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SUPREME COURT TO REVIEW STATUTE OF LIMITATIONS ISSUES IN FEDERAL SECURITIES CASES

On May 26, 2009 the Supreme Court of the United States granted *certiorari* to review *Merck & Co., et al.* v. *Reynolds*, No. 08-905, a matter concerning federal securities claims against Merck arising from Merck's representations about its pain reliever VIOXX. The United States District Court for the District of New Jersey had dismissed the claims as time-barred, but the Third Circuit reversed, concluding there was not a sufficient basis to conclude the action was untimely as a matter of law. The Supreme Court review of the Third Circuit's reinstatement of the claims presents an opportunity for much-needed clarity and uniformity in the application of the statute of limitations to federal securities claims.

THE STATUTE OF LIMITATIONS IN FEDERAL SECURITIES CASES

In the Sarbanes-Oxley Act of 2002, Congress established a limitations period for securities claims alleging a "fraud, deceit, manipulation or contrivance" language that includes claims under section 10(b) of the Securities Exchange Act of 1934. Such claims are untimely unless brought "not later than the earlier of…two years after the discovery of the facts constituting the violation; or…five years after such violation." 28 U.S.C. § 1658(b).[1]

Considerable controversy surrounds the seven words "discovery of the facts constituting the violation." All courts accept, at least in theory, the notion that the plaintiff may be deemed to have discovered "the facts" even if the plaintiff claims ignorance until just before a complaint was filed. Typically, courts ask whether there were "storm warnings" of the existence of a potential claim and whether investors were placed on "inquiry notice" of a claim before the complaint was filed. Under some circumstances, courts will impute "discovery" to the plaintiff before the complaint was filed and determine timeliness of the suit based on that imputation.

Application of these concepts, however, is anything but simple and straightforward. The issues that arise include the following:

- Do publicized accusations against a company amount to "storm warnings," even if they are denied by the company involved?
- Do "storm warnings" alone start the limitations period running, or is the limitations period further postponed to allow further time for investigation by the plaintiff?
- Does it matter whether the plaintiff actually engages in an investigation?
- How receptive should courts be to resolving limitations issues at the motion to

1 Non-fraud claims, such as those under Section 11 of the Securities Exchange Act of 1933 are subject to the shorter limitations period established by pre-Sarbanes-Oxley law: one year from the time of "discovery" but in no event later than three years after the public offering or sale of the security.

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dismiss stage, as opposed to deferring them until summary judgment or trial itself?

Courts in different circuits, and even different panels within the *same* circuit, have in practice given divergent answers to these questions.

THE FEDERAL SECURITIES CLAIMS AGAINST MERCK

Merck announced in September 2004 that it was withdrawing VIOXX from the market. However, beginning years earlier, there was well-publicized debate about the safety of VIOXX. According to the pleadings filed by the parties: (a) in August 2001 an article in the *Journal of the American Medical Association* stated that VIOXX "might lead to increased cardiovascular risks," and (b) in September 2001 the "FDA [US Food and Drug Administration] posted on its website a warning letter…sent to Merck…regarding its marketing and promotion of VIOXX."[2]

The first VIOXX-related securities class action against Merck was filed in November 2003. That case and follow-on suits were sent by the Judicial Panel on Multidistrict Litigation to the District of New Jersey. The pleadings charged that Merck had made misrepresentations with respect to VIOXX since the drug had been introduced in May 1999, thereby (allegedly) inflating the market price of Merck securities.

THE DISTRICT COURT'S DECISION

The District Court held that the claims against Merck were time-barred, reasoning that investors had been placed on "inquiry notice" of claims in 2001, more than two years before the first federal securities case was filed. The District Court relied on the following events to establish "inquiry notice":

- The FDA's September 2001 warning letter alleging misrepresentation of VIOXX's safety profile.
- Numerous articles in mainstream news publications over the next two weeks about VIOXX safety, particularly an October 2001 *New York Times* article attributing to the President of Merck's research laboratory, a statement that acknowledged the possibility that VIOXX could increase a user's risk of a heart attack—a statement that the District Court termed "a significant departure" from Merck's prior statements about VIOXX safety.[3]
- The contemporaneous filings of product liability suits and consumer fraud cases against Merck alleging misrepresentation about VIOXX risks.

The District Court described this "torrent of publicity" as being "more akin to thunder, lightning and pouring rain than subtle warnings of a coming storm."[4] The District Court rejected plaintiff's argument that Merck's subsequent statements defending the product after the FDA warning letter should overcome the storm warnings and delay the running of the limitations period.

THE THIRD CIRCUIT'S DECISION

A divided panel of the Third Circuit reversed. In the opinion of the panel majority, none of the events cited by the District Court, either singly or in combination, were sufficient to establish "inquiry notice" because, in the opinion of the panel majority, these events were insufficient to show that Merck did not hold "in earnest" Merck's publicly-expressed opinions and beliefs in VIOXX safety. In so holding, the panel majority required some indication of scienter before "inquiry notice" could be established. The majority cited the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 and attempted to justify its result on the basis of concern that "too broad an interpretation of inquiry notice" would "open the flood gates to a rush of premature securities litigation."

In concluding that "inquiry notice" had not been established, the panel majority also relied heavily on Merck's defensive statements about VIOXX safety during the period of publicized controversy, the fact that some analysts covering Merck's securities maintained "buy" or "hold" ratings for Merck's stock during the period of public controversy, and the fact that the decline in Merck stock following the FDA warning letter in September 2001 was, in the panel majority's view, relatively modest.

POTENTIAL FOR THE SUPREME COURT'S CLARIFICATION

Merck's petition for *certiorari* stated the question presented as follows:

> Did the Third Circuit err in holding…that under the "inquiry notice" standard applicable to federal securities fraud claims, the statute of limitations does not begin to run

2 Complaint ¶¶ 153, 157.

3 483 F.Supp.2d at 420.

4 483 F. Supp. 2d at 423.

until an investor receives evidence of scienter without the benefit of any investigation.

This framing of the question would permit the Court to address the possible interplay between heightened pleading requirements that have been addressed by other recent Supreme Court decisions. The Supreme Court has specifically directed in securities cases that the elements of loss causation[5] and scienter[6] should be addressed at the pleading stage. More generally, the Court recently held in *Bell Atlantic Corp.* v. *Twombly*, 550 US 544 (2007) that claims should be subjected to a plausibility determination at the pleading stage and the Court's further decision earlier this term in *Ashcroft* v. *Iqbal*, 556 US ___ (May 18, 2009) reinforces *Twombly* and makes clear that the requirement for plausibility determination at the pleading stage applies to *all* claims. If pleading requirements for a securities fraud complaint have now been strengthened, how, if at all, is the inquiry notice concept affected?

In addition, the *Merck* case gives the Supreme Court an opportunity to clarify practical application of the "storm warnings" and the "inquiry notice" concepts. The District Court assumed that once sufficient "storm warnings" appeared, a reasonable investor would have cause to investigate; the statute of limitations would start to run immediately, giving the investor a two-year time frame to complete investigation and frame a securities fraud complaint. By contrast, the Third Circuit panel majority appears to have contemplated that the statute would not even *begin* to run until public information emerged about all elements of a securities fraud claim, including loss causation and scienter.

Circuit courts, and even different panels within the *same* circuit, are in conflict on these issues. Decisions in five circuits (the Second, Fourth, Fifth, Eighth, and Eleventh) follow some variant of the District Court's approach, under which the statute of limitations clock starts when "storm warnings" appear.[7]

5 *Dura Pharmaceuticals* v. *Broudo*, 544 US 336 (2005).

6 *Tellabs, Inc.* v. *Makor Issues & Rights Ltd.*, 551 US 308 (2007).

7 *See,* e.g., *Franze* v. *Equitable Assurance,* 296 F.3d 1250, 1254-55 (11th Cir. 2009); *GO Computer, Inc.* v. *Microsoft Corp.*, 508 F.3d 170, 177 (4th Cir. 2007); *Shah* v. *Meeker,* 435 F.3d 244, 251 (2nd Cir. 2006); *Theoharous* v. *Fong*, 256 F.3d 1219, 1128 (11th Cir. 2001); *Great Rivers Coop* v. *Farmland Indus. Inc.,* 120 F.3d 893, 896, 899 (8th Cir. 1997); *Bodenhamer* v. *Shearson Lehman Hutton, Inc.*, 998 F.2d 1013 (5th Cir. 1993); *Brumbaugh* v. *Princeton Partners*, 985 F.2d 157, 162-634 (4th Cir. 1992); and *Jensen* v. *Snellings*, 841 F.2d 600, 600-07 (5th Cir. 1988).

A modification of that approach delays the starting of the limitations clock after "storm warnings" appear, to allow a plaintiff exercising reasonable diligence some additional time to discover the facts. Decisions in the First, Second, Sixth, Seventh, and Tenth circuits support this approach.[8]

The approach of the Third Circuit panel majority in *Merck*, which delays the start of the limitations clock even further, was espoused by the Ninth Circuit, prompting three Ninth Circuit judges, dissenting from the denial of an en banc hearing to comment, "here we are, out in left field again."[9]

Finally, the *Merck* case could provide guidance on how receptive district courts should be to resolving statute of limitations issues at the pleading stage. This is an issue of great importance to defendants, as deferring resolution until the later stages of the case deprives a defendant of the practical benefit of a successful limitations defense.

We hope that you have found this advisory useful. If you have additional questions, please contact your Arnold & Porter attorney or:

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8 *LC Capital Partners, LP* v. *Frontier Ins. Group, Inc.*, 318 F.3d 148, 154 (2nd Cir. 2003); *New Eng. Health Care Employees Pension Fund* v. *Ernst & Young LLP,* 336 F.3d 495, 501 (6th Cir. 2003); *Young & Lepone*, 305 F.2d 1, 8-10 (1st Cir. 2002); *Marks* v. *CDW Computer Ctrs.*, 122 F.3d 363, 367 (7th Cir. 1997); and *Sterlin* v. *Biomune Sys.*, 154 F.3d 1991 (10th Cir. 1998).

9 *Betz* v. *Trainer Wortham & Co.*, 519 F.3d 863, 865 (9th Cir. 2008)