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United States Supreme Court Clarifies Statute Of Limitations For Private Securities Fraud Actions

In *Merck & Co. v. Reynolds*, No. 08-905, 2010 U.S. LEXIS 3671 (Apr. 27, 2010), the Supreme Court of the United States held that a private securities fraud claim accrues for statute of limitations purposes at the earlier of when (1) the plaintiff does in fact discover, or (2) a reasonably diligent plaintiff would have discovered, "the facts constituting the violation." The Supreme Court held further that "facts constituting the violation" include the "fact" of defendants' scienter, *i.e.*, "a mental state embracing intent to deceive, manipulate, or defraud." This unanimous clarification by the Supreme Court of the how lower courts should apply the statute of limitations for private securities fraud claims provides a bit more breathing room for would-be plaintiffs.

On November 6, 2003, investors in Merck filed a class action alleging that Merck violated of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder, by knowingly misrepresenting the heart attack risks associated with its pain-killing drug Vioxx (leading to economic losses when the risks later became apparent). According to the applicable statute of limitations (*see* 28 U.S.C. § 1658(b)), a securities fraud claim is timely if it is filed no more than "2 years after the discovery of the facts constituting the violation" or "5 years after such violation." Therefore, the "critical date" for timeliness purposes in this action was November 6, 2001, two years before the complaint was filed. Merck argued that before this date the plaintiffs had (or should have) discovered the "facts constituting the violation." If so, by the time the plaintiffs filed their complaint, the two-year limitations period had run. On the other hand, the plaintiffs argued that they had not, and could not have, discovered by the critical date those "facts," particularly not the facts related to scienter, and that their complaint was timely.

The relevant pre-"critical date" facts are as follows:

- In the mid-1990s Merck developed Vioxx. In 1999 the Food and Drug Administration ("FDA") approved it for prescription use.

- In March 2000, Merck announced the results of the "VIGOR" study. The study compared Vioxx with another painkiller, Naproxen. The study revealed that approximately four out of every 1,000

participants who took Vioxx suffered heart attacks, compared to only one per 1,000 participants who took Naproxen. Merck's press release acknowledged VIGOR's adverse cardiovascular data but suggested the discrepancy might be due to the absence of a benefit conferred by Naproxen rather than a harm caused by Vioxx — which later became known as the "Naproxen hypothesis."

- From May 2001 through October 2001, groups of plaintiffs filed products liability lawsuits alleging that Merck had concealed information about Vioxx and intentionally downplayed its cardiovascular risks.

- The FDA sent Merck a warning letter released to the public on September 21, 2001 stating that with respect to cardiovascular risks, Merck's Vioxx marketing was "false, lacking in fair balance, or otherwise misleading." At the same time, the FDA acknowledged that the Naproxen hypothesis was a "possible explanation" of the VIGOR results. However, it found that Merck's "promotional campaign selectively present[ed]" that hypothesis without adequately acknowledging "another reasonable explanation," namely, that Vioxx may have adverse cardio-vascular properties.

- On October 9, 2001, *The New York Times* published an article stating that Merck had reexamined its own data and "found no evidence that Vioxx increased the risk of heart attacks." It quoted the president of Merck Research Laboratories as positing "two possible interpretations": "Naproxen lowers the heart attack rate, or Vioxx raises it." Stock analysts, while reporting the warning letter, also noted that the FDA had not denied that the Naproxen hypothesis remained an unproven but possible explanation.

Plaintiffs alleged that Merck had defrauded investors by promoting the Naproxen hypothesis while knowing it was false. Merck, believing that plaintiffs knew or should have known the "facts constituting the violation" at least two years earlier, moved to dismiss it as time-barred. The United States District Court for the District of New Jersey granted the motion to dismiss, holding that the VIGOR study, the FDA warning letter and Merck's response should have alerted the plaintiffs to a "possibility that Merck had knowingly misrepresented material facts," thus placing plaintiffs on "inquiry notice" of a securities fraud claim as of the date of Merck's response, October 9, 2001. Finding that the plaintiffs had failed to "show that they exercised reasonable due diligence but nevertheless were unable to discover their injuries," the district court took October 9, 2001 as the date that the limitations period began to run and therefore found the complaint untimely.

The United States Court of Appeals for the Third Circuit reversed. The Third Circuit held that the pre-critical date events, while constituting "storm warnings," did not suggest much by way of scienter, and consequently did not put the plaintiffs on "inquiry notice," requiring them to investigate further. Merck

sought review by Supreme Court.

The Supreme Court affirmed the Third Circuit. It held that in the statute of limitations context, the term "discovery" is often used as a term of art in connection with the "discovery rule," a doctrine that delays accrual of a cause of action until the plaintiff has "discovered" it. Relatedly, when "discovery" is written directly in a statute, the Supreme Court held that it should be interpreted to refer not only to actual discovery, but also to the hypothetical discovery of facts a reasonably diligent plaintiff would know. In determining the time at which "discovery" occurs, terms such as "inquiry notice" and "storm warnings" may be useful insofar as they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating. However, the limitations period 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, irrespective of whether the actual plaintiff undertook a reasonably diligent investigation in response to "storm warnings."

Significantly, the Supreme Court held that facts showing scienter are among those that "constitute the violation" in a Section 10(b) and Rule 10b-5 claim. The Supreme court observed that facts which tend to show a materially false or misleading statement (or material omission) are not necessarily sufficient to show scienter. Rather, the relation of falsity and state of mind is more context specific. For instance, an incorrect prediction about a firm's future earnings, by itself, does not automatically show whether the speaker deliberately lied or made an innocent error. Hence, "discovery" of additional context-specific scienter-related facts is required before the plaintiff can be deemed to have "discovered" the "facts constituting the violation."

The Supreme Court held that prior to the "critical date," the plaintiffs did not "discover," and Merck did not show that a reasonably diligent plaintiff would have discovered, the "facts constituting the violation." The Supreme Court reasoned that the FDA's warning letter showed little or nothing about the relevant scienter, *i.e.*, whether Merck advanced the Naproxen hypothesis *with fraudulent intent*. The FDA itself described the hypothesis as a "possible explanation" for the VIGOR results, faulting Merck only for failing sufficiently to publicize the less favorable alternative, that Vioxx might be harmful. Furthermore, the products liability complaints' general statements about Merck's state of mind "show[ed] little more." Without providing any reason to believe that the plaintiffs had special access to information about Merck's state of mind, the products liability complaints alleged only in general terms that Merck "purposefully downplayed and/or understated" the risks associated with Vioxx, the same charge made in the FDA warning letter. More importantly, the complaints did notcontain any information concerning scienter, *i.e.*, that Merck knew the Naproxen hypothesis was false even as it promoted it. Thus, the Supreme Court held that neither of those circumstances nor any of the other pre-critical date circumstances revealed "facts" indicating the relevant scienter. Hence, the plaintiffs' suit was timely.

This decision confirms that, in connection with the statute of limitations for securities fraud claims, the "discovery of the facts constituting the violation" occurs not only when a plaintiff *actually* discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them. It also makes clear that the "facts constituting the violation" include facts indicating defendants' scienter, not just facts suggesting a false or misleading statement or omission. This conclusion is consistent with the analysis for determining whether a particular set of facts gives rise to a strong inference of scienter pursuant to the heightened pleading requirements of the Private Securities Litigation Reform Act of 1995 and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007) [*see* blog article]. The end result is to give potential securities fraud plaintiffs a bit more space within the two-year statute of limitations to bring claims. It is important to note, however, that this ruling does not affect the five-year statute of repose.

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