* at 108-11, 754 A.2d at 1195-97. Justice LaVecchia noted that the reliance requirement is the same under claims of common law fraud and negligent misrepresentation. *Id.* at 109, 754 A.2d at 1195. The court articulated that proof of indirect reliance will satisfy the reliance element of both claims. *Id.* The majority asserted that indirect reliance allows a plaintiff to satisfy the reliance requirement when the plaintiff heard and relied upon misstatements from a defendant's agent or a third party. *Id.* at 108, 754 A.2d at 1195. The court stressed that, when proving indirect reliance, the plaintiff must actually receive and consider the misstatements or omissions. *Id.* at 109, 754 A.2d at 1195. Accordingly, the majority concluded that the fraud-on-the-market theory, which allows a plaintiff to prove reliance

without showing actual receipt and consideration of the misrepresentations or omissions, contravenes and weakens the current indirect reliance requirement. *Id.* at 118, 754 A.2d at 1200-01. Because the plaintiff here admittedly did not rely on the alleged misstatements of iStat, the court held that the plaintiff did not sufficiently show a claim for fraud. *Id.* at 111, 754 A.2d at 1197.

Justice LaVecchia also found persuasive the analysis of indirect reliance and the fraud-on-the-market theory's applicability to state claims undertaken by courts in other jurisdictions. *Id.* at 106, 110-11, 754 A.2d at 1194, 1196. The majority identified three other courts that require actual reliance on the misrepresentations under a theory of indirect reliance: the Florida District Court of Appeals, the California Court of Appeals, and the California Supreme Court. *Id.* at 110-11, 754 A.2d at 1196 (citations and quotation omitted). Justice LaVecchia also asserted that no state court has accepted a fraud-on-the-market theory, outside of dictum, under state law. *Id.* at 113, 754 A.2d at 1198. The majority further noted that the United States District Court of New Jersey, and other federal courts with jurisdiction in New Jersey, have declined to accept the fraud-on-the-market theory under state law. *Id.* at 106, 754 A.2d at 1194.

In addition to the persuasive analysis of other courts, the majority considered the Uniform Securities Law (USL), New Jersey's statutory securities law, in rejecting the fraud-on-the-market theory. *Id.* at 112-13, 754 A.2d at 1197-98. The court explained that the USL does not require securities-fraud plaintiffs to prove reliance on any misrepresentation or omission. *Id.* at 112, 754 A.2d at 1197. Justice LaVecchia emphasized, however, that the USL requires privity in securities-fraud actions. *Id.* The court observed that the privity requirement was not met in this case. *Id.* As a result, Justice LaVecchia propounded that permitting the fraud-on-the-market theory to establish reliance in this case would allow the plaintiff to avoid the New Jersey Legislature's securities-fraud requirements and policy decisions as articulated by the USL. *Id.* at 112-13, 754 A.2d at 1197-98.

Finally, Justice LaVecchia questioned the economic validity of the fraud-on-the-market theory. *Id.* at 113-18, 754 A.2d at 1198-1201. The court examined at length the academic, professional, and judicial criticism of the Efficient Capital Markets Hypothesis, the economic theory underlying the fraud-on-the-market theory. *Id.* The majority noted its reluctance to extend a theory used in the carefully balanced system of federal securities laws—the economic validity of which is strongly questioned—into the broad world of common law fraud. *Id.* at 116-17, 754 A.2d at 1200. Justice LaVecchia observed that adopting the fraud-on-the-market theory for claims of common law fraud would allow future

plaintiffs to satisfy reliance by claiming efficient markets exist in areas outside of securities. *Id.* The majority warned that the movement of such a specialized doctrine into the common law context, which has a more general application, would be dangerous. *Id.* at 118, 754 A.2d at 1200. Justice LaVecchia also noted that the acceptance of the fraud-on-the-market theory in a common law securities claim is especially unwarranted because an adequate federal remedy was available to the plaintiff. *Id.*

Justice Stein, in an opinion joined by Justice O'Hern and Justice Long, dissented from the majority's opinion. *Id.* at 119, 754 A.2d at 1201 (Stein, J., dissenting). Justice Stein, agreeing with the appellate division's analysis, argued that the fraud-on-the-market theory should be capable of satisfying the reliance element of a common law fraud claim. *Id.*

The dissent analyzed the concept of indirect reliance and the United States Supreme Court's treatment and definition of the fraud-on-the-market theory within a federal securities-fraud context, and challenged the majority's determination regarding plaintiff's failure to prove indirect reliance. *Id.* at 120-25, 754 A.2d at 1201-04 (Stein, J., dissenting). Justice Stein asserted that the principles of indirect reliance apply to publicly traded securities where a fraud is made on the public as a whole. *Id.* at 120, 754 A.2d at 1201-02 (Stein, J., dissenting).

Furthermore, the dissent propounded that indirect reliance only requires a misrepresentation, with the intention that it will be communicated to third parties for the purpose of inducing reliance upon said misrepresentation. *Id.*, 754 A.2d at 1201 (Stein, J., dissenting). Justice Stein opined that the stock market itself conveys information to the plaintiff. *Id.* Consequently, the dissent concluded that i-Stat conveyed its misrepresentations to the plaintiff through i-Stat's stock price. *Id.* Justice Stein further asserted that the United States Supreme Court's analysis of the fraud-on-the-market theory in federal securities law claims applies equally to claims of common law fraud. *Id.* at 123, 754 A.2d at 1203 (Stein, J., dissenting). The dissent argued that the reliance element of common law fraud is almost identical to that of a federal securities law claim. *Id.*

Justice Stein also chastised the majority's discussion of the economic theory underlying the fraud-on-the-market theory. *Id.* at 124, 754 A.2d at 1204 (Stein, J., dissenting). The dissent opined that the court need not accept the efficient market hypothesis underlying the fraud-on-the-market theory. *Id.* The dissent argued instead that the court must only accept the right of investors to assume that misrepresentations or omissions have not affected stock prices. *Id.*

Moreover, the dissent commented that the existence and strictures of federal securities claims should not favor rejecting an application of the

fraud-on-the-market theory under common law fraud. *Id.* at 125, 754 A.2d at 1204 (Stein, J., dissenting). Justice Stein justified this position by stating that Congress intended the federal securities laws to supplement, not preempt, state law. *Id.* Lastly, Justice Stein criticized the majority's fear of future common law securities-fraud claims, observing that the PSLRA and the SLUSA restrict the access to state courts by most securities claim plaintiffs. *Id.* at 126-27, 754 A.2d at 1205 (Stein, J., dissenting). The dissent insisted that those plaintiffs exempted from federal restrictions should receive the full benefit of the fraud-on-the-market theory in their state securities claims. *Id.*

Civil securities-fraud claims are often vexatious, driven by attorney's fees and coercive settlement negotiations. This reality of securities-fraud litigation is balanced against a desire to provide legitimate relief for plaintiffs through both federal and state securities laws. Whatever place the fraud-on-the-market theory has in the balance of statutory securities-fraud, no place exists for it in common law actions. The majority, in a well-reasoned opinion, prevents plaintiffs from circumventing the procedural barriers of well balanced federal and state securities laws through substitute common law actions.

Shrewd plaintiffs undoubtedly would seek to take advantage of the fraud-on-the-market theory's relaxed reliance requirements in the broader range of issues that common law fraud reaches. For example, plaintiffs have already sought to apply the fraud-on-the-market theory to consumer fraud and malpractice claims. *Id.* at 117, 754 A.2d at 1200 (citations omitted). As the majority noted, one plaintiff has gone so far as to claim that basketball season ticket holders were defrauded, under the fraud-on-the-market theory, when an athlete was traded to another team. *Id.* (citation omitted). Extending the reliance element of common law fraud would open up a Pandora's box of debate over what constitutes a market. Such an endless dispute would waste New Jersey courts' time and resources, with no corresponding benefit.

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