SEC Actions

Trend Analysis

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THE NEW SUPREME COURT TERM: KEY CASES FOR BUSINESS

The new Supreme Court term began earlier this month. The High Court has a number of cases on its docket which business organizations, together with directors, officers and general counsels should watch closely. Two involve the potential civil and criminal liability of executives. A third case will impact auditors, public companies and the users of their financial statements, since it will ultimately determine who sets the auditing and accounting standards for public companies. A fourth will impact virtually every investor and pension fund, since it is concerned with the fees paid to investment advisers.

Liability in civil cases: The statute of limitations in securities damage actions

The case: Merck & Co. v. Reynolds, Case No. 08-905 arises out of a securities class action based on the sale of the pain reliever Vioxx.

The significance of the issue: At stake is the scope of liability of corporate executives and their companies in securities damage actions. When the statute of limitations begins to run in a securities fraud damage action can have a significant impact on liability, a point well illustrated by this case where, under the district court's decision, the case is time barred, but under the circuit court's view, it is not.

The key issue focuses on what is called "inquiry notice." All circuits agree that the two-year statute of limitations in securities fraud suits begins when the plaintiff has notice. The question of inquiry notice turns on whether plaintiff has sufficient information of possible wrong doing – that is, facts to "excite storm warnings of culpable activity." This is an objective test designed to prevent potential plaintiffs from sitting on their hands. While plaintiffs are presumed to read items such as quarterly reports and similar information, they are not required to sift through mounds of scientific data, for example, to discover a possible claim.

Merck is a securities class action brought against the company and certain of its executives stemming from sales of Vioxx, a prescription pain drug. The suit claims that defendants made material misstatements about the clinical effects of the drug. The inquiry notice issue turns on when plaintiffs had sufficient information to put them on notice.

The FDA approved the drug in May 1999. The VIGOR study, done in January of that year, demonstrated the positive effects of the drug compared to other pain relievers, but showed that Vioxx users had a higher incidence of CV events. The study was fully disclosed. The company noted the incidence was low and theorized a possible explanation. The same question was raised again in a May 8, 2001 FDA hearing and in an August 22, 2001 American Medical Association Journal article, which called the question a "cautionary flag." In September 2001, the FDA stated on its website that it had cautioned the manufacture about misleading advertising regarding Vioxx because the firm minimized the risks although the agency did not dispute Merck's theory about the CV events. The FDA required that the advertising be corrected. Later, a New York Times article, dated October 2001, stated that there are troubling questions about Vioxx and the unexplained risks. In April 2002, there was a labeling change in which the FDA required the company to include the higher incidence of CV events. By October 22, 2003, news reports noted that sales for the drug were falling because of clinical trials suggesting it might increase the risk of heart attacks. An October 30, 2003 news article then reported a

Harvard-affiliated study that showed an increase risk of heart attack in patients taking Vioxx. The complaint was filed in November 2003.

The district court dismissed the action as time barred concluding that by October 2001 when the New York Times article was published the plaintiffs were put on inquiry notice. The Third Circuit reversed. In a 2-1 decision the court held that it is not until the investor has notice of the possibility of a federal securities fraud claim that the statute beings. Here, there was no evidence prior to the Harvard study that the company did not believe its proffered explanation for the possible adverse effects. At the time of that study however, plaintiffs had available possible information of wrong doing to place them on inquiry notice or to excite "storm warning" of culpable activity. Not until that point did plaintiffs have evidence suggesting defendants did not hold the opinions about the possible side effects which they had proffered from the beginning. At that point there was evidence of possible scienter, a key element of a federal securities fraud claim.

A second part of the limitations rule which was not addressed by the Third Circuit, but which could be taken up by the High Court focuses on what obligation the plaintiff has if there is inquiry notice. There are four views: 1) the pure notice test used by Eleventh Circuit under which the statute begins when the plaintiff is put on notice that a representation may be false; 2) the majority rule, which is an inquiry plus reasonable diligence test followed by the Fifth, Sixth, Eighth, Ninth and Tenth Circuits, which hold that the limitation period does not commence until the plaintiff is on notice and, in the reasonable exercise of due diligence, should have discovered the underlying fraud; 3) a variation of the majority rule used by the Seventh Circuit, which holds that it began when the plaintiff discovers facts which are sufficiently probative of the fraud to cause the plaintiff to investigate and completes that inquiry before filing suit; and 4) the approach used by the Second and Third Circuits, which holds that the statute begins to run either when the plaintiff has notice and does nothing or if an inquiry begins at the point when a reasonably diligent investor would have completed the investigation.

The United States, in an *amicus curiae* brief, supports Respondents. Specifically, the government argues that the two-year limitation period does not begin until plaintiff has actually discovered or in the exercise of reasonable diligence ought to have discovered, facts demonstrating that all of the elements of a securities fraud claim can be established. There is "inquiry notice," a concept which identifies the point when a reasonably diligent investor would have commenced an inquiry, only if the available information suggests that a defendant's possible misrepresentation was made with scienter.

Liability in criminal cases: Honest services fraud

The cases: Weyhrauch v. U.S., Case No. 08-1196, *U.S. v. Black*, Case No. 08-876 and *Skilling v. U.S.*, Case No. 08-1394. The three cases raise questions concerning what limiting principles, if any, should be used to define "honest services" fraud, which has been used to criminalize a wide variety of business and public sector conduct.

The significance: "Honest services" fraud, governed by 18 U.S.C. § 1346, is frequently charged against corporate executives for breaches of duty, as well as public officials. The statute does not specifically define the concept of honest services. The statute was passed in the wake of the Supreme Court's decision in *McNally v. U.S.*, 483 U.S. 350 (1987), which held that the theory of "honest services" fraud was outside the scope of the mail fraud statute. Since its passage, Section 1346 has been applied to a wide variety of private and public sector conduct, criminalizing actions which many claim are well beyond those which Congress intended. For example, in one case, Merrill Lynch executives were charged with honest services fraud in the infamous "Enron barge" deal. There, Enron executives booked a transactions involving Merrill and certain barges in a manner which falsified the financial statements of that company. The Merrill executives were indicted and convicted of honest services fraud. The convictions were reversed by the circuit court. Many critics of the statute argue that it is so open-ended that virtually any breach of duty in the work place can become a federal crime, thus exposing executives to federal criminal liability.

Weyhrauch raises the question of what limiting principles should be applied in a public sector case. The defendant is an Alaska state legislator who was indicted based on a claimed failure to disclose. The issue turns on the source of the disclosure obligation. The district court found none in state law. The Ninth Circuit rejected state law as the source of the duty, concluding that it had to be drawn from federal common law. *Black* presents the same question in a private sector case against the backdrop of the convictions of Canadian newspaper magnate Conrad Black. In that case the issue is phrased in terms of whether economic harm to the employer is required. Specifically, *Black* asks whether the statute covers the conduct of a private individual whose claimed scheme to defraud did not contemplate economic or other property harm to the private party to whom honest services were owed.

Skilling raises the same question in a case involving former Enron executive Jeffrey Skilling. That case presents the honest services fraud issue in different terms from *Black*, focusing on whether the government must prove that the conduct was intended to achieve private gain, rather than to advance the interests of the employer. Alternatively, the Court could declare the statute to be so vague and open-ended that it is unconstitutional, a view shared by many. Justice Scalia argued this point in a recent dissent from the denial of *certiorari* in another case.

In *Black,* the government has filed a brief arguing that the scope of honest services fraud is delimited by a materiality requirement which could encompass economic as well as reputational harm.

Last year in *Stoneridge Investment Partners LLC v. Scientific-Atlanta, Inc.*, 128 S.Ct. 761 (2008), which focused on the question of "scheme liability" in securities damage actions, the Court limited the scope of liability for business executives noting in part that securities law liability should not be extended to ordinary business transactions. The question in these three cases is whether the Court will impose similar limitations on honest services fraud, where the stakes for business executives and public officials are much higher in view of the potential criminal liability.

Constitutionality of PCAOB

The case: Free Enterprise Fund v. Public Company Accounting Oversight Board, Case No. 08-861 raises a question concerning the constitutionality of the PCAOB. The issue arises under the separation of powers doctrine and the presidential appointment power.

The significance of the issue: The PCAOB was created as part of the Sarbanes Oxley Act of 2002 in the wake of corporate scandals such as Enron, Worldcom, Global Crossing and others. The board has authority over auditing and accounting standards for public companies. The auditors of public companies must be registered with the board. If the challenge is rejected the current system will remain in place. In contrast, if the constitutional challenge is sustained, it will return auditors and their public company clients to the system which was in place in 2002. Many thought the prior system was inadequate and contributed to the corporate scandals which occurred at the beginning of the decade. Accordingly, a determination that the PCAOB is unconstitutional could have significant implications for all public companies, the auditing profession and the users of financial information from public companies.

Free Enterprise Fund presents the question of whether the PCAOB violates separation of powers principles and the appointment power since it is overseen by the SEC, rather than the President. In the district court, plaintiff argued that the SOX sections creating the board violate separations of powers principles. In addition, they contended that appointment clause is violated because of the fact that PCAOB board members are appointed by the SEC, rather than the President. The district court granted summary judgment in favor of the board. The circuit court affirmed.

Fees for investment advisers

The case: Jones v. Harris Associates, L.P., No. 08-586 presents a question of what standards a plaintiff must meet to bring a claim against an Investment Adviser when challenging the fees charged.

The significance of the issue: For the Fund industry, this is a huge issue since it involves the fees charged. The issue is also significant for virtually every other investor. Most investors in their pension funds hold shares of mutual funds. Many corporate pension funds hold fund shares. The fees charged impact the value of all those shares.

Section 36(b) was added to the Investment Company Act in 1970. Under that Section, the investment adviser has a fiduciary duty with respect to compensation for services. The statute provides for a cause of action by a security holder with respect to the fees paid, noting that approval by the board of directors shall be given consideration as the court deems appropriate in evaluating the question but that personal misconduct need not be established.

In this case, the Seventh Circuit adopted what is essentially a disclosure standard, concluding that as long as all the facts are fully disclosed, the shareholders' action is defeated. The court rejected the widely followed standard of *Gartenberg v. Merrill Lynch*, 694 F.2d 923 (2d Cir. 1982). Under *Gartenberg,* a cause of action could be maintained if the fee is "so disproportionately large" or "excessive" such that it bears no reasonable relationship to the services rendered.

The government's *amicus curiae* brief before the Supreme Court adopts the *Gartenberg* standard. The government specifically rejected the holding of the court of appeals as inappropriate. Interestingly, none of the parties opted for the disclosure approach of the Seventh Circuit. Adoption of that standard would essentially insulate investment adviser fees from challenge.

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These cases, and others which the Court may elect to hear in the future, have the potential to significantly impact business and corporate executives. To date, many Court watchers view the Roberts Court as decidedly pro-business. If that approach continues, the decisions in these cases may delimit potential liability in a favorable manner for business as the Court did in *Stoneridge* and other securities cases. Conversely, the decisions in these actions have the potential to significantly expand liability and impact the operations of business and the liability of executives. Each should be carefully watched for the actual decision as well as the approach used by the High Court and the overall trend of its decisions.

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