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NEW YORK FEDERAL COURT DISMISSES SECURITIES ACT CLAIMS ON STATUTE OF LIMITATIONS GROUNDS AND UNDER THE PSLRA

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Plaintiffs bringing claims under the Securities Act of 1933 often disclaim allegations of fraud in an effort to avoid the reach of more stringent pleading requirements that apply to fraud-based claims. That disclaimer comes at a cost, however, as demonstrated by a recent decision issued by United States District Court Judge Denise Cote[1] dismissing claims brought under the Securities Act of 1933 against a Canadian mining company (NovaGold Resources Inc.), its directors and officers, and six underwriters, which were represented by Milbank. The *NovaGold* decision makes clear that plaintiffs who disclaim reliance on fraud in asserting Securities Act claims face higher hurdles in a number of respects.

In *NovaGold*, the plaintiff alleged that certain defendants violated Sections 11 and 12(a)(2) of the Securities Act, and that some violated Section 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, based on purported misrepresentations relating to a mining project undertaken by NovaGold in Galore Creek, Canada (the "Galore Creek Project"). In drafting its complaint, the plaintiff took great pains in emphasizing that its Securities Act claims were based on strict liability and negligence, and did not sound in fraud.

Dismissing the Securities Act claims against some of the defendants as time-barred, Judge Cote made clear that because the plaintiff's claims did not purport to sound in fraud, plaintiff was on inquiry notice for more than the one-year limitations period that certain statements that appeared in NovaGold's registration statement and prospectus (together, the "Prospectus") were untrue even if the plaintiff *had no notice whatsoever of fraud*. It was reasonable, the Court noted, that plaintiffs need more information to be deemed on notice of a securities fraud claim than they need to challenge a statement as untrue under the Securities Act. Although the Second Circuit has held that "whether a plaintiff had sufficient facts to place it on inquiry notice is 'often inappropriate for

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[1] *In re NovaGold Resources Inc. Securities Litigation,* 08 Civ. 7041 (DLC) (S.D.N.Y. June 5, 2009).

resolution on a motion to dismiss,'" it has made clear that in some cases courts can resolve the issue of inquiry notice as a matter of law, where "the facts needed for determination of when a reasonable investor of ordinary intelligence would have been aware of the existence of fraud can be gleaned from the complaint and papers … integral to the complaint." *LC Capital Partners, LP v. Frontier Insurance Group, Inc.,* 318 F.3d 148, 156 (2d Cir. 2003) (citation omitted). *NovaGold* is an example of a case where the court was able to resolve the inquiry notice issue at the pleadings stage.

Likewise, the Court relied on plaintiff's disclaimer of fraud in holding that the Private Securities Litigation Reform Act's ("PSLRA") safe harbor for forward-looking statements (such as financial projections and statements of future economic performance) protected defendants against liability for these allegedly misleading statements. Judge Cote held that given the plaintiff's disclaimer of fraud, the plaintiff could not seek refuge in any exception to the forward-looking statement safe harbor based on purported actual knowledge of alleged misstatements.

Summary of the Complaint

The corrected consolidated class action complaint (the "Complaint") was brought by lead plaintiff New Orleans Employees' Retirement System, a purchaser of NovaGold stock, against three groups of defendants: (i) NovaGold and certain of its officers and directors; (ii) the underwriters of a secondary public offering of NovaGold stock; and (iii) the engineering firm (Hatch Ltd.) and one of its employees who were responsible for the mining feasibility study (the "Hatch Study") relating to the Galore Creek Project that was incorporated into the Prospectus.

Plaintiff asserted violations of Sections 11, 12(a)(2) and 15 of the Securities Act based on allegations that the Prospectus was false and misleading because it allegedly (1) did not disclose the true capital costs projections for the Galore Creek Project; (2) stated that the Project was economically viable; (3) failed to disclose that proceeds from the offering would be used to fund a new feasibility study; (4) characterized the Hatch Study as the "final" feasibility study; and (5) failed to disclose that NovaGold had already retained another engineering firm (AMEC) to conduct a new feasibility study.

The Complaint recited a number of statements made by NovaGold subsequent to the Registration Statement that continued to contain the same alleged foregoing misstatements and omissions. In an October 15, 2007 press release (the "October 15 Release"), and its Form 6-K quarterly report, NovaGold announced that the "Galore Creek Mining Corporation has engaged [another consultant] to prepare an updated feasibility study to, among other things, support the project financing of Galore Creek. The updated feasibility study is expected to result in significant increases to capital costs." Ultimately, on November 26, 2007, NovaGold disclosed that mining operations at Galore Creek had been suspended indefinitely and that the capital costs had risen to at least $4 billion.

With respect to the Securities Act claims, the plaintiff emphasized: the "Securities Act claims are not based on any allegations of knowing or reckless misconduct on behalf of the Securities Act Defendants. Lead Plaintiff's Securities Act claims do not allege, and do not sound, in fraud and Lead Plaintiff specifically disclaims . . . any reference to or reliance upon allegations of fraud in these non-fraud claims under the Securities Act."

The Opinion and Order

The three defendant groups moved to dismiss the Complaint pursuant to Rules 8(a), 9(b), 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure and the PSLRA. The Court granted the motions to dismiss the claims brought under the Securities Act in their entirety.

Statute of Limitations

Section 13 of the Securities Act imposes on claims under Sections 11 and 12(a)(2) of the Securities Act a one-year statute of limitations period that is triggered when the plaintiff "'obtains actual knowledge of the facts giving rise to the action or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge.'" Order at 24 (citation omitted). The Court held that the notice giving rise to a duty of inquiry (so-called "storm warnings") under Section 13 was triggered by the October 15 Release. The Court made clear that although circumstances giving rise to the duty of inquiry must relate directly to the alleged misrepresentations and omissions on which the plaintiff bases its claims, they "'need not detail every aspect' of the alleged scheme." *Id.* at 24-25 (citing *Staehr v. Hartford Fin. Servs.*, 547 F.3d 406, 427 (2d Cir. 2008)). The Court emphasized that when the storm warnings take the form of company-specific information probative of the alleged wrongdoing, a duty to investigate arises. *Id.* at 25.

The Court found that the October 15 Release, stating that another engineering company had been retained to prepare an updated feasibility study and that capital cost estimates were expected to significantly increase, triggered the duty of inquiry, as the statement contained "'company-specific information' that relates directly to the misrepresentation alleged." *Id.* at 30 (citing *Staehr*, 547 F.3d at 428). In particular, the Court stated, the October 15 Release "put plaintiff on inquiry notice of the claims relating to the retention of AMEC . . . [and NovaGold's] characterization of the Hatch Study as the 'final' feasibility study that had 'confirmed' the economic viability of the Project." *Id.*

Of note, the Court rejected the plaintiff's argument that its action was timely because the October 15 Release did not indicate the existence of a securities fraud claim, noting that fraud is not a requirement of a Securities Act claim and holding that a plaintiff is on inquiry notice when it learns of the probability of an earlier untrue statement or omission, *not* when it learns that a misstatement involved fraud. Importantly, for future claims brought under the Securities Act, the Court explained: "it is reasonable to require that plaintiffs need more information before they may be charged with being on notice of a securities fraud claim than they need to bring a claim challenging an untrue statement." *Id.* at 32 n.6.

The Court further rejected the plaintiff's argument that the Release did not constitute inquiry notice because it failed to suggest the extent of the underestimation of costs associated with certain specific aspects (*e.g.,* the completion of a tailings dam and water diversion structures) of the Galore Creek Project. The Court held that the Release clearly stated that the new study is "expected to result in significant increases in capital costs," and that the Release did not need to detail every aspect of the alleged scheme. *Id.* at 32 (citing *Staehr,* 547 F.3d at 427). Likewise, the Court disagreed with the plaintiff's argument that the allegedly small drop in share price following the Release established that there was no inquiry notice. *Id.* (citing *Newman v. Warnaco Group, Inc.*, 335 F.3d 187 (2d Cir. 2003)) (when determining the presence of inquiry notice in the securities fraud context, stock price is "typically not dispositive standing alone"). Rather, the Court held that the "stock price drop following the press release" supports the finding of inquiry notice. *Id.* at 34.

PSLRA Safe Harbor for Forward-Looking Statements

The Court also held that the alleged misrepresentations in the Prospectus relating to the costs and economic viability of the Galore Creek Project were forward-looking statements (*i.e.,* projections) that were accompanied by sufficient cautionary language (including the characterization of cost figures as "estimates"), and therefore eligible for protection under the PSLRA safe harbor and the bespeaks caution doctrine. Specifically, the Court noted, "[a]t the time of the Secondary Offering, years remained until Galore Creek was operational, and a prediction about its ultimate costs . . . are "'projection[s].'" *Id.*

Significantly, the Court would not permit the plaintiff to try to avoid dismissal on the basis of an exception to the safe harbor of the PSLRA for forward-looking statements "made with 'actual knowledge' that they are false or misleading."[2] The Court noted that the plaintiff had gone "to great pains to allege that misstatements in the Registration Statement resulted from negligence, not fraud, and to disclaim any intention that the Securities Act claims sound in fraud." *Id.* at 48. The Court held that because the Complaint disclaimed any reliance on fraud, the Complaint "fail[ed] to allege that defendants made objectionable statements in the [Prospectus] with knowledge of their falsity." *Id.* at 48-49.

Conclusion

We do not seek to describe all of the other grounds for dismissal of the Securities Act claims herein, but instead refer you to the *NovaGold* decision itself, which we believe will prove valuable to defendants in defending against Securities Act claims. Plaintiffs will have to think twice before disclaiming allegations of fraud when trying to avoid increased pleading burdens associated with fraud-based claims.

[2] *Id.* at 38 (citing 15 U.S.C. § 77z-2(c)(1)(B)).

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