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Expert Analysis

'Staehr' Increases Burden of Proof To Place Investor on Inquiry Notice

On Nov. 17, 2008, in *Staehr v. The Hartford Fin. Servs. Group Inc.*, a panel of the U.S. Second Circuit Court of Appeals reversed a district court's decision to dismiss a securities class action filed against The Hartford Financial Services Group Inc. (The Hartford) on the grounds that it was time-barred.¹ In so doing, the Second Circuit imposed a higher burden than the Third Circuit had in *In re Merck & Co. Inc. Sec., Derivative & "ERISA" Litig.*, 543 F.3d 150, 161-71 (3d Cir. 2008), holding that, in order to place an investor on inquiry notice concerning a defendant's potential fraud, the information must generally be both defendant-specific and reasonably accessible to an investor of ordinary intelligence.

The burden was changed quickly by the Second Circuit after the Third Circuit's "storm warnings" decision in *Merck*.² *Merck*, a securities fraud action, had indicated that the statute of limitations begins to run when the shareholder has either actual or inquiry notice—the latter triggered by "storm warnings"—that the defendant made a fraudulent misrepresentation.³



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Factual Background

The Hartford is a large insurer in the property-casual and life insurance industries. Through its subsidiaries, The Hartford markets and sells investment and insurance products to individuals and businesses. Commercial insurance brokers act as intermediaries between The Hartford and its policyholders. Due to consolidation in the industry, Marsh Inc. and Aon Corp. dominated over 70 percent of the insurance brokerage market by 2003.

Shareholders alleged that The Hartford entered into "contingent commission" arrangements with insurance brokers, a euphemism for kickbacks, whereby insurance brokers would receive payments from The Hartford in exchange for steering business to it. The Hartford purportedly paid brokers kickbacks based on: the volume of the premiums the brokers steered to The Hartford; the growth and retention of business; and the profitabil-

ity of the products purchased by the brokers' clients. These payments created a conflict of interest by motivating brokers to serve The Hartford's interests instead of their clients.⁴

On Oct. 14, 2004, the Office of the New York Attorney General (NYAG) filed a lawsuit against Marsh Inc. The NYAG complaint described "the undisclosed commission pay-offs and bid-rigging schemes that a cartel of large insurers and insurance brokers were using to prop up their businesses and cause customers to purchase insurance at higher prices and less favorable terms than the market otherwise would have dictated." The complaint cited The Hartford for its role in paying undisclosed "contingent commissions" and providing inflated bids. The NYAG lawsuit and The Hartford's purported involvement was the subject of widespread media attention.

Procedural History

On Oct. 15, 2004, a day after the NYAG filed its lawsuit, shareholders filed the first of several securities fraud class actions against The Hartford and its senior officers. The complaints alleged that The Hartford's shareholders were misled into believing that they were investing in a company whose success was premised on the strength of the company's business, when it was in fact the product of undisclosed illicit kickbacks.

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After the various cases were consolidated and lead plaintiffs were appointed, the defendants filed a motion to dismiss the complaint as barred by the statute of limitations, among other grounds.⁵ Taking judicial notice of materials that purportedly constituted storm warnings, the district court granted defendants' motion and found that shareholders were on inquiry notice of the fraud longer than the applicable two-year statute of limitations.⁶

Relevant Standard

The two-year statute of limitations for securities fraud claims begins to run only after the shareholder obtains *actual knowledge* of the facts giving rise to the action or *notice* of the facts, which in the exercise of reasonable diligence, would suggest to an investor of ordinary intelligence the *probability*⁷ that she has been defrauded.

The precise date on which knowledge will be imputed to an investor will depend on what the investor does after being placed on constructive notice. If the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose. If the investor makes an inquiry, however, the court will impute knowledge from the date that the investor, in the exercise of reasonable diligence, should have discovered the fraud.⁸

Storm Warnings Analysis

In reversing the district court, the Second Circuit rejected arguments that the following exhibits triggered storm warnings prior to Oct. 15, 2002: (i) an assortment of media reports regarding illicit practices in the insurance industry; (ii) certain regulatory filings by The Hartford and its subsidiaries that purportedly disclosed its "contingent commissions"; and (iii) four complaints filed in state courts relating to industry wrongdoing.⁹

The court of appeals held that the information contained in the exhibits did not constitute storm warnings based on two overarching principles: (i) the information must be specific enough to

suggest to an investor of ordinary intelligence the probability of fraud by The Hartford as opposed to others in the industry; and (ii) the information in question must be reasonably accessible to an ordinary investor.

Media Reports

Courts routinely consider the extent of media coverage in deciding whether inquiry notice was triggered.¹⁰ The Hartford submitted 17 articles to the court, four of which were from mainstream media publications, with the remaining 13 from insurance industry newsletters.

As the court explained, for inquiry notice to exist, the triggering information must relate directly to the misrepresentations and omissions alleged against

'Staehr' held that to place an investor on inquiry notice about a defendant's potential fraud, information must be both defendant-specific and reasonably accessible to an ordinary investor.

a defendant: "We do not mean to suggest that inquiry notice could never be established on the basis of nonspecific public pronouncements, but the level of particularity in pleading required by the [Private Securities Litigation Reform Act of 1995] is such that inquiry notice can be established only where the triggering data relates directly to the misrepresentations and omissions alleged."¹¹

Only one of the articles mentioned The Hartford whatsoever. The remainder focused on industry practices, particularly conflicts at the broker level. Because the articles were devoid of company-specific (i.e., The-Hartford-specific) information, the argument that they constituted storm warnings was rejected: "The media reports cited by [The Hartford] at most suggest the potential for conflicts of interest involving some insurers, but not the probability of fraud by The Hartford. This is understood by the very article

on which the [The Hartford] and the District Court rely most heavily—the New York Times article—which specifically said that not all insurers pay contingent commissions, without identifying either those companies that do or those that do not. The references in the articles and newsletters to 'contingent commissions' and brokerage firms' conflicts are not specific enough to provide an ordinary investor with indications of the probability (not just the possibility) of fraud by The Hartford. Focusing almost exclusively on brokers' practices, the press articles do not clearly suggest that any insurers committed misconduct."

The 13th article mentioned The Hartford (by quoting the one sentence in one of the complaints that lists The Hartford as one of the insurers who paid contingent commissions), but it did so in passing, and in the context of an article concerning practices by brokers not insurers. "In short, [the court could not] say either that this article would have come to the attention of a reasonable investor of ordinary intelligence, or that, if it had, its contents were sufficient to place such an investor on notice of the probability of fraudulent conduct by The Hartford."

Thus, the court adopted a sliding-scale approach: "Given the objective standard for inquiry notice, there is an inherent sliding scale in assessing whether inquiry notice was triggered by information in the public domain: 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. In finding that the 'storm warnings' were sufficient to trigger inquiry notice in this case, the District Court necessarily concluded that an ordinary investor would come across the judicially noticed materials submitted by [The Hartford], i.e., that these materials were reasonably accessible. Based on the record before us, we simply cannot agree."

Regulatory Filings

The Hartford also presented samples

of annual state insurance filings and a two-page excerpt from The Hartford's Form 10-K filed in 2001. The Hartford argued that these documents disclosed the "contingent commissions" because they contained the use of the term. The court rejected this argument because the documents were too vague to suggest to a reasonable investor the probability of fraud. The state filings did not indicate, for example, that the "contingent commission" expenses stemmed from fraudulent schemes; instead the kickbacks were captured under "seemingly benign categories of expenses in the absence of further explanation." The same was true for the "Revenue Recognition" subsection of The Hartford's Form 10-K, which contained the term "contingent commissions" but did not explain it in any meaningful way. As the court countered, "The Form 10-K does use the phrase 'contingent commission' in one subsection. This is quite significant because we normally will charge investors with notice of the information in the 10-K. However, the 10-K at issue here did not define the term at all or give any indication of its significance." In other words, for information to be relevant to a storm warnings analysis, it must be reasonably indicative of the fraud alleged.

Lawsuits

The Hartford also argued that four civil lawsuits provided investors with sufficient detail to alert them to the probability of fraud. Two of the lawsuits did not mention The Hartford at all, and the third mentioned The Hartford but did not specifically accuse it of wrongdoing. In contrast, the fourth lawsuit was grounded on the alleged failure of The Hartford to disclose the payment of kickbacks by nine of its insurance subsidiaries. The court agreed that these specific allegations should alert a reasonable investor that something was wrong and would therefore trigger a duty to inquire further.

Notwithstanding the specificity of the information, the court determined that inquiry notice did not arise because the complaint was not "reasonably acces-

sible" to an ordinary investor: "[The] lawsuit was not referenced in any of the news articles or regulatory filings offered by [The Hartford]. It would be unreasonable to expect an ordinary investor to be aware of this lawsuit under these circumstances. 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."¹²

Conclusion

Given the fact-intensive nature of the storm-warnings doctrine, there can be little doubt that the Second Circuit will be called upon again to clarify its jurisprudence. In the meantime, the court's decision will be the new touchstone for statute of limitations arguments in securities fraud actions. Both shareholders and defendants will need to be mindful of the sliding-scale approach set down by the panel. On the one hand, company-specific information may not be enough to constitute storm warnings because the public documents are deemed too inaccessible; on the other hand, well-publicized industry problems may be deemed too vague to put investors on notice of probable fraud at a particular company. Either way, the likely outcome is that defendants will submit ever more voluminous exhibits on motions to dismiss in an effort to convince the court of the specificity and accessibility of such information.



1. In recent years, inquiry notice has been the subject of frequent Second Circuit rulings. See, e.g., *Shah*, 435 F.3d 244; *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161 (2d Cir. 2005); *LC Capital Partners, LP v. Frontier Ins. Group Inc.*, 318 F.3d 148 (2d Cir. 2003); *Newman v. Warnaco Group Inc.*, 335 F.3d 187 (2d Cir. 2003); *Levitt v. Bear Stearns & Co.*, 340 F.3d 94 (2d Cir. 2003).

2. See, e.g., *Betz v. Trainer Wortham & Co. Inc.*, 519 F.3d 863 (9th Cir. 2008); *Shah v. Meecker*, 435 F.3d 244, 249 (2d Cir. 2006).

3. See *Staeher v. The Hartford Fin. Servs. Group*

Inc., Docket No. 06-3877-cv, 2008 U.S. App. LEXIS 23551 (2d Cir. Nov. 17, 2008).

4. The Hartford also allegedly engaged in "bid rigging" with insurance brokers to eliminate competition and artificially inflate the price of insurance products. The bid-rigging allegations were largely irrelevant to the court's inquiry notice analysis.

5. Shareholders asserted claims under §§10(b) and 20(a) of the Securities Exchange Act of 1934 (Exchange Act). As the Court of Appeals noted, since July 30, 2002, a private federal action for securities fraud must be commenced before the earlier of two years after the discovery of the facts constituting the violation or five years after such violation. 2008 U.S. App. LEXIS 23551, *10 (citing 28 U.S.C. §1658(b)).

6. See *Staeher v. The Hartford Fin. Servs. Group Inc.*, 460 F. Supp. 2d 329 (D. Conn. 2006).

7. See 2008 U.S. App. LEXIS 23551 at *11-14. Unlike the Second Circuit, the majority of courts of appeals to have addressed the issue employ a possibility standard when evaluating the likelihood of wrongdoing sufficient to constitute storm warnings. See, e.g., *In re Merck*, 543 F.3d at 162-64; *GO Computer Inc. v. Microsoft Corp.*, 508 F.3d 170, 179 (4th Cir. 2007); *Tello v. Dean Witter Reynolds Inc.*, 494 F.3d 956, 970 (11th Cir. 2007).

8. See 2008 U.S. App. LEXIS 23551 at *11-14.

9. The court rejected shareholders' objection to the district court's decision to take judicial notice of documents not within the four corners of the complaint. The documents were not considered for the truth of the matters asserted therein, but rather to establish the information in the public domain that would trigger an investor's duty to inquire as to the truth. 2008 U.S. App. LEXIS 23551, at *49-55.

10. See, e.g., *In re Alcatel Sec. Litig.*, 382 F. Supp. 2d 513, 523 (S.D.N.Y. 2005) (noting that determination of whether storm warnings existed "depends on the quantity of information available to the plaintiffs"); *Rochelle v. Marine Midland Grace Trust Co.*, 535 F.2d 523, 532 (9th Cir. 1976) ("Information in public records or published by the news media may be so massive that investors will not be heard to say that they remained ignorant of the financial plight of the corporation involved....").

11. The PSLRA, which amended the Exchange Act, requires plaintiffs to plead each false statement with particularity and a strong inference of scienter as to each defendant. See 15 U.S.C. §78u-4(b). In light of the heightened pleading standard, other courts have been reluctant to impose too high a burden on investors when conducting a storm warnings analysis. See, e.g., *In re Merck & Co. Inc. Sec., Derivative & "ERISA" Litig.*, 543 F.3d 150, 164-65 (3d Cir. 2008).

12. The court rejected the argument that if the plaintiff in the California lawsuit could detect "storm warnings" then so too could shareholders in this action. The plaintiff in the California action was a lawyer at a firm which specialized in battling commercial insurers and was therefore deemed "an investor of more-than-ordinary intelligence."