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GEORGIA APPEALS COURT DETERMINES THAT BOTH SCIENTER AND JUSTIFIED RELIANCE ARE ESSENTIAL ELEMENTS OF A CLAIM UNDER GEORGIA'S SECURITIES FRAUD STATUTE

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While the federal securities laws contain several antifraud provisions, the Georgia Securities Act (or "Blue Sky Law") has its own statute that creates claims for securities fraud. O.C.G.A. § 10-5-12(a). That provision states, among other things, that

> (a) it shall be unlawful for any person: . . . (2) in connection with an offer to sell, sale, offer to purchase, or purchase of any security, directly or indirectly:
>
> (A) to employ a device, or artifice to fraud;
>
> (B) to make an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading; or
>
> (C) to engage in an act, practice, or course of business that operates or would operate is a fraud or deceit upon a person . . . .

It has long been settled that a plaintiff alleging securities fraud under Section 10(b) of the Securities Exchange Act of 1934 must allege and prove scienter, or a mental state embracing an intent to deceive or defraud, and justifiable reliance on the alleged fraud in order to prevail on a claim *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976). However, it has not until recently been judicially determined whether a plaintiff alleging a claim under the Georgia Securities Act needs to make and prove similar allegations in order to prevail.

In fact, two federal courts which had addressed that very question, both in the Eleventh Circuit and in the Northern District of Georgia, both suggested that there may not be any requirement that a plaintiff allege scienter or reliance in order to state a claim under the anti-fraud provisions of the Georgia Securities Act. *Diamond v. Lamotte*, 709 F.2d 1419, 1424 (11th Cir. 1983); *Binder v. Roth*, 1987 WL 124018, at *4, footnote 5 (N.D.Ga. 1987). The reasoning behind this determination was that, while scienter is required under Rule 10(b) of the federal statute, scienter is not required under the Georgia statute because the language of Georgia's state securities anti-fraud provision tracks the language of § 410(a) of the Uniform Securities Act and § 12(a)(2) of the Securities Act of 1933 (neither of which require a showing of scienter). Obviously, if a plaintiff is not required to allege that a defendant in a claim under Georgia's Securities Act acted with an affirmative intent to deceive, or even with severe recklessness, that plaintiff's claim becomes significantly easier to establish.

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The Georgia Court of Appeals, however, in *Keogler v. Krasnoff,* has recently held that, in order to state a claim under O.C.G.A. § 10-5-12(a), a plaintiff must in fact allege and establish both scienter and justified reliance on any alleged fraudulent misrepresentation in order to prevail. 2004 WL 1472687 (Ga. App., July 1, 2004). The litigation in *Keogler* arose out of the failure of SGE Mortgage Funding Company ("SGE"). Defendant Krasnoff was SGE's largest investor. Id. at p. 2. In January of 1998, after many of SGE's checks to its investors were returned for insufficient funds, Krasnoff and two other investors began to look into the cause of the problems with SGE. Id. They discovered that the company was in fact insolvent, and promptly filed a petition to place SGE into receivership. Id.

Shortly thereafter, the Keogler's filed this action against the CEO of SGE and Krasnoff alleging among other things securities fraud under O.C.G.A. § 10-5-12(a). The evidence of fraud on the part of the CEO was apparently so compelling that the court in fact granted plaintiff Keogler's motion for directed verdict against him on liability and damages. The case against Krasnoff, however, was allowed to go to the jury. As to defendant Krasnoff, the jury returned a defense verdict. The plaintiffs appealed the defense verdict on the grounds that the jury was improperly charged that the plaintiff was required to establish scienter in order to state a claim for securities fraud, as well as reasonable reliance.

The Court of Appeals upheld the verdict and held that proof of both scienter and reasonable reliance are required in order for a plaintiff to prevail on a claim under the anti-fraud provision of Georgia's Securities Act. In so holding, the court held that the elements of a claim under O.C.G.A. § 10-5-12(a) would be evaluated as analogous to the necessary elements of a claim under § 10(b) of the Securities Act of 1934, which include both scienter and reliance. For its analogy to the elements required for a claim under § 10(b) of the 1934 Act, the Keogler court cited *Bryant v. Avado* Brands, 187 F.3d 1271, 1281 (11th Cir. 1999).

Accordingly, depending on what, if anything, happens to the holding of the Keogler case at the Georgia Supreme Court level (the decision has been appealed), it now appears that a plaintiff bears a significantly more difficult burden in order to state a claim than may have been previously thought. Unless *Keogler* is overturned or otherwise modified in the Georgia Supreme Court, a plaintiff now must establish not only that a defendant in an action under O.C.G.A. § 10-5-12(a) made an untrue statement to him in connection with a purchase or sale of a security, but also that any such statement was made with the affirmative intent to deceive the plaintiff, or at a minimum, with severe recklessness, and that the plaintiff actually relied upon this statement in making his purchase or sale.

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