Chicago Daily Law Bulletin.

Serving the city's law profession since 1854

August 9, 2017

Not enough to link past acts to fraud

By Steven P. Garmisa
Hoey & Farina

Trying to finesse the five-year statute of repose for securities fraud claims under Section 10(b) of the Securities and Exchange Act of 1934, William Howe relied on the "continuing fraudulent scheme" doctrine when he sued Alexandr Shchekin on Oct. 1, 2015, based on alleged misrepresentations and omissions involving investments in ReadOz LLC that occurred both before and after Oct. 1, 2010.

Federal securities fraud claims are governed by 28 U.S.C. Section 1658(b), which provides a two-year statute of limitations, cushioned by a discovery rule, and a five-year statute of repose.

The line of cases cited by Howe when responding to Shchekin's motion to dismiss Count 1 of the complaint concluded that the countdown for a Section 10(b) claim starts running "from the date of the last alleged misrepresentation regarding related subject matter." *In re Beacon Associates Litigation*, 282 F.R.D. 315 (S.D.N.Y. 2012).

Because some of the alleged misrepresentations occurred within five years of when he sued, Howe argued he could hold Shchekin liable for all of the alleged fraud. But most courts "have rejected the continuing fraudulent scheme theory," U.S. District Judge John Z. Lee explained.

Agreeing with the majority approach, Lee ruled that the statute of repose "bars Howe from relying on any misrepresentations or omissions in support of his claim that occurred before the filing of his initial complaint on Oct. 1, 2015."

As for alleged violations of Section 10(b) that weren't barred by the statute of repose, Lee concluded that Howe and a second plaintiff, D & D Auto Resort LLC, failed to satisfy the heightened pleading requirements imposed by the Private Securities Litigation Reform Act of 1995.

But he gave them a chance to try drafting a complaint that satisfies the Private Securities Litigation Reform Act and also avoids "puzzle pleading" — the situation where "plaintiffs abdicate their role of connecting representations to contradictions." *Howe v. Shchekin*, 15–CV–8675 (March 3, 2017).

Here are highlights of Lee's opinion (with omissions not noted in the text):

The parties agree that the "violation" that triggers Section 1658(b)'s limitations and repose periods is the date of a misrepresentation or omission made in connection with a sale that gives rise to a claim, rather than the date of the sale itself. The parties disagree, however, on how the repose period should apply to the facts of this case.

Here, plaintiffs filed suit initially on Oct. 1, 2015. Thus, the repose period would seem to bar Howe from relying on any misrepresentations or omissions that occurred prior to Oct. 1, 2010.

Seeking to avoid this result, Howe asks this court to apply a "continuing fraudulent scheme theory."

Some district courts outside of this circuit have applied such a theory to blunt the statute of repose where a plaintiff alleges a series of misrepresentation or omissions, some inside and some outside the repose period. In such circumstances, these courts have held that the statute of repose "runs from the date of the last alleged misrepresentation regarding related subject matter." *In re Beacon Associates Litigation*, 282 F.R.D. 315 (S.D.N.Y. 2012) (quoting *Plymouth County Retirement Association v. Schroeder*, 576 F.Supp.2d 360 (E.D.N.Y. 2008)).

Support for the theory, however, is tenuous. One court applying the theory has noted that "jurisdictions have arrived at varying and inconsistent results on this issue," *Plymouth*, 576 F.Supp.2d at 378, and the court has found scant reasoning that supports the theory.

A majority of courts across circuits, however, have rejected the continuing fraudulent scheme theory. *Carlucci v. Han*, 886 F.Supp.2d 497 (E.D. Va. 2012) (collecting cases). These courts have relied on two different arguments, both based on statements by the Supreme Court that undercut the theory.

First, to permit the repose period to run only from the date of the last misrepresentation in a series of misrepresentations would read into the statute a form of equitable tolling that preserves earlier misrepresentations. The Supreme Court, however, has held that a bar virtually equivalent to Section 1658(b)(2) is not subject to equitable tolling. *Lampf v. Gilbertson*, 501 U.S. 350 (1991).

Additionally, the Supreme Court has elsewhere characterized Section 1658(b)(2) as "unqualified" and "giving defendants total repose after five years." *Merck v. Reynolds*, 559 U.S. 633 (2010). The Supreme Court offered this characterization in order to defuse concerns that predicating the running of the statute of limitations in Section 1658(b)(1) upon a reasonable investor's discovery of pertinent facts would permit "stale claims."

The court agrees with the reasoning of *Carlucci* and similar cases and concludes that reading the continuing fraudulent scheme theory into Section 1658(b)(2) would unjustifiably qualify the repose period and permit stale claims.

Applying the statute of repose to Howe's claim in [C]ount 1, Section 1658(b)(2) bars Howe from relying on any misrepresentations or omissions in support of his claim that occurred before the filing of his initial complaint on Oct. 1, 2015.

Howe's complaint identifies various misrepresentations and omissions that predate Oct. 1, 2010. Thus, the complaint establishes everything necessary for the repose period to apply as a matter of law.

Howe's claim in [C]ount 1 is therefore dismissed with prejudice to the extent it relies on misrepresentations or omissions that predate Oct. 1, 2010.

Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act

Shchekin then moves to dismiss any remaining claims under Count 1, arguing that plaintiffs' remaining pleadings do not satisfy the heightened pleading requirements applicable to such claims under Rule 9(b) and the Private Securities Litigation Reform Act.

Section 10(b) of the Securities and Exchange Act prohibits the use or employ, in connection with the purchase or sale of any security, of any manipulative or deceptive device or contrivance in contravention of

such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.

The SEC in turn promulgated Section 10b-5, which forbids making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading in connection with the purchase or sale of any security.

The basic elements of a Section 10b-5 claim are: (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.

As a general matter, Section 10b-5 claims sound in fraud and are therefore subject to the heightened pleading requirements of Rule 9(b). Thus, the complaint must state with particularity the circumstances of the purported fraud. These circumstances include the identity of the party who made the alleged misrepresentation, the time, place and content of the misrepresentation and the method of communication of the purported misrepresentation.

But the PSLRA goes beyond Rule 9(b), imposing even more demanding requirements on Section 10b-5 claims. In particular, the PSLRA instructs that "the complaint shall specify each statement alleged to have been misleading" and "the reason or reasons why the statement is misleading." 15 U.S.C. Section 78u–4(b)(1).

Additionally, the complaint must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." Section 78u–4(b)(2)(A). If these requirements are not met, the court must, on defendant's motion, dismiss the complaint. Section 78u–4(b)(3)(A).

Removing the repose-barred misrepresentations and omissions from [p]laintiffs' complaint, there appear to be only four remaining bases for Howe's Section 10b-5 claim: (1) "Shchekin never presented or delivered to Howe a prospectus for his investment in ReadOz"; (2) "Shchekin knowingly sold securities to an unaccredited investor, Howe"; (3) "Shchekin sold unregistered securities to Howe"; and (4) "Shchekin failed to advise Howe that ReadOz could only accept investments over $50,000."

These remaining allegations are deficient under the PSLRA in a number of different ways.

As an initial matter, Shchekin's purported actions are just that: actions. They are not false statements of fact or omissions of material facts that render statements misleading.

Construed most charitably, Howe identifies three incidents that could constitute omissions: Shchekin failed to tell Howe that investment units in ReadOz were only available to accredited investors, failed to inform Howe that the investment units were unregistered and failed to advise Howe of the $50,000 investment threshold.

Howe, however, does not allege with particularity why these omissions are misleading; he has not identified any particular statements that Shchekin made and coupled them with specific, contradictory information known to Shchekin that rendered his statements misleading.

Perhaps Howe's hope was that the [c]ourt would draw a connection between Shchekin's alleged "omissions" and Shchekin's purported statements in ReadOz's 2008 Regulation D filing. But Howe does not plead this connection himself, as the PSLRA requires him to do. *Alizadeh v. Tellabs*, No. 13 C 537 (N.D. Ill. June 16, 2014) (discouraging "puzzle pleading" in which plaintiffs abdicate their role of connecting representations to contradictions).

An additional failing in Howe's pleading is his conclusory allegations of scienter.

Howe's conclusory allegations of scienter — that "Shchekin intentionally made the misrepresentations and omissions of material facts in order to convince Howe to invest in ReadOz" — are insufficient to satisfy the PSLRA.

For these reasons, Shchekin's motion to dismiss what remains of Howe's Section 10b-5 claim is granted.

Given that [p]laintiffs have only amended their complaint once (on their own accord without a ruling from this [c]ourt), and mindful of the demanding pleading standards of the PSLRA, the dismissal is without prejudice.