MUCH ADO ABOUT NOTHING

Some herald the Supreme Court's decision in ***Merck & Co., Inc. v Reynolds***, ___ U.S. ___ (2010), as a sign that the Court will be expanding the rights of plaintiffs in securities litigation. After all the Court adopted a reasoned approach in determining that limitations does not run on a misrepresentation claim under the federal securities laws until the plaintiff has notice of facts that would support a strong inference of scienter (intent to deceive or defraud or extremely reckless conduct with such an effect). The Court observed that the available information about Merck's conduct (namely newspaper articles, scientific studies, investigatory assertions by the FDA, and allegations in other lawsuits) would not lead a Plaintiff to believe that Merck had intended to deceive, manipulate, or defraud the investing public or had acted with extreme recklessness. These, of course, are the required backbone of any securities cause of action for misrepresentation. See ***Ernst & Ernst v Hochfelder***, 425 U.S. 185 (1976).[1] In my article ***Liability of Professionals under State and Federal Securities Law***,[2] I stated that the heightened pleading requirements set out in the ***Private Securities Litigation Reform Act of 1995 (PSLRA)*** could well create a situation where information in newspaper articles initiated limitations but would be inadequate to satisfy these pleading requirements.[3] In ***Merck*** the Court alleviated my concern about the statute of limitations but in doing so highlighted the impossible task of pleading such a cause of action.

MERCK

Merck involved a claim under 15 ***USCA*** § 78(j)(b) (misrepresentations or omission in connection with the sale of a security commonly referred to as Section 10(b) of the ***Securities and Exchange Act of 1934***), that its officers and directors had failed to alert the investing public that its involvement in Vioxx litigation could be financially disastrous. Specifically, the plaintiffs asserted that Merck had misrepresented the scientific evidence that supported the efficacy and safety of the drug. The limitation period for such a suit is two years from discovery of (or "should have discovered") the offense but no greater than five years from the date of the alleged misrepresentation or omission. See 28 ***USCA*** § 1658(b). Suit was filed on November 6, 2003. Facts known prior to November 6, 2001, were: "(1) a March 2000 "VIGOR" study comparing Vioxx with the pain killer naproxen and showing adverse cardiovascular results for Vioxx, which Merck suggested might be due to the absence of a benefit conferred by naproxen rather than a harm caused by Vioxx (the "naproxen hypothesis"); (2) an FDA warning letter, released to the public on September 21, 2001, saying that Merck's Vioxx marketing with regard to the cardiovascular results was 'false, lacking in fair balance, or otherwise misleading'; and (3) pleadings filed in products-liability actions in September and October 2001 alleging that Merck had concealed information about Vioxx and intentionally downplayed its risks." ***Merck*** at _____. These facts, taken individually or in concert, do not, said the Court, constitute evidence of the necessary intent to deceive and do not raise a strong inference of such intent. ***Merck*** at ____. The Court rejected the notion that limitations commenced when Plaintiffs had evidence sufficient to cause a reasonable investor to investigate further. Thus "storm warnings" or "inquiry notice" only established a date when an investigation should have commenced. ***Merck*** at ____. The Court disapproved the line of cases from the circuits that held to the contrary.[4] Once inquiry becomes reasonably necessary the defendant still must establish the date by which a reasonably prudent

investor would have or should have discovered the facts concerning defendant's fraudulent state of mind. ***Merck*** at _____. The feature in ***Merck*** that is most confusing is the treatment of the "naproxen hypothesis." Merck contended in 2000 that the results of the VIGOR study may be due to the possibility that naproxen mitigated against heart attacks, although Vioxx did increase the risk when compared to naproxen by a 4 to 1 margin. The degree of increased risk when compared to all other causes was not stated. Then in mid 2001 the FDA stepped forward and labeled Merck's marketing as false, unbalanced, or otherwise misleading. How that does not alert an investor that Merck was using false data to support its product escapes me. Although the FDA did not label the "hypothesis" as false, I think any plaintiff's lawyer or jury would draw that conclusion.

The actual problem, as I see it, was that the data did not show a sufficient increased risk to satisfy the ***Dauber***[5] standard, at least as applied in Texas.[6] From a limitations stand point ***Merck*** is more like the Hormone Replacement Therapy (HRT) cases where limitations did not commence until there was sufficient evidence of a causal relationship between the drug and the perceived harm.[7] But back to the point. Pleading that a study shows adverse consequences, that the product manufacturer minimized, and that the FDA labeled that minimization as false and misleading is insufficient to cogently infer scienter. If that is true, then nothing short of a confession will permit the inference. I can't but feel that Merck was using the old briar patch strategy to advance its ultimate goal to defeat future securities fraud cases where scienter must be pleaded and proved.

INFERENCES

So, facts showing that a defendant's representations were false are insufficient to commence limitations and are obviously inadequate to satisfy ***PSLRA***'s heightened pleading requirements that require allegations of facts providing a strong inference of defendant's actionable state of mind. The inference of scienter must be at least as strong as any other inference that could be raised by the facts. See ***Telabs v Makor Issues & Rights Ltd.***, __ U.S. ___, 127 S. Ct. 2499 (2007) Whether the inferences are to be evaluated individually or in concert is an open question. Thus it remains to be seen whether 50% or some lesser percentage is required when there are more than two possible inferences that may be drawn from the facts.[8] Frankly, the issue could not be more complicated. An inference is a tool for establishing a fact from circumstantial evidence. The usual example is when two actors (A and B) may have shot the plaintiff, and a decision must be made which one did it. Both were present. Both had a gun and fired it. Both deny having hit the plaintiff. Based upon these facts there is a 50% probability and, therefore, a 50% inference that A did it and the same probability and inference that B did it. Without more the fact finder must decide whose denial is more credible.[9] Additional facts relating to habit or motive or concealment may make the fact finder's task easier, but resolution will still turn on which defendant's denial is more believable. If there were three actors (A, B, and C), the task of the fact finder becomes more daunting. The probability that A, B or C was the shooter is now 33. 33%, and resolution of the causation issue will still turn on credibility. At some point in this formulation, however, a court will likely say that there are too many potential shooters to warrant a decision based upon credibility alone, and the plaintiff will be denied any recovery. Another fact situation is where there are several tortfeasors whose conduct may be a cause of plaintiff's

damages. An example of this would be where several companies pollute a stream, and the plaintiff's cows become sick and die after drinking the polluted water. In Texas, at least, the issue of causation has been simplified by a judicially adopted rule that shifts the burden of disproving causation to the defendant polluters.[10] A third example is where a doctor mis-diagnoses a patients condition or mis-administers a medication, and the patient dies. Expert testimony, however, establishes that the patient, even with a proper diagnosis or medication, had less than a 50% chance of survival. Many jurisdictions now permit the patient's family a monetary recovery for loss of chance. If the patient had a 30% chance of survival the family can recover 30% of the damages.[11] BUT the difficulties involved in these adventure in fact finding pale when compared to a fact finding of "intent." This subjective determination, in the absence of a confession, requires the fact finder to examine the defendant's conduct and decide whether he knew or was extremely reckless in not knowing that the representation was false and intended the harm caused by his actions. Essentially this is the process required for a determination that a defendant acted with "scienter." In all instance, the facts will show that the corporation issued a false statement and the plaintiffs or the market relied on those false statements in making investment decisions or setting a stock price.[12] All federal courts have decreed that something more than making a false statement is required. According to the Fifth Circuit falsity and motive and opportunity are insufficient to justify a finding of scienter.[13] In this circuit the plaintiff must plead more than that the defendant made the false statement (with no group attribution), intended for the plaintiff to rely on it, and profited from the transaction.[14] What more must the plaintiff plead in order to satisfy the ***Telabs*** requirements that the inference of scienter be cogent, compelling and at least as strong as any competing inference? There is a grave yard full of cases where pleading was found inadequate, but little guidance has been provided on what will pass muster.

SCIENTER

In criminal law intent is a necessary element of many crimes. Convictions are routinely obtained based upon the universally accepted premise that a person intends the probable consequences of his acts. The jury must be instructed that the inference is only permissive not mandatory. To do otherwise, it is said, would dilute the standard of proof applicable in criminal cases.[15] But it is a rare case where a jury would decline to accept the inference as proof of intent beyond a reasonable doubt. In a criminal case where intent to defraud or deceive is charged a jury may infer guilt from facts demonstrating that the defendant made a misrepresentation to a bumpkin and profited from the transaction. Even in the absence of other evidence, reliance and intent to defraud may be inferred based upon the permissive inference, and a guilty verdict will be the usual result. The most simplistic example of this criminal inference is where Bully A strikes Mother B in the shoulder with a club. The blow fractures Mother B's arm, and she bleeds to death. A jury will decide whether the natural and probable consequences of the act was a death. If so, the perp could be convicted of second degree murder based upon an inference that is sufficiently strong to carry a burden of proof "beyond a reasonable doubt." But the jury could also conclude that the death was not the result of an intent to kill (thus rejecting the inference) and convict the perp of lesser charges like negligent homicide or manslaughter or even aggravated assault.[16] Contrast this with the facts in a recent Fifth Circuit case, ***Indiana Electrical Worker's Pension Trust Fund IBEW v Shaw Group, Inc.,*** 537 F.3d 527 (5th Cir 2008). There the president of a corporation signed a SOA certification that the financial statement of his company was properly presented under GAAP and that sufficient safeguards were in place to insure

accurate financial information. In addition the facts pleaded were that a senior officer instructed his field personnel that sales being reported were too low and to do something about that which resulted in inflated sales being reported. The court held that the GAAP deficiency was not actionable unless the evidence showed that there were glaring errors in the financial statement to alert the president to his potential misrepresentation -- thus extreme recklessness. As to the instruction to "get the numbers up" the court held that the evidence was insufficient to show that the senior officer intended field agents to cook the books. Thus both were deemed inadequate to cogently infer scienter, although the court conceded that such an adverse inference might be drawn from these facts, it was not at least as strong as an inference of negligence or innocence. I read this decision out loud at Cardozo's grave site, and I promise I could hear him twisting in his casket.[17] He would first say that someone ought not make an affirmative representation unless he had ascertained that the facts were correct. If he didn't know whether the representation was true he should not have made it. See ***Ultramares Corp. v George A Touche***, 255 N.Y. 170 (N.Y. Ct of App 1922) ("The defendants certified as a fact, true to their own knowledge, that the balance sheet was in accordance with the books of account. If their statement was false, they are not to be exonerated because they believed it to be true (Hadcock v. Osmer, supra; Lehigh Zinc & Iron Co. v. Bamford, 150 U.S. 665, 673; Chatham Furnace Co. v. Moffatt, 147 Mass. 403; Arnold v. Richardson, 74 App. Div. 581). We think the triers of the facts might hold it to be false.") Cardoza had no difficulty in concluding that it was for a jury to decide whether the representation was false and, if so, impose liability on the accountant for fraud.[18] As to the Fifth Circuit's refusal to strongly infer that the statement "to get the numbers up" was not sufficient to demonstrate intent to deceive, I suspect that Cardozo simply shook his head in disbelief. A recent Texas Tech Law Review article discusses the varying views of the circuit courts in analyzing when a strong inference of scienter has been made. See Lane, ***The Plaintiffs Growing Burden in Securities Class Action Litigation***, 41 Tex. Tech L. Rev. 615 (2008). He concludes, as do I, that the interpretation adopted in ***Telabs*** and implemented in ***Merck***, seriously threatens federal securities litigation with extinction.

CONCLUSION

The facts in ***Merck*** were insufficient, according to the Court, to initiate limitations. If so, then a recitation of those facts would be insufficient to plead a strong inference of scienter. The subjective nature of the inquiry requires the pleading of facts which will not be available without further discovery and evaluation. But if the necessary facts cannot be pleaded at the outset there will be no discovery after a motion to dismiss is filed[19], and such a motion will always be filed. Thus Plaintiff's ability to discover the necessary facts will not be aided by any type formal discovery. In my article ***Federal Securities Litigation versus Amateur Golf*** [20] I concluded that those who suffer losses from a misrepresentation in connection with a purchase or sale of a security were better off seeking relief under the Texas Blue Sky Law,[21] but if they persisted they could make more money playing amateur golf.

ENDNOTES:

1. While the Court has not yet approved recovery where only extreme recklessness is involved it is unlikely that it will disapprove the numerous lower court decisions so holding. E.g. ***Baesa Sec. Litig***., 969 F.Supp. 238, 241 (SDNY 1997).

2. This article was accepted for publication by the Houston Lawyer but has not yet appeared in print. It can be viewed at www.courtoflastresortmontgomerytexas.com.

3. Because scienter involves an element of intent the plaintiff must plead all facts that give rise to a strong inference of that state of mind. See 15 ***USCA*** §78u-4(b)(2).

4. This is the one positive effect of ***Merck***. I could never understand how a duty to inquire further would initiate limitations when the question was the date on which the plaintiff knew or should have known of the wrongdoing unless the facts establishing liability were determinable by a reasonable investor the same day the inquiry began.

5. ***Dauber v Merrill Dow***, 509 U.S. 578 (1993). This case required scientifically valid proof of causation between toxin and disease.

6. In Texas toxic tort litigation, the plaintiff must introduce epidemiologic proof demonstrating, to a moral certainty that there is a relationship between the toxin and the disease. Usually this will require proof that there is a 95% certainty that the toxin causes an increased risk greater than 50%. See ***Merrell Dow Phar., Inc. v Havner***, 953 S.W.2d 706 (Tex. 1997) . In prior articles I have characterized this requirement as the courts shining the shoes of Corporate America. See Ravkind, ***Science on Trial***, Toxic Tort Journal (Spring 1998), and Ravkind, ***Quis Custodiet Ipsos Custodes*** , publication pending. Both articles can be viewed at www.courtoflastresortmontgomerytexas.com.

7. ***In re Prempro Products Liability Litigation***, 586 F.3d 547, 564-565 (8th Cir. 2009)

8. See Article, ***Strong Inference Pleading Standard***, 121 Harv. L. Rev. 385 (2007). The article points out the deficiencies in ***Telabs v Makor Issues & Rights Ltd.***, __ U.S. ___, 127 S. Ct. 2499 (2007)

9. When I began practicing law fifty years ago the issue of "tort-causation" was reasonably straightforward. Generally, causation required that there be a "but for" connection between the action complained of and the damage suffered. The only limitation was that the damages suffered be of a type reasonably foreseeable from the conduct in question – proximate causation. In certain circumstances that limitation was viewed to be a question of law to be decided by the court – legal cause. Dean Leon Green's concept of "better risk bearer" mitigated against any broad application of legal cause. See Green, ***Rationale of Proximate Cause*** (1927). Cases like ***Cook v Lewis***, 1 Dom L Rep 1, 3-4 (Can Sup Ct 1951) (two hunters firing their rifles), ***Landers v. East Texas Salt Water Disposal Co.,*** 151 Tex. 251; 248 S.W.2d 731 (1952) (multiple polluters of a stream), and ***Gardner v National Bulk Carriers, Inc***., 310 F.2d 284 (4th Cir. 1962) (no effort to rescue a seaman lost overboard), were exceptions to the traditional requirements and were based upon notions of fairness and justice.

10. See ***Landers v. East Texas Salt Water Disposal Co.,*** 151 Tex. 251; 248 S.W.2d 731 (1952).

11. See generally ***Loss of Chance as Technique: Towing the Line at 50%***, 72 Tex L Rev. 369 (1993).

12. Fraud on the market theorizes that an efficient market sets the price of a security based upon all available information and individual reliance is not a necessary ingredient for liability to attach. See ***Basic Inc. v Levinson***, 485 US 224 (1988).

13. See ***Press v Chemical Investment Services Corp.***, 166 F.3d 529, 538-539 (2nd Cir. 1999); ***Industrial Technology Ventures LP v Rowland Revocable Trust***, 688 F. Supp. 229, 246 (WDNY 2010). In spite of the legislative history clearly showing that Congress did not codify the Second Circuit's interpretation only because it was deemed too restrictive, several circuits have said that pleading motive and opportunity is insufficient to infer scienter. See ***Nathenson v Zonagen Inc.***, 267 F.3d 400, 410-411 (5th Cir. 2001).

14. See Fed. R.Civ. Proc.(***FRCP***) Rule 9(h). This Rule also provides that state of mind may be pleaded generally. "Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally." Thus, in the absence of the stringent pleading requirements in ***PSLRA***, this issue would be non existent.

15. See ***United States v Chiantese***, 560 F.2d 1244, 1254-1255 (5th Cir 1977).

16. See ***State of Utah v. James***, 819 P.2d 781; 171 Utah Adv. Rep. 12; 1991 Utah LEXIS 139 (Supp Ct Utah 1991). In this exhaustive opinion by the Utah Supreme Court the issue is cogently examined. The court finds that motive and opportunity plus any type of conduct that suggests (infers) evil intent is sufficient to convict a defendant of a serious crime. The court does point out that the incident inference would not be sufficient to establish premeditation.

17. Just a story. I don't actually know where the great one is buried.

18. Remarkably, the Texas Supreme Court recently cited and discussed ***Ultrameres*** to support its conclusion to limit accountant liability for fraud. See ***Grant Thornton, LLC v High Prospect Income Fund***, ___ S.W.3d ___ (Tex. 2010). True enough, Cardozo would restrict recovery for negligent misrepresentation to those in virtual privity with the tort feasor, but he clearly disavowed such a limitation where fraud was involved.

19. ***PSLRA*** specifically directs that no discovery will be allowed when a motion to dismiss is filed. See 15 USCA §78u-4((b)(3)

20. This article was presented at the meeting of the Business Law Section of the State Bar in June 2007. It can be reviewed at www.courtoflastresortmontgomerytexas.com.

21. Texas Securities Act, ***Tex Rev Civ Stat Anno***, art 581-1, et seq.