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REPORT FROM WASHINGTON

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The Supreme Court Rejects "Inquiry Notice" as Trigger to Start Running the Statute of Limitations in Securities Fraud Cases

April 29, 2010

In its decision in *Merck & Co., Inc. v. Reynolds*, No. 08-905, issued on April 27, the United States Supreme Court set forth the standard under which lower courts should evaluate motions to dismiss securities fraud cases on statute of limitation grounds. In an opinion authored by Justice Breyer, the Court rejected the argument that the statute of limitations begins to run after a potential plaintiff is placed on "inquiry notice"—the point at which facts would lead a reasonably diligent plaintiff to investigate further. Instead, the Court held 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." Without addressing what other facts may fall within its scope, the Court also concluded scienter is among those "facts constituting the violation."

BACKGROUND

The *Reynolds* appeal relates to Merck & Co., Inc.'s ("Merck's") marketing of Vioxx, one of a class of anti-inflammatory medicines known as "COX-2 inhibitors." Vioxx shared the anti-inflammatory properties of drugs such as ibuprofen and naproxen, but did not carry the risk of gastrointestinal damage associated with those drugs. Merck sought to capitalize on this by emphasizing the drug's safety and its commercial prospects through press releases and other public statements.

Beginning in January 1999, Merck performed a study to compare the effectiveness of Vioxx to that of naproxen, which ultimately showed that users taking Vioxx had a higher incidence of heart attack than users of naproxen. Although it is alleged that Merck did not perform any studies to verify its theory, Merck hypothesized that naproxen decreased the risk of heart attack ("naproxen hypothesis"), not that Vioxx increased the risk of heart attack. Merck therefore did not disclose warnings concerning an increased risk of heart attack associated with Vioxx.

On October 30, 2003, *The Wall Street Journal* published an article addressing a Harvard-affiliated Brigham and Women's Hospital in Boston study ("Harvard Study"), which had found an increased risk of heart attack in patients taking Vioxx compared with patients taking either Celebrex or a placebo. On September 30, 2004, Merck withdrew Vioxx from the market.

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Beginning on November 6, 2003, various plaintiffs, including Respondent Richard Reynolds, sued Merck in federal district courts throughout the country, claiming, *inter alia*, that the company had violated Section 10(b) of the Securities and Exchange Act of 1934. Merck moved to dismiss plaintiffs' securities fraud claim on the ground that it was time-barred because plaintiffs were on inquiry notice of the claim before November 6, 2001, more than two years prior to the filing of their initial complaints. Judge Stanley Chesler of the District Court of New Jersey granted Merck's motion to dismiss on the basis that the claim was time-barred. The court found that "sufficient storm warning" had put plaintiffs on inquiry notice more than two years before the filing of Respondents' complaints.

On appeal, the Third Circuit reversed the District Court's dismissal and remanded, holding that the District Court "acted prematurely in finding as a matter of law that [Respondents] were on inquiry notice of the alleged fraud before October 9, 2001." The Third Circuit found that Respondents did not have sufficient notice that Merck did not believe in the naproxen hypothesis, and that its marketing and representations relating to Vioxx were fraudulent, until the subsequent Harvard Study.

The Third Circuit's decision reversing the District Court's dismissal was not surprising given the Circuit's past decisions on the issue. *See, e.g., Benak v. Alliance Capital Mgmt, L.P.*, 435 F.3d 396, 400 (3d Cir. 2006) (noting that the "inquiry notice" analysis is premised on "the assumption that a plaintiff either was or should have been able, in the exercise of reasonable diligence, to file an adequately pled securities fraud complaint"). The Ninth Circuit has also interpreted inquiry notice narrowly, requiring potential plaintiffs to be aware of evidence of scienter before the two-year period of limitations begins to run. *See Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 869 (9th Cir. 2008) (cert. petition pending). Other Courts of Appeal, however, have found sufficient notice to putative plaintiffs when they possess sufficient information, or such information is otherwise in the public domain, to cause a reasonable investor to suspect the *possibility* that the defendant has engaged in securities fraud. *See, e.g., Great Rivers Coop. Of S.E. Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, 896 (8th Cir. 1997); *Law v. Medco Research, Inc.*, 113 F.3d 781, 785 (7th Cir. 1997); *Howard v. Haddad*, 962 F.2d 328, 330 (4th Cir. 1992) (Powell, J.); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1996 (10th Cir. 1998); *Jensen v. Snellings*, 841 F.2d 600, 607 (5th Cir. 1988). Under the Second Circuit's standard, "[i]nquiry notice gives rise to a duty of inquiry 'when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded.'" *Lentell v. Merrill Lynch & Co. Inc.*, 396 F. 3d 151, 168 (2d Cir. 2005).

At the November 30 oral argument, Merck principally argued that, under the statute, it is sufficient for a plaintiff who suspects the possibility of wrongdoing to be on inquiry notice, requiring the plaintiff to exercise reasonable diligence in investigating his or her potential claim. Respondents, on the other hand, argued that the Court should apply the "normal and well-established meaning" of the word "discovery," *i.e.*, that the statute of limitations should begin to run only when plaintiffs actually discovered fraud. Finally, the United States argued that the statute's two-year limitations period begins to run only after the plaintiff discovers or should have discovered facts demonstrating that all elements of a securities-fraud violation can be established, including scienter.

SUMMARY OF THE DECISION

In its opinion, written by Justice Breyer and joined by Justices Kennedy, Ginsburg, Alito, and Sotomayor, the Supreme Court held 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."

The Court began by addressing whether "discovery," as used in the statute, refers only to actual discovery, or whether it also covers facts that a reasonably diligent plaintiff would have discovered. Though noting that it is not "obvious" that the statute's language incorporates constructive discovery, the Court held that the language covers both actual and constructive discovery "[g]iven the history and precedent surrounding the use of the word 'discovery' in the limitations context generally as well as in this provision in particular . . . ." Agreeing with the parties and the Government, the Court concluded: "Congress intended courts to interpret the word 'discovery' in § 1658(b)(1)" similar to the manner in which "treatise writers now describe 'the discovery rule' as allowing a claim 'to accrue when the litigant first knows *or with due diligence should know* facts that will form the basis for an action.'"

"It would therefore frustrate the very purpose of the discovery rule in this provision . . . if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter."

OPINION OF THE COURT

Turning next to Merck's arguments, the Court rejected its contention that Respondents' claims here accrued before November 6, 2001.

First, the Court disagreed with Merck's position that the statute does not require "discovery" of scienter-related "facts." Reasoning that a "plaintiff cannot recover without proving that a defendant made a material misstatement *with an intent to deceive*," the Court found that "facts showing scienter are among those that 'constitute[e] the violation.'" The Court observed: "It would therefore frustrate the very purpose of the discovery rule in this provision . . . if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter."

Second, the Court dismissed Merck's argument that facts tending to show a materially false or misleading statement are also ordinarily sufficient to show scienter. By way of example, the Court noted that: "an incorrect prediction about a firm's future earnings, by itself, does not automatically tell us whether the speaker deliberately lied or just made an innocent . . . error."

"If the term 'inquiry notice' refers to the point where the facts would lead a reasonably diligent plaintiff to investigate further, that point is not necessarily the point at which the plaintiff would already have discovered facts showing scienter or other 'facts constituting the violation.'"

OPINION OF THE COURT

Third, the Court rejected Merck's claim that the statute of limitations began prior to November 2001 because Respondents were on "inquiry notice." According to the Court, "[i]f the term 'inquiry notice' refers to the point where the facts would lead a reasonably diligent plaintiff to investigate further, that point is not necessarily the point at which the plaintiff would already have discovered facts showing scienter or other 'facts constituting the violation.'" Although "terms such as 'inquiry notice' and 'storm warnings' may be useful," the Court reiterated that "the limitations period does not being to run until the plaintiff thereafter discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation' . . . ."

Finally, the Court disagreed with Merck's contention that the record demonstrated that Respondents had discovered or should have discovered "the facts constituting the violation." According to the Court, the record failed to demonstrate any "facts" indicating scienter prior to November 2001.

Justice Scalia authored an opinion, joined by Justice Thomas, concurring in part and concurring in the judgment. Justice Scalia agreed with the Court both "that scienter is

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JUSTICE SCALIA, concurring

among the 'facts constituting the violation' that a plaintiff must 'discove[r]' for the limitations period to begin," and that Respondents' suit is timely. Justice Scalia, however, disagreed that "discovery" embodies both actual and constructive discovery because the "natural" reading of the statute implicates only actual discovery. "Even assuming that Congress intended to incorporate the Circuits' views" by including constructive discovery in the definition of "discovery," he warned, "Congress's collective intent (if such a thing even exists) cannot trump the text it enacts . . . ." Accordingly, Justice Scalia "would hold that only actual discovery suffices to start the limitations period for §10(b) claims."

Justice Stevens authored his own opinion concurring in part and concurring in judgment. Justice Stevens stated: "the Court's explanation of why the complaint was timely filed is convincing and correct." However, he would have reserved judgment as to whether "discovery" includes both actual and constructive discovery until the Court were faced with a case in which the differences between the time of actual discovery and time of constructive discovery affected the outcome of the case.

IMPLICATIONS

The Court's decision in *Reynolds* is significant in that it has resolved a circuit split concerning the proper standard lower courts should apply in evaluating whether securities fraud claims are time-barred. Counsel will need to examine potential statute of limitations defenses in existing and future securities fraud litigation in light of the Court's articulated standard. Furthermore, although the Court's decision is on its face limited to securities fraud claims, plaintiffs may try to argue that the Court's standard should apply in other contexts.

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