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Broker-Dealers Have No Duty To Noncustomers

Law360, New York (December 9, 2010) -- In a case of first impression in New Jersey, the Appellate Division has held that a securities broker-dealer does not owe a duty to noncustomers. Frederick v. Smith, 2010 N.J. Super. LEXIS 212, **6-10 (App. Div. Nov. 9, 2010). Frederick follows a number of federal court cases that have dismissed claims sounding in negligence brought by noncustomers against financial institutions (including broker-dealers) based on the lack of a duty owing to the noncustomers, including claims that the financial institutions were negligent in failing to detect and prevent Ponzi or other fraudulent schemes perpetrated by their customers.

See, e.g., Kolbeck v. LIT America Inc., 923 F. Supp. 557, 571-72 (S.D.N.Y. 1996), aff'd, 152 F. 3d 918 (2d Cir. 1998); In Re Agape Litigation, 681 F. Supp. 2d 352, 361 (E.D.N.Y. 2010); Renner v. Chase Manhattan Bank, 1999 WL 47239, *13 (S.D.N.Y. Feb. 3, 1999); Guidry v. Bank of LaPlace, 740 F. Supp. 1208, 1218-19 (E.D. La. 1990), aff'd as modified, 954 F. 2d 278 (5th Cir. 1992).

Relying on both this line of cases as well as New Jersey common law, the Appellate Division in Frederick concluded that because the plaintiffs had no relationship with the defendant broker-dealer, and because the operator of the fraudulent scheme had no relationship with the broker-dealer other than as owner of the account into which the plaintiffs' funds were placed, "as a matter of law, no duty should be imposed on [the broker-dealer] to periodically examine the account's activities for indicia of fraud." Frederick, 2010 N.J. Super. LEXIS at **1-2.

The Frederick Decision

In Frederick, the plaintiffs alleged that they were induced by defendant Maxwell Smith to invest approximately $10 million over a period of years in Healthcare Financial Partnership (HFP). Defendant Smith represented HFP to be "a secure tax-free investment which paid a high level of interest through investment in a diversified portfolio of high yielding income projects." Frederick, 2010 N.J. Super. LEXIS 212 at **1-3.

HFP, however, turned out to be a fictitious entity and therefore a fraudulent scheme. Id. at *1. As part of the fraud, Smith instructed the plaintiffs to remit their funds to an account that he maintained with defendant Merrill Lynch, Pierce, Fenner & Smith Inc. Specifically, the plaintiffs alleged that Smith instructed them "to make their checks payable to 'Merrill Lynch A/C #36641' or 'directly to Merrill Lynch,' misrepresenting to Plaintiffs that Merrill Lynch was the security's underwriter." Frederick, 2010 N.J. Super. LEXIS 212 at **3-4.

Smith deposited these checks in his Merrill Lynch account and thereafter converted those funds. Id. Smith was not employed by Merrill Lynch, and the plaintiffs were not customers of Merrill Lynch. Id. at **4-5. Rather, Smith was employed by several other brokerage firms during this period where the plaintiffs were his customers. Id. at *4. By the time the plaintiffs discovered Smith's fraudulent scheme, they had lost nearly all of their funds. Id.

The plaintiffs filed suit against inter alia Merrill Lynch to recover their monies, alleging that Merrill Lynch was "negligent for failing to discover Smith's use of his Merrill Lynch account to perpetrate a fraud." Frederick, 2010 N.J. Super. LEXIS at ** 4-5. The trial court dismissed the plaintiffs' claims against Merrill Lynch pursuant to Rule 4:6-2(e).

The Honorable W. Hunt Dumont, J.S.C. rejected the plaintiffs' argument that a fiduciary relationship existed between them and Merrill Lynch by virtue of the fact that "they wrote checks directly to Merrill Lynch when investing in HFP," interpreting "the applicable law as limiting a brokerage firm's duty to only its customers." Id. at *5.

The plaintiffs appealed the trial court's dismissal of their claims for negligence. On appeal, while acknowledging that "a bank or brokerage firm does not typically owe a duty to non-customers," the plaintiffs nonetheless argued that "Merrill Lynch owed them a duty in this case because it 'accepted more than $9 million of [p]laintiff[s'] money … by way of checks payable to Merrill Lynch.'" Id.

The Appellate Division panel (Judges Mary Cuff, Clarkson Fisher and Marie Simonelli) affirmed the dismissal of the plaintiffs' negligence claims. In an opinion authored by Judge Fisher, the court concluded that "the absence of any relationship between Plaintiffs and Merrill Lynch precludes the imposition of a duty on Merrill Lynch to periodically or regularly police the personal account maintained by Smith for indicia of fraud." Id. at *9.

The Frederick court began its analysis by observing that "although our courts have not previously considered whether a brokerage firm owes a duty towards noncustomers in this context, our Supreme Court has expressed a 'reluctance to impose a duty of care on banks in respect of a total stranger.'" Frederick, 2010 N.J. Super. LEXIS at **6-7 (quoting Brunson v. Affinity Fed. Credit Union, 199 N.J. 381, 403 (2009)).

In concluding that Merrill Lynch did not owe a duty to the plaintiffs, the panel found instructive the Supreme Court's decision in City Check Cashing v. Mfrs. Hanover Trust Co., 166 N.J. 49, 60 (2001). In City Check Cashing, the plaintiff check cashing business was presented with a forged check appearing to have been marked certified by the defendant bank. City Check Cashing, 166 N.J. at 52-53.

Prior to cashing the check, the plaintiff's manager contacted a representative of the defendant who initially expressed concerns about the check's legitimacy, and promised to look at it more closely. Id. at 53-54. Not hearing from the defendant's representative for several hours, the plaintiff cashed the check. Id. at 55.

The Supreme Court reinstated the trial court's order granting the defendant summary judgment on the plaintiff's claim for negligence, holding that "absent some 'agreement, undertaking or contract' between the parties, a bank does not owe a duty to a noncustomer." Id. at 62. The Supreme Court explained that noncustomers cannot maintain claims against banks "[a]bsent a special relationship" because "'[i]n actions based on nonfeasance,' there must be 'some definite relation between the parties of such a character that social policy justifies the imposition of a duty to act.'" City Check Cashing, 166 N.J. at 59-60.

Turning to whether such a duty should be imposed on a broker-dealer, the Frederick court observed that the plaintiffs had not "demonstrated why some other rule should apply to a brokerage firm with regard to an individual's personal brokerage account." Frederick, 2010 N.J. Super. LEXIS at *8.

In this regard, the panel found instructive "the fact that Plaintiffs' theory appears never to have been accepted by any of the federal courts that have considered it; those federal courts, including the federal district court in this State …, that have explored the issue, have held that a brokerage firm is under no obligation to be a fraud watchdog for noncustomers." Id. at *8.

Observing that "[t]he common theme in all these cases is that a duty arises only 'when the broker does business with the plaintiff,'" Judge Fisher held that this "theme is consistent with the common law approach, expressed in Brunson and City Check Cashing, that precludes claims made by non-customers against banks." Frederick, 2010 N.J. Super. LEXIS at *9.

Judge Fisher held further that "the fact that Plaintiffs may have at times submitted checks directly to Merrill Lynch, as instructed by Smith, did not create a relationship where none previously existed." Id. at *9. Finding that "Merrill Lynch deposited the checks in Smith's account as directed …, issued no statements to Plaintiffs and derived no financial benefit from the fact that checks may have been written directly to Merrill Lynch instead of Smith," the Frederick panel concluded that "in the absence of no greater nexus between Plaintiffs and Merrill Lynch or between Smith and Merrill Lynch, Plaintiffs

possess no viable negligence claim against Merrill Lynch." Id. at **9-10.

Conclusion

While Frederick is a case of first impression in New Jersey, the decision is not at all controversial, as it merely extends to a securities broker-dealer established New Jersey precedent that immunizes a bank from liability to a noncustomer in the absence of a special relationship.

Nor is the Frederick panel's rejection of the plaintiffs' argument that a duty should be imposed based on the submission of checks directly to Merrill Lynch surprising, as courts have previously rejected arguments that a duty should be imposed based on the financial institution defendants' alleged actual or constructive knowledge that the funds which were being deposited into their customers' accounts belonged to third party investors. See, e.g., Kolbeck, 923 F. Supp. at 561-62 and 571-72; Renner, 1999 WL 427329 at ** 2 and 13.
Frederick thus represents a continuation of what has become the almost universally accepted common law rule that broker-dealers and other financial institutions have no obligation to be "fraud watchdog[s] for non-customers." Frederick, 2010 N.J. Super. LEXIS at *8.

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