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Merck v. Reynolds: The Supreme Court Clarifies The Standard For Determining When A Plaintiff "Discovers" Fraud For Limitations Purposes In Section 10(b) Actions

On April 27, 2010, the Supreme Court issued *Merck & Co. v. Reynolds*, 559 U.S. __, No. 08-905 (Apr. 27, 2010),[1] which construed the statute of limitations applicable to private actions brought under Section 10(b) of the Securities Exchange Act of 1934. The relevant provision, 28 U.S.C. §1658(b), provides that a complaint is timely if filed by the earlier of "2 years after the discovery of the facts constituting the violation" or "5 years after such violation." In a decision that will make it easier for plaintiffs to avoid dismissal of complaints on grounds that they are time-barred, the Court held that the two-year statute of limitations accrues when the plaintiff actually discovers the facts constituting the violation, including scienter, or when a reasonably diligent plaintiff would have discovered such facts -- whichever occurs first. The Court rejected the argument that facts tending to show a materially false or misleading statement or omission are ordinarily sufficient to show scienter. Resolving a conflict among the circuits, the Court also held that the "discovery" of facts sufficient to put a plaintiff on "inquiry notice" does not automatically start the running of the statute of limitations, regardless of whether the plaintiff commenced an investigation.

I. BACKGROUND

Prior to *Merck*, the Courts of Appeals had differing views on the relationship of "inquiry notice" to the accrual of the limitations period. Those views most favorable to defendants held that the limitations period began to run when information put plaintiffs on "inquiry notice" of the possibility or probability of fraud, or the need to investigate. Others held that if a plaintiff did investigate, the limitations period ran from the date such investigation should have revealed the fraud. Those views most favorable to plaintiffs held that the limitations period accrued only when a reasonably diligent plaintiff should have discovered facts constituting the fraud after being put on "inquiry notice."

In the *Merck* litigation, a group of investors sued pharmaceutical manufacturer Merck & Co. under Section 10(b), alleging that the company defrauded investors by knowingly misrepresenting the side effects associated with its anti-inflammatory drug Vioxx. Merck moved to dismiss the complaint as untimely on the ground that the plaintiffs

[1] The slip opinion is available at http://www.supremecourt.gov/opinions/09pdf/08-905.pdf

knew or should have known "the facts constituting the violations" at least two years before filing their complaint.

The district court granted Merck's motion to dismiss, holding that several events that occurred more than two years before the complaint was filed -- including a study comparing Vioxx to a competitor's drug, an FDA warning letter, and Merck's response to the letter -- put the plaintiffs on "inquiry notice" of the alleged fraud and triggered the statute of limitations. The Third Circuit reversed after concluding that the plaintiffs were not on "inquiry notice" more than two years before filing the complaint because the earlier events discussed by the district court -- despite constituting "storm warnings" -- were not sufficiently suggestive of scienter and, thus, did not require them to investigate further.

II. THE SUPREME COURT'S OPINION

In an opinion written by Justice Breyer, with concurring opinions by Justices Stevens and Scalia, the Court agreed that the complaint was timely under Section 1658(b)(1) and affirmed. Although the parties agreed on the interpretation of the word "discovery" in Section 1658(b)(1), as a threshold matter the Court began by clarifying that the term "refers not only to a plaintiff's *actual* discovery of certain facts, but also to the facts that a reasonably diligent plaintiff would have discovered" because the statutory language did not make that interpretation obvious. *Merck*, slip. op. at 8. The Court explained that the statute of limitations for Section 10(b) actions was originally articulated in *Lampf, Pleva, Lipkand, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), and that in 2002 Congress enacted identical language in Section 1658(b)(1) against a background of judicial precedent uniformly interpreting that language as encompassing both facts a plaintiff actually knew and facts a reasonably diligent plaintiff would have known. *Merck*, slip. op. at 10-12.[2]

The Court then turned to Merck's arguments that the plaintiffs' claim had accrued more than two years before the filing of the complaint and rejected each argument in turn. First, the Court rejected Merck's argument that scienter is not one of "the facts constituting the violation" under Section 1658(b)(1). The Court explained that scienter, "a mental state embracing intent to deceive, manipulate, or defraud," is a critical element of a Section 10(b) claim and "assuredly a fact." Noting the heightened requirements for pleading scienter, the Court concluded that it would violate the purpose of the "discovery rule" codified in Section 1658(b)(1) if the limitations period began to run regardless of whether a plaintiff had discovered facts demonstrating scienter. *Id.* at 12-13. The Court declined to consider whether other elements of a Section 10(b) claim, including reliance, loss, and loss causation,

[2] In his concurring opinion, Justice Stevens stated that it was unnecessary to discuss whether Section 1658(b)(1) requires actual or constructive discovery to trigger the two-year limitations period. Justice Scalia concluded that only actual discovery triggers the limitation period under Section 1658(b)(1), and that the plaintiffs' complaint was timely because Merck had not shown that the plaintiffs actually discovered scienter more than two years before filing suit.

are "facts constituting the violation" that need to be discovered before a claim accrues. *Id.* at 13-14.

Second, the Court rejected Merck's argument that "facts that tend to show a materially false or misleading statement (or material omission) are ordinarily sufficient to show scienter as well." The Court reasoned that because the relationship between a statement's falsity and the speaker's state of mind is context specific, Section 1658(b)(1) "may require 'discovery' of scienter-related facts beyond the facts that show a statement (or omission) to be materially false or misleading." The Court also noted that the five-year statute of repose in Section 1658(b)(2) should allay concerns that the "discovery" requirements regarding scienter will allow plaintiffs to pursue stale claims. *Id.* at 14.

Third, the Court rejected Merck's argument that the limitations period under Section 1658(b)(1) began to run when the plaintiffs were on "inquiry notice" -- that is, the time "at which a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct a further inquiry." *Id.* (internal quotation marks omitted). The point at which a plaintiff is put on "inquiry notice" does not necessarily correspond to the point at which a plaintiff discovers or should have discovered "the facts constituting the violation" under Section 1658(b)(1). The Court also rejected Merck's fallback argument that the limitations period should run from "inquiry notice" when the plaintiff fails to undertake an investigation after that point in time. The Court explained that, according to the plain language of the statute, only "discovery" of "facts constituting the violation" triggers the two-year limitations period regardless of whether or not a diligent plaintiff undertook or should have undertaken an investigation after being put on "inquiry notice." *Id.* at 15-16.

Finally, the Court rejected Merck's argument that, even under the Court's interpretation of Section 1658(b)(1), the plaintiffs' claim was untimely because they had or should have discovered "the facts constituting the violation" more than two years before filing the complaint. The Court determined that none of the pre-November 2001 publicly-known events or circumstances revealed facts indicative of scienter. *Id.* at 17-19.

III. IMPLICATIONS

Merck's lenient view of the two-year discovery rule and its rejection of the relevance of "inquiry notice" to the analysis of when a Section 10(b) claim accrues, while providing uniformity among the circuits, will make it more difficult for defendants to prevail on motions to dismiss complaints on statute of limitations grounds. Defendants will have to do more than point to the existence of a misleading statement or omission of which a reasonably diligent plaintiff should have been aware, while being careful not to concede facts constituting scienter. The decision will also likely lead plaintiffs to argue that, in addition to scienter, other elements of a Section 10(b) claim (*e.g.* reliance and loss causation) are "facts constituting the violation" that must be discovered before the statute of limitations is triggered.

Merck should not, however, impact the statute of limitations analysis for claims under Sections 11 and 12(a)(2) of the Securities Act of 1933. The limitations period applicable to those claims is contained in Section 13 of that Act. While the language of Section 13 is similar to the Court's construction of Section 1658, plaintiffs asserting claims under the Securities Act need not allege scienter, loss causation or (except in narrow circumstances) reliance. Moreover, such claims (unless they "sound in fraud") are not subject to the heightened pleading standard of Rule 9(b).

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