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Litigation

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SECURITIES LITIGATION UPDATE — SUPREME COURT RESOLVES CIRCUIT SPLIT REGARDING SECTION 10(b) STATUTE OF LIMITATIONS AND SECOND CIRCUIT ADDRESSES WHO CAN BE LIABLE UNDER SECTION 10(b)

It is an unusual day when both the Supreme Court and one of the most important circuit courts for securities litigation issue decisions likely to have a major impact on securities litigation around the United States. It is even more unusual when a circuit judge seemingly invites *en banc* rehearing while concurring with the result in a case. Yet that is precisely what happened on April 27, 2010. The Supreme Court's decision in *Merck & Co., Inc. v. Reynolds*, No. 08-905 (U.S. Apr. 27, 2009) ("*Merck*"), in which all nine justices agreed as to the result, settled a circuit split about how to apply the statute of limitations for claims under Section 10(b) of the Securities Exchange Act of 1934; one effect of the *Merck* decision may be to force defendants moving to dismiss Section 10(b) claims to choose between arguing that a plaintiff has not adequately pleaded scienter and arguing that claims are time-barred. The Second Circuit's decision in *Pacific Investment Management Company LLC v. Mayer Brown LLP*, No. 09-1619-cv (2d Cir. Apr. 27, 2009) ("*PIMCO*"), in contrast, adopted a restrictive view of who can be sued under Section 10(b) by adopting a bright line rule to which the Securities and Exchange Commission was opposed.

Merck

Merck arose from Merck's alleged failure to disclose adequately to its shareholders the dangers and risks associated with Vioxx, and particularly Merck's allegedly misleading suggestion that differing heart attack risks disclosed in a comparative study of Vioxx and naproxen were the consequence of beneficial medical effects of naproxen rather than adverse effects of Vioxx. The case arrived in the Supreme Court on certiorari from the Third Circuit, which had reversed the district court's dismissal of the case on statute of limitations grounds. The Supreme Court affirmed the circuit, allowing the case to proceed.

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Specifically focusing upon 28 U.S.C. §1658(b)(1), which provides that an action under Section 10(b) may be brought not later than “2 years after the discovery of the facts constituting the violation,” the Supreme Court held that the cause of action accrues upon the earlier of (i) the date on which the plaintiff actually discovered the facts constituting the violation and (ii) the date by which a reasonably diligent plaintiff would have discovered those facts.¹ In so holding, the Supreme Court implicitly rejected decisions from several circuits² that had viewed the two-year limitations period as running from the date on which the plaintiff received “storm warnings” sufficient to put him or her on “inquiry notice” to investigate whether he or she had been defrauded. As the Supreme Court explained, the touchstone is “discovery of the facts,” not something — like inquiry notice or storm warnings — that may have taken place *before* actual discovery and could or would have led to actual discovery. The Supreme Court specifically rejected Merck’s fallback argument (suggested by *Shah v. Meeker*, 435 F.3d 244 (2d Cir. 2006)) that, at least in the situation where the plaintiff made no effort to investigate his or her claim, the two-year limitations period should run from the point of inquiry notice. The Supreme Court also rejected the argument that inquiry notice is the preferable triggering event because courts would find it too difficult and complicated to determine “when a hypothetical reasonably diligent plaintiff would have ‘discover[ed]’ the necessary facts,” noting that at least five circuit courts have followed the approach it selected in securities cases without undue difficulties.

In what may be a more important development for defendants considering a motion to dismiss Section 10(b) claims as time-barred, the Supreme Court held that a defendant pursuing such a motion must show that the plaintiff knew, or in the exercise of reasonable diligence would have discovered, facts *showing the defendant’s scienter* more than two years before the filing of the action. The Supreme Court ruled that scienter is one of the “facts constituting the violation,” noting that “[a] plaintiff cannot recover without proving that a defendant made a material misstatement *with an intent to deceive* — not merely innocently or negligently,” (emphasis in original) and that Congress had enacted heightened pleading standards for scienter in the Private Securities Litigation Reform Act of 1995. The Supreme Court squarely rejected Merck’s arguments that discovery of scienter-related facts was not required by §1658(b)(1) or, alternatively (and somewhat uncharacteristically for a defendant), that facts showing a materially false or misleading statement or omission are sufficient to show scienter.

This aspect of the Court’s holding thus requires a defendant contemplating a statute of limitations-based motion to dismiss to be prepared to show that, more than two years before the filing of the action, facts indicating that the defendant acted with scienter (intent to defraud or reckless indifference to the accuracy of a disclosure) were in the public domain. Yet experience has shown that a motion to dismiss asserting the plaintiff’s failure to plead scienter with the particularity required by the PSLRA is often a powerful weapon against a securities fraud complaint. Defendants may now find it difficult to join arguments that a plaintiff failed to plead scienter and that claims are time-barred in a motion to dismiss. Because *Merck* could be read to require a defendant asserting that a Section 10(b) claim was time-barred under § 1658(b)(1) to concede that the publicly available facts were sufficient to allow a plaintiff to conclude that the defendant had acted with scienter, that may mean that making a limitations argument effectively concedes that a plaintiff could plead scienter as required by the PSLRA. Because of the

¹ §1658(b)(2) provides an absolute bar of five years after the violation.

² *E.g.*, *Franze v. Equitable Assurance*, 296 F.3d 1250 (11th Cir. 2002); *Theobarous v. Fong*, 256 F.3d 1219 (11th Cir. 2001); *Fujisawa Pharmaceutical Co. v. Kapoor*, 115 F.3d 1332 (7th Cir. 1997); *Great Rivers Cooperative of Southeastern Iowa v. Farmland Industries, Inc.*, 120 F.3d 893 (8th Cir. 1997); *Dodds v. Cigna Securities, Inc.*, 12 F.3d 346 (2d Cir. 1993), all cited in *Merck*.

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potential impact on challenges to a plaintiff's scienter allegations, defendants may feel comfortable bringing statute of limitations-based motions only in the most clear-cut situations, where success on a class-wide basis seems all but guaranteed.

An interesting point is presented by Justice Scalia's opinion concurring in part and concurring in the judgment, in which Justice Thomas joined. Justice Scalia argued — notwithstanding the contrary of views of the parties and the Solicitor General — that the proper construction of §1658(b)(1) permitted only a single trigger for the two-year limitations period: actual discovery of the facts constituting the violation. Contrasting §1658(b)(1) with the limitations period provided in Section 13 of the Securities Act of 1933, which explicitly refers to *both* actual discovery *and* when discovery should have been made by the exercise of reasonable diligence, Justice Scalia found no reason to read §1658(b)(1)'s simple reference to “discovery” as including both alternatives and took issue with the majority's assertion that the broader reading had been uniformly adopted by the circuit courts with respect to limitations provisions of the Securities Exchange Act that similarly referred only to “discovery.”

PIMCO

PIMCO was part of the securities fraud litigation that followed the demise of Refco Inc. Mayer Brown LLP had served as Refco's primary outside counsel from 1994 through its collapse and Joseph Collins was the Mayer Brown billing partner in charge of the Refco account. After Refco collapsed, the plaintiffs in the consolidated Refco securities class action brought claims against Mayer Brown and Collins. The plaintiffs alleged that (i) Mayer Brown and Collins were involved in negotiating the terms of certain loans that had been used misleadingly to disguise and conceal the existence of substantial related party obligations, drafted and revised documents relating to those loans, transmitted those documents to the participants in the loans, and retained custody of and distributed executed copies of the documents and (ii) Mayer Brown and Collins were responsible for false statements in a Refco Offering Memorandum and two Refco Registration Statements. On the basis of those allegations, the plaintiffs asserted claims against Mayer Brown and Collins under Sections 10(b) and Section 20(a) of the '34 Act and Rule 10b-5(b). The plaintiffs also alleged that Mayer Brown and Collins were liable under Rule 10b-5(a) and (c) under a “scheme liability” theory.

Mayer Brown and Collins moved to dismiss on the basis that they could not be held liable under Section 10(b) for statements that were not attributed to them when the statements were disseminated and that the “scheme liability” claims could not survive under the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, 552 U.S. 148 (2008). The district court granted the motion to dismiss and the plaintiffs appealed to the Second Circuit. The two primary issues addressed by the Second Circuit were (i) whether a defendant can be held liable under Rule 10b-5(b) for false statements they allegedly drafted but that were not attributed to them when the statements were disseminated to the public and (ii) whether “scheme liability” could be alleged under Rule 10b-5(a) and (c) after *Stoneridge*.

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With respect to whether attribution is required under Rule 10b-5(b), the appeal became a contest between two liability theories. On the one hand, the plaintiffs and the SEC argued that a defendant can be liable for *creating* a false statement that investors rely on, whether or not the statement is attributed to the defendant when it is disseminated. According to this formulation, a defendant can be alleged to have created the false statement if (i) the statement is written or spoken by him, (ii) he provides false or misleading information that another person puts into the statement, or (iii) he allows a statement to be attributed to him. On the other hand, the defendants argued that attribution when a statement is disseminated is the *sine qua non* of a primary liability claim. The Second Circuit concluded that a speaker can only be liable for statements expressly attributed to him or her at the time of dissemination. Being identified as having been involved in a transaction is not enough; likewise insufficient is the public's understanding that he or she was involved "behind the scenes." Instead, the plaintiff's claim must be based on a statement actually made by the defendant or on statements expressly adopted by the defendant. The rule articulated by the Second Circuit is simple: For a defendant to face claims under Rule 10b-5(b) for a statement made to the public, the statement must be specifically attributed to the defendant at the time it is disseminated. Absent such express attribution, there can be no liability under Rule 10b-5(b).

In resolving this question, the Second Circuit engaged in a detailed discussion of its prior decisions, some of which it acknowledged could have been viewed as inconsistent regarding this issue. Just as important, the Second Circuit engaged in a detailed analysis of *Stoneridge*, concluding that *Stoneridge's* focus on the reliance element of Rule 10b-5(b) was more consistent with the "attribution" test than the "creation" test. Indeed, the Second Circuit concluded that the creation test the plaintiffs and SEC advocated was less rigorous than the "substantial participation" test the court had previously rejected, and therefore could not be the basis for Rule 10b-5(b) claims. In reaching its conclusions, the Second Circuit declined to adopt the SEC's views regarding how to draw the line between primary and secondary liability for the purposes of a civil claim under Rule 10b-5(b).

Following its extensive analysis of the plaintiffs' Rule 10b-5(b) claims, the Second Circuit made short work of the plaintiffs' "scheme liability" claims. Deeming itself bound by *Stoneridge*, it held that when a plaintiff alleges that an issuer made a false statement and a defendant somehow helped, that is not sufficient for liability under Rules 10b-5(a) and (c). As with Rule 10b-5(b), a claim under Rule 10b-5(a) or (c) requires that investors have relied on allegedly deceptive conduct by the defendant and that investors have known that such conduct was attributable to the defendant.

PIMCO also could have effects beyond the two concrete questions it addressed. *First*, one of the areas of uncertainty the Second Circuit discussed was whether corporate officers can be held liable for false information given to and disseminated by securities analysts even if no statements are attributed to the officers. Two Second Circuit cases permitting such claims³ were mentioned by the Second Circuit as not having made reference to the key decisions relating to the proper scope of liability under Rule 10b-5(b), raising questions about the continued viability of their holdings in future securities cases in which plaintiffs base claims on statements by analysts. Narrowing or overturning those holdings would generally be beneficial to defendants in securities litigations.

³ *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004); *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000).

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Second, Judge Parker, a senior Second Circuit judge, concurred in the panel's decision but concluded his concurrence with this statement:

In light of the importance of the existence, *vel non*, of an attribution requirement to the securities laws, the bar, and the securities industry, this case could provide our full Court, as well as, perhaps, the Supreme Court, with an opportunity to clarify the law in this area.

The Second Circuit rarely grants *en banc* rehearings; it has only issued a handful of *en banc* decisions since 2000 and the vast majority of petitions for rehearing *en banc* in the Second Circuit are denied. Suggesting in a concurrence that a case may warrant *en banc* rehearing or hearing by the Supreme Court is unusual and may signal that *PIMCO* will not be the final word on these issues. This may reflect something similar to the frustration expressed by the district judge who dismissed the claims (who is now a Second Circuit judge) that there was no civil recourse against someone who was convicted criminally and sentenced to seven years (as Collins was).

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