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Second Circuit Clarifies Standard Regarding Knowledge Of Facts That Constitute A Securities Fraud Violation For Purposes Of Triggering The Two-Year Statute Of Limitations For Rule 10b-5 Claims

In *City of Pontiac General Employees' Retirement System v. MBIA, Inc.*, 2011 U.S. App. LEXIS 3813 (2d Cir. Feb. 28, 2011), the United States Court of Appeals for the Second Circuit delineated the standard needed to asses how much information a reasonably diligent investor must have about the facts constituting a securities fraud violation before those facts are deemed "discovered" for purposes of triggering the statute of limitations for a claim under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Securities & Exchange Commission ("SEC") Rule 10b-5, 17 C.F.R. § 240.10b-5.In doing so, the Second Circuit addressed the gap left by the United States Supreme Court in *Merck & Co. v. Reynolds*, 130 S. Ct. 1784, 1796 (2010) [*see* blog article here], where the Supreme Court expressly declined to prescribe a list of the facts needed to constitute a securities law violation for purposes of triggering the statute of limitations.

MBIA, Inc. ("MBIA") sells insurance policies guaranteeing the principal and interest on bonds, thereby allowing its bond issuing clients to pay lower interest rates. According to the operative complaint, in 1998, one of MBIA's major policyholders defaulted on a bond issue insured by MBIA, leaving MBIA with a $170 million debt that threatened its liquidity and credit rating. To avoid this impairment of its credit rating, MBIA made a deal with three European reinsurance companies whereby they reinsured MBIA on the defaulted bonds *nunc pro tunc*, which resulted in their paying the $170 million loss incurred by the bond default. In exchange, MBIA paid $3.85 million "upfront" as a premium and committed to purchasing additional reinsurance from the European companies over a six-year period at a premium of $297 million. The bonds that would be reinsured over the following six years were among MBIA's highest rated bonds. MBIA initially booked this odd transaction ("1998 transaction") as income, and it continued to do so in its SEC Form 10-Ks from 1998 through 2003.

Several times in later years, the 1998 transaction became the subject of comment in the financial trade press, most of it either positive or ambivalent; but some of it suggested that the transaction was more a loan than a reinsurance contract. In early 2005, after the SEC and the New York State Attorney General both launched investigations into its accounting practices, MBIA restated its financial statements for 1998-2003 to treat the 1998 transaction as a *loan* rather than as *income*.

In April 2005, purchasers of MBIA stock filed a securities fraud class action, alleging that MBIA violated Section 10(b) and Rule 10b-5 when it originally accounted for the 1998 transaction as income rather than as

a loan in its 10-Ks in its 1998 through 2003 financial statements. MBIA moved to dismiss the complaint for failure to adequately plead causation, material misrepresentation and scienter. MBIA also moved to dismiss the complaint as time-barred by the applicable two-year statute of limitations and five-year statute of repose under the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), Pub. L. No. 107-204, § 804, 116 Stat. 745, 802 (2002) (codified at 28 U.S.C. § 1658(b)).

The United States District Court for the Southern District of New York dismissed the action as barred by the statute of limitations for security fraud claims. The district court held that the trade press discussions of the 1998 transaction put the proposed class on inquiry notice of the alleged fraud by December 2002, more than two years before suit was filed in April 2005. It accordingly granted MBIA's motion on statute of limitations grounds, expressly declining to reach MBIA's alternative arguments challenging the sufficiency of the pleading and the statute of repose.

The Second Circuit vacated the district court's dismissal and remanded the case for reconsideration of the statute of limitations analysis in light of the Supreme Court's subsequent decision in *Merck*. The Court of Appeals first noted that although it had previously affirmed the district court's ruling that the original record put the class on inquiry notice by December 2002, thereby rending the fraud claim time-barred under the applicable two-year statute of limitations, after the district court's latest decision in the case and prior to oral argument in the appeal, the Supreme Court in *Merck* changed the law of the Second Circuit with respect to the triggering of the applicable two-year statute of limitations.

Prior to *Merck*, the law of the Second Circuit had provided that a plaintiff was on "inquiry notice" when public information would lead a reasonable investor to investigate the possibility of fraud. If at that point the plaintiff failed to initiate such an investigation, the Second Circuit deemed the statute of limitations to start running on the day the plaintiff should have begun investigating. *Merck* overruled this analysis. *Merck* held that the limitations period begins to run only after a reasonably diligent plaintiff would have discovered the facts constituting the violation — including facts giving rise to a strong inference of the defendant's scienter — irrespective of whether the actual plaintiff undertook a reasonably diligent investigation. In other words, the limitations period commences not when a reasonable investor would have begun investigating, but when such a reasonable investor conducting such a timely investigation would have uncovered the facts constituting a violation.

In light of *Merck*, the Court of Appeals noted that two questions remained unresolved:

1. What are the facts that together constitute a securities fraud violation for purposes of commencing the statute of limitations? and

2. With regard to any particular one of these facts, how much information does the reasonable investor need to have about it before it is deemed "discovered" for purposes of commencing the statute of limitations?

The Second Circuit explained that in order to apply *Merck* with consistency, a standard is needed to assess how much information a reasonably diligent investor must have about the facts constituting a securities fraud violation before those facts are deemed "discovered" and the statute of limitations begins to run. Among other things, the Court held that since the purpose of the statute of limitations is to prevent stale claims, "it would make no sense for a statute of limitations to begin to run before the plaintiff even has a claim: A claim that has not yet accrued could never be considered stale." Thus, in the limitations context, the Court held that "it makes sense to link the standard for 'discovering' the facts of a violation to the plaintiff's ability to make out or plead that violation." Only after a plaintiff can adequately plead his claim can that claim be said to have accrued, and only after a claim has accrued can the statute of limitations on that claim begin to run.

Accordingly, the Court of Appeals ultimately held that a fact is not deemed "discovered" until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint. In other words, the reasonably diligent plaintiff has not "discovered" one of the facts constituting a securities fraud violation until he can plead that fact with sufficient detail and particularity to survive a motion to dismiss. Under this standard, the amount of particularity and detail a plaintiff must know before having "discovered" the fact will depend upon the nature of the fact. Based on this holding, the Court remanded the case again to the district court to reconsider, based on the entire record and in light of *Merck* and its opinion, when the lead plaintiff had enough information about MBIA's scienter to plead it with sufficient particularity to survive a motion to dismiss under the heightened pleading requirements for scienter under the Private Securities Litigation Reform Act of 1995 ("Reform Act"), 15 U.S.C. § 78u-4(b)(2). The two-year statute of limitations could not commence before that point.

This decision provides the first clear guidance in light of *Merck* regarding the facts that together constitute a securities fraud violation for purposes of triggering the statute of limitations. *Merck* had held that, in connection with the statute of limitations for securities fraud claims, the "discovery of the facts constituting the violation" occurs not only when a plaintiff *actually* discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them." This decision elaborates on this standard by holding that a fact is not deemed "discovered" until a reasonably diligent plaintiff would have sufficient information about that fact — including scienter — to plead it adequately in a complaint to survive dismissal under the Reform Act's heightened pleading requirements.

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