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Second Circuit Discusses "Storm Warnings" in Rejecting Section 10(b) Statute of Limitations Defense

On November 17, 2008, the United States Court of Appeals for the Second Circuit issued its decision in *Staehr* v. *The Hartford Financial Services Group, Inc.*[1] In rejecting Defendants' statute of limitations defense, the Court offered insight and clarification on what public information may constitute "storm warnings" sufficient to trigger inquiry notice in a §10(b) securities fraud action.

I. Background and Procedural History

Staehr arose out of "contingent commission" arrangements in which insurance brokers received supplemental payments for steering clients to particular insurers' services. This practice was common until October 14, 2004 when the New York Attorney General's Office ("NYAG") sued a major insurance brokerage firm alleging that such agreements harmed consumers by inflating insurance rates. The Hartford Financial Services Group, Inc. ("Hartford") was an insurer named in the complaint as a participant in the schemes. Immediately following the NYAG's suit, Hartford's investors sued alleging that the insurer made misrepresentations and omissions about the commission arrangements[2] to sustain artificially high market prices for its securities in violation of §10(b) of the Securities Exchange Act of 1934.[3]

The district court dismissed the complaint as time-barred pursuant to a two-year statute of limitations, concluding that the "cumulative effect" of media reports, regulatory filings and lawsuits discussing the insurer/broker arrangements were sufficient "storm warnings" to place average investors on notice of probable fraud by Hartford.[4] While most of this information did not specifically mention Hartford, the district court ruled that Plaintiffs were on inquiry notice no later than July 25, 2001, meaning that their claim expired over a year before they filed suit.

After a detailed analysis, the Second Circuit vacated and remanded, finding that the public information offered by the Defendants was not sufficiently specific and widespread to trigger the limitations period.[5]

II. The Second Circuit's Decision

The Second Circuit began by reviewing its prior treatment of the "storm warnings" doctrine, starting with its 1993 decision in *Dodds v. Cigna Securities, Inc*.[6] There, an unsophisticated investor alleged that her financial advisor recommended she invest in overly risky securities. The district court dismissed her case as time-barred by the then one-year limitations period for §10(b) actions. The Second Circuit affirmed, stating that the limitations

[1] *Staehr* v. *The Hartford Financial Services Group, Inc.*, 2008 WL 4899445 (2d Cir. Nov. 17, 2008).

[2] Plaintiffs also alleged that Defendants engaged in "bid-rigging" schemes with brokers to artificially raise the price of insurance products. *Id*.

[3] *Id*. at 6. Plaintiffs also brought control person claims against Hartford's senior officers under §20(a) of the Act.

[4] *Staehr* v. *Hartford Fin. Servs. Group, Inc.*, 460 F. Supp.2d 329, 339 (D. Conn. 2006).

[5] The court also held, as a threshold issue, that press reports, lawsuits and regulatory filings may be judicially noticed without regard to the truth of their contents in deciding whether "storm warnings" were adequate. *Staehr*, *supra* note 1, at 31.

[6] 12 F.3d 346 (2d Cir. 1993).

period is triggered when 1) plaintiffs have actual notice of fraud or 2) when they have inquiry notice, i.e. when an investor of ordinary intelligence would inquire after a totality of the circumstances suggests probable fraud. Since the *Dodds* plaintiff received prospectuses disclosing the risk when she invested, she was on inquiry notice and her claim was barred.

Staehr then discussed five subsequent Second Circuit "storm warnings" decisions. In two of those cases, the court found the warnings sufficient. In *LC Capital Partners, LP* v. *Frontier Ins. Group, Inc.,*[7] investors' claims that an insurer concealed its knowledge of "grossly inadequate" reserves were deemed time-barred based on the company's prior announcement that it had taken three substantial reserve charges.[8] Three years later, in *Shah* v. *Meeker,*[9] the court affirmed dismissal of a claim alleging that Morgan Stanley failed to disclose analyst bias after defendants submitted a *Fortune* magazine article specifically discussing Morgan Stanley's practices. The court found that the article described the defendants' acts with such a "degree of specificity" as to put plaintiffs on notice of a potential claim.[10]

In the other three cases, the court rejected the defendants' statute of limitations defense. In *Newman* v. *Warnaco Group, Inc.,*[11] the district court dismissed as time-barred plaintiffs claims that defendants misrepresented sales projections, finding inquiry notice triggered by a revised 10-K showing "dramatic" changes in financial data.[12] The Second Circuit vacated because the defendants had provided a "seemingly benign" explanation for the revisions with no indication that they were caused by fraud.[13]

The same year, in *Levitt* v. *Bear Stearns & Co.,*[14] plaintiffs alleged that the defendant committed fraud while acting as clearing agent for a broker through which plaintiffs bought stock. The defendant argued, and the district court agreed, that a National Association of Securities Dealers ("NASD") arbitration proceeding alleging similar claims as plaintiffs and a Texas federal action against defendants triggered the statute of limitations. The Second Circuit vacated because factual issues remained as to whether plaintiffs could have discerned "storm warnings" about "secondary wrongdoers," i.e. parties other than the company in whose stock plaintiffs invested (e.g. brokers).[15]

The final case the *Staehr* court discussed is *Lentell v. Merrill Lynch & Co.*[16] – another "secondary wrongdoer" case – where defendants issued misleading reports about companies in which plaintiffs invested. The

[7] 318 F.3d 148 (2d Cir. 2003).

[8] This warning was buttressed by secondary warnings: a related article in an industry publication and prior litigation on the same issue. *Id*. at 150.

[9] 435 F.3d 244 (2d Cir. 2006).

[10] Because the *Fortune* article was a sufficient warning, the *Shah* court declined to address whether articles in the *Wall Street* Journal and *The New Yorker* generally describing the type of fraud alleged (but not mentioning the defendants) would trigger inquiry notice.

[11] 335 F.3d 187 (2d Cir. 2003).

[12] *Id.* at 192.

[13] *Id*. at 194.

[14] 340 F.3d 94 (2d Cir. 2003).

[15] *Id*. at 104.

[16] 396 F.3d 161 (2d Cir. 2005).

district court dismissed on statute of limitations grounds. The Second Circuit disagreed,[17] finding that the purported warnings were merely "generic articles on the subject of structural conflicts [at financial firms]" falling "well short" of the specificity necessary to trigger inquiry notice.[18]

Against this backdrop of "storm warning" precedent, the Court of Appeals turned its attention to the documents the *Staehr* Defendants contended were sufficient to put Plaintiffs on inquiry notice. Specifically, Hartford argued for three types of "storm warnings": 1) media reports from popular news sources[19] and industry newsletters,[20] 2) a 10-K and other state filings by its subsidiaries, and 3) four state lawsuits in Texas and Illinois. The court dismissed each as insufficient to trigger inquiry notice, finding that the information was non-specific and inaccessible to an ordinary investor.

First, in analyzing the media reports, the court employed *Lentell*'s "degree of specificity" standard, concluding that the articles failed to mention Hartford's connection with the commission schemes in sufficient detail to warrant a finding of inquiry notice. None of the mainstream publications mentioned Hartford. Instead, they focused on broker impropriety and referenced insurers only in general terms.[21] Only one of thirteen industry publications mentioned Hartford by name, and only "in passing and in the context of an article concerning practices by brokers ... that would appear to victimize insurers."[22] The court concluded that *Staehr* was closer to *Lentell* than *Shah* since, in the latter case, the articles were "so issuer-specific and so prominent."[23] It rejected Defendants' argument that *Lentell*'s holding was limited to "secondary wrongdoer" cases.[24]

Second, the court held that Hartford's regulatory filings lacked the sort of specificity that would suggest fraud since, like in *Newman*, the filings bore no indication that the commissions related to fraudulent schemes. The portions of the filings that described the commissions were "seemingly benign categories of expenses in the absence of further explanation."[25] And even though the 10-K specifically used the term "contingent commissions," it did not define it or indicate its significance.[26]

Finally, the court turned to the four previously filed state lawsuits. It rejected "storm warning" classification for three of them on specificity grounds: two for failing to name Hartford at all and a third because

[17] The Second Circuit nonetheless affirmed dismissal on separate grounds: plaintiffs' failure to state loss causation. *Id.* at 177.

[18] *Id.* at 170.

[19] Specifically, Hartford submitted two *New York Times* articles, a *Financial Times* article, and a *Chicago Tribune* article. *Staehr*, *supra* note 1, at 19.

[20] Hartford submitted thirteen articles in total from industry publications like *National Underwriter*, *Business Insurance* and *Canadian Underwriter*. *Id*.

[21] Some articles even included information that could assuage investors concerns about potential improprieties. For example, a *New York Times* article discussing the contingent commission arrangements noted that not all insurers paid fees to get business. *Id*. at 41.

[22] *Id*.

[23] *Staehr*, *supra* note 1, at 42.

[24] *Id.* at 39.

[25] *Staehr*, *supra* note 1, at 47.

[26] *Id.* at 48. The court was careful to note, however, that public filings can be useful to put investors on notice in other circumstances. For example, the court noted that a better explanation of contingent commissions in the 10-K and more mainstream articles discussing the issue would "present a different case." *Id*.

it did not specifically accuse Hartford of wrongdoing. The final lawsuit, however, alleged that nine of Hartford's subsidiaries violated California law by failing to disclose commissions to brokers. This met the court's standard for specificity.[27] But while the California case was specific enough to trigger notice, the court found that it was not reasonably accessible to an ordinary investor because it was filed in an "unlikely venue," received no publicity, and did not result in any timely published opinions.[28] Having rejected each of Defendants' potential "storm warnings," the court vacated and remanded.

III. Significance of the Decision

The *Staehr* court reaffirmed the rule that company-specific information reasonably accessible to ordinary investors will put plaintiffs on inquiry notice. It declined, however, to preclude adequately pervasive general information from constituting "storm warnings" so long as it suggests probable fraud. Thus, *Staehr* established the following sliding scale: "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."[29] Secondary wrongdoers, *Staehr* reaffirmed, must also overcome courts' extraordinary reluctance to dismiss absent a "manifest indication" that plaintiffs could foresee warnings.[30]

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

[27] Although the California case did not allege bid-rigging schemes, the court noted that "storm warnings" need not detail the entire fraud. *Id.* at 49; *see also LC Partners*, *supra* note 10, at 155 (the storm warnings related to under-reserving should have "alert[ed] any reasonable investor that something is seriously wrong."). Additionally, both the district court and the Second Circuit agreed that the contingent commission arrangements were the heart of the complaint. 460 F. Supp. 2d at 339, *and Staehr*, *supra* note 1, at 50.

[28] *Id.* at 51.

[29] *Staehr*, *supra* note 1, at 45.

[30] *Lentell*, 396 F.3d at 169.

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