ARNOLD & PORTER LLP

ADVISORY

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SUPREME COURT RESTRICTS STATUTE OF LIMITATIONS DEFENSE IN FEDERAL SECURITIES CASES

In its April 27, 2010 decision in *Merck & Co., et al* v. *Reynolds*, No. 08-905, the Supreme Court of the United States clarified the standard for determining whether the statute of limitations has run for federal securities claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Under the Sarbanes-Oxley Act of 2002, Congress established a limitations period that securities claims alleging a "fraud, deceit, manipulation or contrivance" must be 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). The Supreme Court accepted *certiorari* in the *Reynolds* case to address a split between circuit courts over how to interpret the phrase "discovery of the facts constituting the violation."

Writing for a unanimous Court, Justice Breyer wrote that

> a cause of action accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, "the facts constituting the violation"—whichever comes first. We also hold that the "facts constituting the violation" include the fact of scienter, "a mental state embracing intent to deceive, manipulate, or defraud."

Slip Op. at 1. The Supreme Court affirmed the Third Circuit decision in *In re Merck & Co. Securities, Derivative & "ERISA" Litig.*, 543 F.3d 150 (2008), which held that various suits filed by class action plaintiffs were timely because the events of which plaintiffs were aware (so called storm warnings) would not have alerted them of the possibility that defendants were acting with scienter. Before the April 27, 2010 decision, there was considerable division between appellate courts on the questions of when a claim accrues and whether plaintiffs were required to have notice that defendants acted with scienter.

BACKGROUND & THE DECISIONS BELOW

The *Reynolds* case arose from Merck's announcement in September 2004 that it was withdrawing Vioxx from the market. Beginning years earlier, there was well-publicized controversy about the safety of Vioxx. Notably, according to the complaint: (1) in March 2000, Merck released the results of a Vioxx study which noted that a small number of participants suffered heart attacks; (2) in August 2001 an article in the *Journal of the American Medical Association* reported on

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heart attack risks of Vioxx; and (3) in September 2001 the FDA released to the public a warning letter charging that Merck had misstated Vioxx's safety profile.

The first Vioxx-related securities class action against Merck was filed in November 2003. The plaintiffs 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 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 noted that the contemporaneous filing of product liability suits, the US Food and Drug Administration's (FDA's) September 2001 "warning letter," and numerous press articles constituted a "torrent of publicity…more akin to thunder, lightning and pouring rain than subtle warnings of a coming storm." 483 F. Supp. 2d at 423.

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. In concluding that "inquiry notice" had not been established, the panel majority also relied heavily on Merck's positive statements about Vioxx's 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.

THE SUPREME COURT DECISION

Justice Breyer's decision for the unanimous Supreme Court started its analysis by noting that both parties and the Solicitor General (on behalf of the United States) agreed that "discovery" encompassed both "actual discovery" by a plaintiff of facts as well as "the facts that a reasonably diligent plaintiff would have discovered." Op. at 8. The Court noted that while the statutory language did not speak to this issue, that this interpretation was consistent with judicial precedents at the time the Sarbanes-Oxley Act was adopted.[1]

The Court then turned to the primary issue on appeal—whether a plaintiff is required to discover facts of scienter. It started with the statutory language that the limitations period begins to run once there has been "discovery of the facts constituting the violation," and noted that scienter was both an element of a Section 10(b) violation. and can only be established through facts. The Court concluded that facts of scienter can be distinct from establishing that there has been a material misrepresentation because "an incorrect prediction…does not automatically tell us whether the speaker deliberately lied or just made an innocent (and therefore nonactionable) error." Slip Op. at 13-14.

In ruling in this manner, the Supreme Court expressly rejected decisions from several appellate courts that the statute of limitations would start to run from the time that plaintiffs were on "inquiry notice," meaning the "point at which a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct a further inquiry." Slip Op. at 14. The Court held that the statute expressly used the word "discovery" and noted that the point "where the facts would lead a reasonably diligent plaintiff to investigate further" was "not necessarily" the same point where a plaintiff would have "discovered facts showing scienter or other facts construing the violation." Slip Op. at 15. The Court wrote that "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when

1 Justice Scalia, joined by Justice Thomas, wrote a separate concurrence disagreeing with this aspect of the analysis, arguing that "discovery" should only encompass actual, rather than constructive discovery.

facts would have prompted a reasonably diligent plaintiff to begin investigating," but that the actual statute of limitations "does not begin to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation,' including scienter." Slip Op. at 17.

SIGNIFICANCE OF DECISION

While the Supreme Court's decision resolves considerable division between the appellate courts on the significance of "storm warnings," it leaves open one important issue: whether the "facts showing scienter" that will trigger the running of the statute of limitations need to be sufficient to meet the heightened statutory pleading requirement that plaintiffs in securities fraud cases plead "with particularity facts giving rise to a strong inference" of scienter. While Justice Breyer acknowledged the heightened pleading standard applicable to scienter allegations, he went on to state that it would "frustrate the very purpose of the discovery rule…if the limitations period began to run regardless of whether a plaintiff had discovered *any* facts suggesting scienter." Slip Op. at 13 (emphasis added). Accordingly, it is not clear from the decision whether a lesser standard governs the facts needed to start the limitations period than that required to meet the plaintiffs' pleading burden.

It is clear, however, that the decision substantially limits the utility of the statute of limitations as a defense at the early stages of a securities fraud case. Historically, assertion of a statute of limitations defense at the pleading stage was difficult, both because the statute of limitations is typically an affirmative defense (meaning that a defendant has the burden of proof at trial), and a plaintiff could often assert that there were factual disputes as to whether he or she had acted with reasonable diligence. The Supreme Court's holding that a claim does not accrue until a plaintiff discovered or should have discovered facts establishing scienter gives the plaintiffs' bar another argument that there were facts establishing a violation that could not have been known at an earlier time.

There is one other potentially worrisome aspect of the decision from a defense perspective. While the Court expressly did not address whether "discovery" means discovery of facts of all of the other elements of a securities fraud claim (such as reliance, loss, and loss causation), Slip Op. at 14, it is not clear how the reasoning of the decision would permit the Court to distinguish discovery of these elements from discovery of scienter. If the Supreme Court were to take the next step down this road and hold that a plaintiff's statute of limitations does not accrue until discovery that the plaintiff has incurred loss, that would give plaintiffs at least two years after a stock drop to bring suit; and if plaintiffs are able to argue that they could not discover evidence of scienter even after a stock drop, they would have even longer.

The Court's decision is striking for its unanimity, especially given the sharp divisions between the courts of appeals on the issues presented. It remains to be seen how restrictively, in practice, the lower courts will apply this new standard.

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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