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What Does *Merck & Co. v. Reynolds* Mean for the Future of the Statute of Limitations Defense in Securities Fraud Litigation?

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Last week, the Supreme Court, in *Merck & Co. v. Reynolds*,[1] sharply curtailed the utility of the statute of limitations defense in private securities litigation under §10(b) of the Securities Exchange Act of 1934 by holding that the two-year limitations period under 28 U.S.C. §1658(b)(1) commences when the plaintiff actually discovers "the facts constituting the violation" or when a "reasonably diligent plaintiff" would have discovered those facts, whichever comes first. Among the facts that must either be discovered or discoverable for a plaintiff's claim to accrue is whether the defendant acted with scienter—the intent to defraud—a requirement that will likely make it more difficult for defendants to assert the statute of limitations defense in most cases. Contrary to the rule previously followed in many jurisdictions, mere "inquiry notice"—the point at which available information would lead a reasonably diligent plaintiff to begin investigating a potential claim—is not sufficient to start the running of the two-year limitations period. One piece of good news for defendants is that the opinion appears to reinforce the stringency of the requirement to plead facts that support "a strong inference" of scienter with particularity under the Private Securities Litigation Reform Act of 1995 (PSLRA).[2]

The *Merck* Opinion

Enacted as part of the Sarbanes-Oxley package of reforms in 2002, 28 U.S.C. §1658(b)(1) requires that complaints by private plaintiffs that claim fraud, manipulation, deceit, or contrivance under the Securities Exchange Act of 1934 be filed no later than the earlier of "two years after the discovery of the facts constituting the violation" or "five years after such violation." In *Merck*, the plaintiffs filed a securities fraud class action complaint in 2003, alleging that Merck had misled investors about the drug Vioxx's safety and commercial viability. Merck moved to dismiss, asserting that the claim was barred by the two-year statute of limitations because the plaintiffs had been put on notice of their potential claim more than two years earlier by a publicly available "warning letter" from the FDA to Merck that described Vioxx's marketing as "false, lacking fair balance, or otherwise misleading" in light of conflicting views within the industry about whether Vioxx increased heart attack risk and pleadings in products liability lawsuits that accused Merck of concealing material facts concerning

the dangers of Vioxx.[3] Agreeing with Merck, the District Court dismissed the complaint on the ground that the plaintiffs should have been aware of the *possibility* of Merck's alleged misrepresentations more than two years before they filed their complaint, thus placing them on "inquiry notice" of the need to investigate their potential claim.[4] On appeal, the Third Circuit reversed, holding that the availability of information regarding a potential misrepresentation more than two years before the plaintiffs filed their complaint did not commence the running of the statute of limitations. The Third Circuit held that this information may have constituted "storm warnings," but did not suggest that Merck acted with scienter, a necessary element under §10(b), and therefore did not put the plaintiffs on inquiry notice of a potential §10(b) violation.[5]

In an opinion by Justice Breyer, the Supreme Court affirmed the Third Circuit's decision that the complaint against Merck was timely.[6] The Court first noted the extent of disagreement among the lower courts as to when §10(b) claims accrue.[7] The Eleventh Circuit, for example, had held that the statute of limitations begins to run when the plaintiff is put on inquiry notice of the need to investigate.[8] The rule in the Second Circuit, by contrast, commenced the limitations period upon either inquiry notice if the plaintiff does not investigate, or if the plaintiff does investigate, once that investigation should have revealed the fraud.[9] In yet another variation, the Sixth Circuit had held that the statute always runs from when a plaintiff should have discovered the facts constituting the violation after receiving inquiry notice.[10]

In affirming the Third Circuit's decision, the Court articulated three essential principles for applying §1658(b)(1) to securities fraud claims:

(1) A plaintiff's claim accrues, and the two-year clock begins to run, either when the plaintiff actually discovers "the facts constituting the violation" or when a "reasonably diligent plaintiff" would have discovered such facts, "whichever comes first." The Court concluded that allowing constructive discovery (the "reasonably diligent plaintiff" standard) was consistent with the statute's language, which was modeled on language used in prior cases that recognized constructive discovery.[11]

(2) In addition to the existence of a material misrepresentation or omission, the "facts constituting the violation" include the "important and necessary element" of scienter. The Court reasoned that, because the PSLRA requires a plaintiff to allege facts supporting "a strong inference" of scienter to survive a motion to dismiss, it "would frustrate the very purpose of the discovery rule in this provision . . . if the limitations period began to run regardless of whether the plaintiff had discovered any facts suggesting scienter." The Court expressly reserved the question of whether the "facts constituting the violation" include the elements of reasonable reliance, loss causation, and damages.[12]

(3) "Inquiry notice"—*i.e.*, notice of facts that would lead a reasonably diligent plaintiff to investigate further—does *not* start the two-year clock. The Court observed that the point in time at which a plaintiff is placed on inquiry notice does not necessarily coincide with when a reasonably diligent plaintiff would have discovered "facts constituting the violation," as required by the statute.[13]

In light of these principles, the Court concluded that the complaint against Merck was timely

because publicly available information—the FDA warning letter and assertions in products liability complaints—showed "little or nothing about the here-relevant scienter," because that information did not suggest that Merck knew at the time it made the statements at issue that those statements were false.[14]

What *Merck* Means for Private Securities Fraud Litigation

The *Merck* decision is likely to affect private securities fraud litigation in a number of ways, most of which will benefit plaintiffs.

First, the number of §10(b) complaints dismissed under the two-year statute of limitations will likely fall. Under the inquiry notice standard that previously applied in many jurisdictions, defendants could at times prevail by pointing to earlier public disclosures that presaged the plaintiff's claim, but which did not necessarily reveal facts indicative of fraudulent intent. Because public evidence suggesting that a defendant may have acted with scienter often does not emerge until much later in time (if at all), *Merck*'s effect in such cases will be to postpone the accrual of plaintiffs' claims, bringing more claims safely within the two-year limitations period. As a result, the two-year statute of limitations may become a less powerful defense because it will often be more difficult for a defendant to show that enough of the facts alleged by the plaintiff in support of scienter were either known to the plaintiff or publicly available more than two years before the complaint was filed.

Second, in cases where the statute of limitations arguably applies, the battle lines will largely be drawn around the issue of when a reasonably diligent plaintiff would have pieced together sufficient evidence to support a strong inference of scienter. In that regard, the Court noted that "inquiry notice"—defined by Merck as "the point 'at which a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct further inquiry'"—may still be relevant in determining when a reasonably diligent plaintiff should have begun to investigate and thereby discovered the facts constituting the violation.[15] Cases cited by the Court indicate that this inquiry will be fact-specific and focus on whether and when the information alleged in support of scienter was reasonably accessible to the plaintiff.[16]

Third, by requiring evidence of scienter to be at least discoverable to start the two-year clock, *Merck* may diminish the incentive for some plaintiffs to investigate their potential claims and file suit promptly. This is particularly true in the Second Circuit, where the statute of limitations previously commenced at the point of inquiry notice for plaintiffs who did not thereafter promptly investigate their potential claims. A delay in filing complaints may result in the litigation of more stale claims, which could lead to higher defense costs due to the proliferation of discoverable documents over time and the difficulty of reconstructing events that occurred years earlier. The five-year statute of repose under 28 U.S.C. §1658(b)(2) will provide at least some protection against claims that are based on events more than five years old.

Fourth, with the luxury of time on their side, plaintiffs may intentionally delay filing complaints if they believe that a target company's stock price is likely to decline further. Doing so would permit

plaintiffs to argue that they incurred bigger losses and should therefore receive larger settlements or damage awards. While it may be difficult for plaintiffs in such cases to prove that their losses are entirely due to the alleged fraud, defendants may nevertheless feel more pressure to settle weak claims due to the threat of increased exposure.

Fifth, the silver lining of *Merck* for defendants is that the Court reinforced the principle that the PSLRA sets a high bar for pleading with particularity facts that give rise to a strong inference that the defendant acted with fraudulent intent. In particular, the Court noted that scienter may not be inferred simply from the existence of a materially misleading statement, pointing to "an incorrect prediction about a firm's future earnings" as one example that would not by itself support a strong inference of scienter.[17] The Court also held that the warning letters from the FDA and products liability lawsuits claiming that Merck misled the public about the dangers of Vioxx were *insufficient* to reveal the facts indicating scienter "whether viewed separately or together."[18] That ruling should give ammunition to defendants when they are confronted with complaints describing uncertainty or debate about the subject matter of a securities fraud claim to argue that such allegations, without more, do not satisfy the strong inference pleading requirement of the PSLRA.

[1] No. 08-95 (U.S. Apr. 27, 2010) ("Slip Op.").

[2] 15 U.S.C. §78u-4(b)(2) (requiring plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

[3] Slip Op. at 4-5.

[4] *In re Merck & Co. Sec., Deriv. & "ERISA" Litig.*, 483 F. Supp. 2d 407, 423 (D.N.J. 2007).

[5] *In re Merck & Co. Sec., Deriv. & "ERISA" Litig.*, 543 F.3d 150, 172 (3d Cir. 2008).

[6] Justice Stevens filed an opinion concurring in part and concurring in the judgment, and Justice Scalia filed an opinion concurring in part and concurring in the judgment, which Justice Thomas joined.

[7] Slip Op. at 7-8.

[8] *See Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001).

[9] *See Shah v. Meeker*, 435 F.3d 244, 249 (2d Cir. 2006).

[10] *See New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F. 3d 495, 501 (6th Cir. 2003).

[11] Slip Op. at 8-12.

[12] Slip Op. at 12-13.

[13] Slip Op. at 14-17.

[14] Slip Op. at 17-18.

[15] Slip Op. at 16 ("The limitations period puts plaintiffs who fail to investigate once on 'inquiry notice' at a disadvantage because it lapses two years after a reasonably diligent plaintiff would have discovered the necessary facts.").

[16] *See, e.g., Rothman v. Gregor*, 220 F.3d 81, 97 (2d Cir. 2000).

[17] Slip Op. at 14.

[18] Slip Op. at 18-19.

Authors

Andrew B. Weissman

RETIRED PARTNER

+1 202 663 6000

Andrea J. Robinson

RETIRED PARTNER

+1 617 526 6000

Christopher Davies

PARTNER

Vice Chair, Securities & Financial Services Department

christopher.davies@wilmerhale.com

+1 202 663 6187