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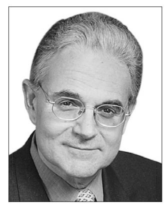
CORPORATE AND SECURITIES LITIGATION

Expert Analysis

Second Circuit and Inquiry Notice Triggering Statute of Limitations

By **Sarah S. Gold**

And **Richard L. Spinogatti**

A new U.S. Court of Appeals for the Second Circuit decision discusses the characteristics of public information that will put a plaintiff on "inquiry notice" of allegedly fraudulent conduct and thus trigger the statute of limitations for a securities fraud claim.

In *Staehr v. Hartford Financial Services Group Inc.*, 2008 WL 4899445 (2d Cir. Nov. 17, 2008), the court held that both the specificity and accessibility of public information about the allegedly fraudulent conduct must be evaluated along a "sliding scale" to determine whether it will trigger a duty to inquire.

In a decision that is instructive for corporate defendants seeking finality on potential claims, the Second Circuit ruled that the multiple sources of public information cited by defendants, including a directly pertinent lawsuit that was not disclosed in The Hartford's filings nor otherwise publicized, were insufficient to put plaintiffs on inquiry notice.

The Inquiry Notice Standard

A private securities fraud action must be commenced before "the earlier of…two years after the discovery of the facts constituting the violation; or…five years after such violation." 28 U.S.C. §1658(b). The two-year statute of limitations begins to run only after the plaintiff "obtains actual knowledge of the facts giving rise to the action or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge." *LC Capital Partners, LP v. Frontier Ins. Group Inc.*, 318 F.3d 148, 154 (2d Cir. 2003). When there is no actual knowledge, but "the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded, a duty of inquiry arises, and knowledge will be imputed to the investor who does not make such an inquiry." *Dodds v. Cigna Sec.*, 12 F.3d 346, 350 (2d Cir. 1993).

The date for imputing knowledge depends on what the investor does after being placed on constructive notice: If the investor makes no inquiry once the duty to do so arises, knowledge will be imputed as of the date the duty arose. However, if the investor makes some inquiry, the court will impute knowledge of what an investor in the exercise of reasonable diligence should have discovered and, in such cases, the limitations period begins to run from the date the inquiry should have revealed the fraud. *LC Capital*, 318 F.3d at 154.

'Staehr'

In October 2004, shortly after the New York attorney general announced his investigation of "contingent commission" kickbacks paid to insurance brokers by insurance companies including The Hartford, plaintiffs filed several (later consolidated) suits alleging that The Hartford fraudulently failed to disclose the kickbacks and bid-rigging schemes. Defendants moved to dismiss on several grounds, including the expiration of the limitations period.[1] Defendants contended that plaintiffs were on inquiry notice of their fraud claims more than two years before the suits were commenced. 2008 WL 4899445 at *2.

Judge Christopher Droney of the U.S. District Court for the District of Connecticut addressed only the statute of limitations argument and dismissed the complaint on that basis. He found that the "cumulative effect" of several publicly available news articles, lawsuits, and regulatory filings that collectively referred to the industrywide practice of paying "contingent commission" kickbacks to insurance brokers should have suggested to an investor of ordinary intelligence that The Hartford was likely one of the insurance companies involved in the kickback scheme. 460 F.Supp.2d 329, 339 (D. Conn. 2006). He concluded that plaintiffs were on inquiry notice in July 2001, when a lawsuit was filed in California Superior Court alleging that several of The Hartford's subsidiaries had engaged in undisclosed payments of "contingent commission" kickbacks to insurance brokers. Id. at 339-40; 2008 WL 4899445 at *17-18.

The Second Circuit disagreed, finding that the cited public information was either insufficiently specific or insufficiently accessible to permit a holding, as a matter of law, that plaintiffs were on inquiry notice by July 2001. 2008 WL 4899445 at *20, 22. In a decision written by District Judge Colleen McMahon, the court first ruled that the public documents submitted by defendants were permissible subjects of judicial notice on the motion to dismiss because they were not offered for their truth, but for the fact that their content was publicly stated. Id. at *19. Turning to the inquiry notice issue, the court noted that the triggering information must "relate [] directly to the misrepresentations and omissions the Plaintiffs later allege in their action against the defendants," although the "'[s]torm warnings' need not detail every aspect of the allegedly fraudulent scheme." Id. at *21. The court then performed a detailed, critical analysis of the public documents claimed to be "storm warnings," finding them insufficient individually or collectively to trigger a duty of inquiry.

The court first considered the legal effect of the press articles discussing contingent commissions, four from mainstream publications and 13 from insurance industry trade publications. None of the mainstream articles mentioned The Hartford, nor did 12 of the industry newsletters. The sole article mentioning The Hartford, as well as most of the others, focused on insurance broker conflicts of interest, not wrongdoing by insurers. Id. at *22, 23, 25. This lack of specific, directly related information was fatal.

While the court acknowledged that company-specific information was not essential for inquiry notice, its absence does bear directly on whether a plaintiff should be charged with the duty to inquire. Id. at *22. Although in some cases nonspecific

SARAH S. GOLD *is a partner and* RICHARD L. SPINOGATTI, *a senior counsel, at Proskauer Rose.* KAREN E. CLARKE, *an associate at the firm, assisted in the preparation of this article.*

information might suggest to an ordinary investor the probability that she has been defrauded, it did not here because it focused primarily on brokers' conduct and did not suggest the required probability of fraud by The Hartford. Id. at *24. Contrasting other cases in which inquiry notice was found, based on either widespread nonspecific news coverage or on company-specific coverage, the court concluded that "the nonspecific and barely publicized news reports in this record" did not reasonably provide plaintiffs with a similar level of awareness of the fraud alleged. Id. at *27.

'Inherent Sliding Scale'

The court described an "inherent sliding scale" in assessing whether information in the public domain triggers inquiry notice: "the more widespread and prominent the public information disclosing the facts underlying the fraud, the more accessible this information is to plaintiffs, and the less company-specific the information must be." Id. at *27. In *Staehr,* because the sole article mentioning The Hartford and most of the other articles appeared in specialty publications, it could not be concluded that they would or should come to the attention of an ordinary investor and thus were insufficient to trigger inquiry notice. Id. at *28.

The court next considered The Hartford's public filings. The 2001 Form 10-K did mention "contingent commission" payments, which was, as The Hartford argued, "the very evil decried in the complaint." However, while investors normally will be charged with notice of information in a 10-K, the court explained that this 10-K did not define the term "contingent commission" or give any indication of its significance. Although the term was defined in some newspaper articles, and investors might be charged with notice of such information if sufficiently widespread. Here the record showed only a small number of articles explaining the term's significance, and a reasonable investor of ordinary intelligence would not necessarily have encountered them.

As the court explained, "[m]ore articles in mainstream publications discussing the 'contingent commissions' issue, combined with a reference in the 10-K, would present a different case." Id. at *29.

Finally, the Second Circuit considered four lawsuits that had been filed in various state courts concerning the contingent commissions issue. Two did not mention The Hartford at all. A third did mention The Hartford, but did not accuse it of any wrongdoing. The fourth, *Turner II* (on which the District Court relied), however, was highly pertinent. In *Turner II,* there were specific allegations that The Hartford's subsidiaries failed to disclose kickback schemes involving the payment of contingent commissions. Those allegations "should alert a reasonable investor that something is wrong," triggering a duty to inquire further. Id. at *30. However, this complaint was not "reasonably accessible" to an ordinary investor. The lawsuit was not discussed in any of the news articles, nor was it disclosed in any of The Hartford's state or federal regulatory filings, and thus it would be unreasonable to expect an ordinary investor to be aware of it.

"We cannot say that the reasonable investor of ordinary intelligence would or should have known about a lawsuit filed in an unlikely venue (a California state court), that received no publicity whatever (not even in niche publications) and that did not, at least based on the record before us here, result in published or broadly disseminated opinions within the relevant time period. It has not been demonstrated that this obscure and unpublicized lawsuit was reasonably accessible to such an investor." Id. at 31.

The court rejected defendants' contention that since the *Turner II* plaintiff could detect "storm warnings" causing him to file suit in July 2001, so could have the *Staehr* plaintiffs. The *Turner* plaintiff was a lawyer at a firm known for battling commercial insurers, who likely had "more-than-ordinary intelligence" and "does not set the standard" for an ordinary investor of reasonable intelligence. Id. at *31.

Accordingly, the Second Circuit vacated and remanded, expressing no view on defendants' other grounds for dismissal because the district court had not reached them.[2]

> 'Staehr' said both the specificity and accessibility of public information about alleged fraud must be evaluated along a "sliding scale" to determine if it triggers a duty to inquire.

'Staehr's' Lessons

The Second Circuit made clear that it decided only that inquiry notice could not be established by defendants as a matter of law, based on the record before it on the motion to dismiss. It did not preclude the possibility that, following discovery, defendants could show on summary judgment that plaintiffs had actual notice of the California lawsuit or the allegedly fraudulent kickback conduct, or could compile a better record of documents suggesting preclusive inquiry notice.

The Second Circuit's decision is consistent with its prior precedents, which focused on whether the cited public information was sufficiently specific and related to the claimed fraud to charge the plaintiff with inquiry notice. However, *Staehr* goes a step further in emphasizing the need to give critical attention to how accessible the information is to ordinary investors, and to assess the information's impact along a "sliding scale," in which the quantity and prominence of the information is balanced against its specificity. A publicly available complaint, even if company-specific and directly on point, might not trigger inquiry notice if it is "obscure and unpublicized" and would not be seen by an ordinary investor. On the other hand, widespread mainstream press coverage of an industry problem, even if not company-specific, might create a duty in an ordinary investor to inquire further about the company in which he is investing.

The Court's focus on the accessibility of public information raises an interesting parallel to the question of what information is presumed to become part of the "total mix" of company or industry information that is synthesized in the market price of its stock. The mere fact that information is "out there" in some public domain does not mean that it is automatically reflected in the stock price. Rather, it would need to come to the attention of a meaningful segment of the market, i.e., analysts, institutional investors, and the media, in order to be synthesized into the market price. A complaint may exist in a public file, but that "public" document cannot logically affect the market price, or trigger inquiry notice, until news of the complaint is disseminated to a larger audience.

Conclusion

The *Staehr* decision is instructive to litigants and district courts, both in reaffirming the propriety of taking judicial notice of external documents and in exemplifying the proper assessment of the specificity and accessibility of public information said to trigger inquiry notice. When weighing the value of discretionary disclosures, public companies should take note of their ability to cut off claims by making timely disclosures of lawsuits or other matters in their SEC filings.

The outcome of *Staehr* would likely have been different had The Hartford made public disclosure of the *Turner II* suit in 2001, or provided a definition of the "contingent commissions" it did disclose.

1. Among the other grounds were that loss causation could not be established.
2. Compare, e.g., *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161 (2d Cir. 2005) (rejecting district court's finding of inquiry notice, but affirming dismissal on loss causation ground).