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U.S. Supreme Court Interprets Statute of Limitations in Securities Fraud Ruling

The 2 year statute of limitations in a private securities fraud action begins to run when plaintiffs know or reasonably should know that fraud has occurred. Fraud in a typical securities case may involve an issuer of securities who makes false, misleading or incomplete statements about its business or prospects. To be successful, the plaintiff must show that the false or misleading statements or omissions were made with an intent to deceive or defraud- a state of mind technically referred to as scienter.

Assuming that fraud can be proven, pinpointing the precise time that fraud was known- or should have been known- by the plaintiff is critical, because a lawsuit that is filed more than 2 years after such fraud was known may be dismissed. Thus the question is presented: what must be known by a plaintiff for a court to conclude that the statute begins to run? Will clear evidence that false or misleading statements have been made be sufficient to commence running of the 2 year statute? Or must there be more? Must the plaintiff also know that the false or misleading statements were made with an intent to deceive? The Supreme Court addressed this issue in Merck & Co., Inc., et al v. Reynolds et al.

On April 27, 2010, the United States Supreme Court issued its opinion, affirming the Third Circuit Court of Appeals and holding that facts showing the defendant possessed scienter- the intent to deceive, manipulate, or defraud- must be known or reasonably discoverable by the plaintiff before the statute of limitations in a private securities fraud action brought under Section 10(b) of the '34 Act begins to run.

Background

Vioxx was a drug developed and marketed as a pain inhibitor by Merck in the mid-1990's. Its strength lay in its ability to inhibit pain without causing the negative gastrointestinal side effects of aspirin, ibuprofen, and naproxen. Initially successful, the benefits of Vioxx were brought into question by a study comparing Vioxx with naproxen: that study suggested that participants who took Vioxx were significantly more likely to have heart attacks than participants who took naproxen. Merck attempted to explain away these negative effects by suggesting that naproxen possessed beneficial effects for individuals with cardiovascular disease that were not shared by Vioxx. Merck stuck to this story until FDA action and product liability lawsuits forced it to withdraw the drug from the market.

Plaintiffs were purchasers of Merck's securities during the time Merck continued to market Vioxx. Their case was based on allegations that Merck's disclosures concerning its drug, Vioxx, were materially false and misleading, and that they suffered damages by purchasing Merck's securities before those disclosures were corrected. Merck's defense was based on its claim that the statute of limitations had run before plaintiffs filed their case.

Merck argued that the statute of limitations period should begin to run at the time when the plaintiffs knew or reasonably could have discovered that the materially false or misleading statements or omissions were made. It attempted to show that the accuracy of its disclosures about Vioxx were challenged by three significant and very public disclosures: (1) publication of the March 2000 study that compared Vioxx with the painkiller naproxen, showing adverse cardiovascular results for Vioxx; (2) an FDA warning letter that became public in 2001 stating that Merck's Vioxx marketing was "false, lacking in fair balance, or otherwise misleading;" and (3) several products-liability actions filed in 2001 alleging that "Merck had concealed information about Vioxx and intentionally downplayed its risks." Merck attempted to convince the Court that those public facts were overwhelming evidence that its disclosures about Vioxx were false or misleading, and sufficient to begin running the statute of limitations.

The relevant statute of limitations for a § 10b case provides that a securities fraud complaint must be filed no more than "2 years after the discovery of facts constituting the violation or 5 years after the violation." 28 USC § 1658(b). Plaintiff investors filed their action on November 6, 2003 – more than 2 years after the study was published showing adverse cardiovascular risks associated with Vioxx as well as more than 2 years after the FDA warning letter and the products-liability actions became public.

At trial, the District Court sided with Merck, and held that the public facts implying that Merck's disclosures were false or misleading were sufficient to commence running of the statute of limitations. The Third Circuit reversed, holding that the statute could not begin to run until the Plaintiffs not only knew that Mercks' disclosures were false or misleading, but that they had been made with an intent to deceive or defraud.

The Supreme Court's Holding

The Supreme Court agreed with the Third Circuit and held that knowledge of facts showing that a misrepresentation or omission has been made is not enough to begin the 2 year statute of limitations. In affirming the Third Circuit, the Supreme Court held that scienter, because it is an essential element of a private securities fraud action, must also be known or reasonably knowable by the plaintiffs for the statute of limitations to begin to run.

The Court stated that "… the limitation period does not begin to run until the plaintiff… discovers or a reasonably diligent plaintiff would have discovered 'the facts constituting the violation.'" The Court added that the "facts constituting the violation" specifically include facts showing an intent to deceive or defraud The Court further explained that "where § 10(b) is at issue, the relation of factual 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."

It is difficult to imagine circumstances more suggestive of the underlying falsity of a defendant's disclosures than those presented in the Merck decision. With its decision, the Supreme Court has now held that almost certain knowledge that a defendant's statements are false or misleading is insufficient to begin running the statute of limitations. For the limitations period to begin, plaintiffs must also know, or have reason to know, that the defendants who made such false or misleading statements did so with scienter- the intent to defraud or deceive.

Conclusion

Private securities litigation is based on proof of false or misleading statements that are material and made or omitted with scienter. Whether and when statements are made or omitted that prove to be false is a fairly straightforward inquiry. Whether such statements are material is another, more elusive matter, and has been part of the mystery of private securities fraud litigation since such actions first arose. The state of mind of a defendant- the intent to deceive or defraud-is yet another mystery, and determining the presence of that state of mind adds to the challenge of securities litigation.

It may be argued that the Supreme Court, by tying the running of the statute of limitations to knowledge of that state of mind, has increased the uncertainty surrounding securities litigation. Proof of when the plaintiff knows or has reason to know the defendant's state of mind will certainly be a matter of much contention.

If you have any questions relating to this alert, please feel free to contact John Henry or any other member of Miller & Martin's Securities Practice Group.

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance. Should you need assistance from a Miller & Martin attorney, please call 1-800-275-7303.

Atlanta | Chattanooga | Nashville
www.millermartin.com

ATLANTA

1170 Peachtree Street,
N.E., Suite 800
Atlanta, GA 30309-7706

CHATTANOOGA

832 Georgia Avenue,
Suite 1000,
Volunteer Building
Chattanooga, TN 37402-2289

NASHVILLE

150 Fourth Avenue North,
Suite 1200, One Nashville Place
Nashville, TN 37219