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Merck & Co. v. Reynolds: Some Open Questions on Availability Of Statute of Limitations Defense in Federal Securities Cases

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In its April 27, 2010 decision in *Merck & Co., et al v. Reynolds*, No. 08-905, the Supreme Court significantly restricted the availability of the statute of limitations as a defense in 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.''

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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 consti-

> tuting 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 *Reynolds* 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. While the *Reynolds* decision has unquestionably limited the potentially utility of the statute of limitations as a defense in securities fraud claims, there remain several open questions as to how the Supreme Court's holding will be implemented by the lower courts. After setting out the background on the *Reynolds* case, this article discusses some of these open questions.

Background & The Decisions Below

The *Reynolds* case arose the well-publicized controversy about the safety of Vioxx, a prescription medication sold by Merck. 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 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 securities claims 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 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 Third Circuit decision deepened the split between appellate courts deciding when the statute of limitations begins to run under an inquiry notice standard. Some appellate courts held that the statute of limitations begins to run when there were ''storm warnings'' of possible fraud that would lead a reasonable investor to investigate. *See, e.g.*, *Franze v. Equitable Assurance*, 296 F.3d 1250, 1254-55 (11th Cir. 2002); *GO Computer, Inc. v. Microsoft Corp.*, 508 F.3d 170, 177 (4th Cir. 2007). Other appellate courts held that once a plaintiff was constructively or actually aware of possible fraud, the statute of limitations begins to run on the date the plaintiff, through exercising reasonable diligence, could have discovered the facts underlying the fraud. *See, e.g.*, *New England Health Care Employees Pension Fund v. Ernst & Young LLP*, 336 F.3d 495, 501 (6th Cir. 2003); *Young v. Lepone*, 305 F.3d 1, 8-10 (1st Cir. 2002). The Ninth Circuit took a third approach, holding that the statute of limitations does not begin to run until the plaintiff has specific evidence to establish the elements of a securities fraud claim. *See, e.g.*, *Betz v. Trainer Wortham & Co.*, 519 F.3d 863 (9th Cir. 2008).

The Supreme Court Reynolds 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 the term ''discovery'' in the Sarbanes-Oxley Act 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 principle 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 a fact and an element of a Section 10(b) violation. 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 the line of appellate decisions 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

[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.

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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 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 and Open Questions

It is clear that the *Reynolds* decision substantially limits the utility of the statute of limitations as a defense at the early stages of a securities fraud case. That said, the successful assertion of a statute of limitations defense at the pleading stage historically was difficult for defendants to achieve for several reasons:

- Because the statute of limitations is typically an affirmative defense (meaning that a defendant has the burden of proof at trial), many courts had held that the assertion of a statute of limitations defense in a motion to dismiss was premature. *See, e.g.*, *La Grasta v. First Union Secs., Inc.*, 358 F.3d 840, 848 (11th Cir. 2004); *Marks v. CDW Computer Cntrs., Inc.*, 122 F.3d 363, 367 (7th Cir. 1997).
- Outside of the rare circumstances when it was clear from the complaint that a claim was untimely, the assertion of a ''storm warnings'' argument typically required defendants to supplement the record with various public announcements to demonstrate that plaintiffs should have known of their right to file suit. Courts were divided on whether it was appropriate to consider such materials in considering a motion to dismiss. *Compare Staehr v. Hartford Fin. Serv.*, 547 F.3d 406 (2d Cir. 2008) (holding appropriate to take judicial notice of press coverage in assessment of ''storm warnings'') *with Cooperative de Ahorro y Credito Aquada v. Kidder, Peabody & Co.*, 993 F.2d 269 (1st Cir. 1993) (consideration of materials not attached to complaint in considering statute of limitations is inappropriate on motion to dismiss).
- Plaintiffs could often assert that there were factual disputes as to whether he or she had acted with reasonable diligence, or whether the time to discover the cause of action should be tolled under fraudulent concealment or equitable tolling principles. *See, e.g.*, *Ritchey v. Horner*, 244 F.3d 625 (8th Cir. 2001).

The Supreme Court's holding that a claim does not accrue until a plaintiff discovered or should have discovered facts establishing scienter makes it even more difficult to successfully assert a statute of limitations defense because it gives the plaintiffs' bar another argument that there were facts establishing a violation that could not have been known at an earlier time.

While the Supreme Court's decision resolves considerable division between the appellate courts on the significance of ''storm warnings,'' there are several significant open questions following the *Reynolds* decision.

First, the decision does not address what quantum of facts are necessary to constitute the ''facts showing scienter'' that will trigger the running of the statute of limitations. In particular, does the *Reynolds* decision mean that that the statute of limitations does not run until a plaintiff has evidence of some facts establishing that the defendants might have acted recklessly or with intent to commit fraud, or does the statute of limitations not begin to run until plaintiff has sufficient facts to satisfy the heightened pleading requirement required under the Private Securities Law Reform Act of 1995 (''PSLRA'')? Under the PSLRA, a plaintiff in a securities fraud case must plead ''with particularity facts giving rise to a strong inference'' of scienter.

While Justice Breyer acknowledges the heightened pleading standard applicable to scienter allegations, he goes 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 *Reynolds* decision whether a lesser standard governs the facts needed to start the limitations period than that required to meet the plaintiffs' pleading burden.

To the extent this issue was discussed by the appellate courts before the *Reynolds* decision, they suggest that they would take different approaches to this issue. For example, in the Third Circuit's decision in *Reynolds*, the court noted that the key inquiry is whether the ''plaintiff either was or should have been able, in the exercise of due diligence, to file an *adequately pled* securities fraud complaint,'' suggesting that a plaintiff must have discovered adequate facts to meet the heightened pleading standard, since the purpose of the statute of limitations was not to ''open the floodgates to a rush of premature securities litigation.'' [Op. at 22-23]. In contrast, the Ninth Circuit in *Betz* suggested that the inquiry is whether there was discovery of ''facts suggesting that the defendants consciously or deliberately and recklessly deceived [the plaintiff],'' that inquiry notice would be triggered by facts ''sufficiently probative of fraud,'' and noted that the statute of limitations ''may compel plaintiffs to file a suit based on skimpy facts.'' 519 F.3d at 868, 870-71.

Second, the *Reynolds* Court expressly left open the question whether ''discovery'' could mean that the statute of limitations does not begin to run until the plaintiff has discovered facts of other elements necessary to plead a securities fraud claim (such as reliance, loss, and loss causation). Slip Op. at 13-14. The Court did note that the Solicitor General, arguing as *amicus curiae*, suggested in its brief that these other elements ''are not naturally viewed as among the 'facts constituting the violation.' '' Slip Op. at 14 (quoting Brief for United States as *Amicus Curiae* 12 n.1). Such an argument could be made based on the semantic distinction that the ''elements'' necessary to state a cause of action are different than and supplemental to those necessary to establish a ''violation'' of Section 10(b) or Rule 10b-5; such an argument would certainly be consistent with the position of the U.S. Securities and Exchange Commission that it need not show investor loss, loss causation, or investor reliance to bring an enforcement action under Section 10(b). But it is not clear how the reasoning of the Supreme Court's decision would permit the Court to distinguish discovery of these elements from discovery of scienter.

In this regard, it is notable that both the Third Circuit decision in *Reynolds* and the Ninth Circuit decision in *Betz* contain language suggesting that discovery must be of each of the elements necessary to state a claim.

For example, as discussed earlier, the Third Circuit articulated the standard as whether the plaintiff has access to sufficient information to file an ''adequately pled securities fraud complaint,'' which suggests that a plaintiff must have the ability to discover sufficient facts to be able to plead reliance, loss, and loss causation. 543 F.3d at 164. Similarly, the *Betz* court articulated the question as one whether the plaintiff ''discovered that she had a claim against the defendants for securities fraud,'' in conjunction with citing a case ''listing the elements of a federal securities fraud claim.'' 519 F.3d at 867.

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 or loss causation, 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.

Finally, the Supreme Court did not squarely address the status of the extensive lower court case law construing the concept of ''inquiry notice.'' While the Court did reject Merck's position that the statute of limitations should necessarily start to run from ''the point where the facts would lead a reasonably diligent plaintiff to investigate further,'' the Court does suggest that ''terms such as 'inquiry notice' and 'storm warnings,' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating.'' Slip Op. at 15, 17. How the lower courts interpret these concepts is still open to question.

Conclusion

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.