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Merck & Co., Inc. v. Reynolds: *Supreme Court Clarifies When 2-Year Limitations Period for Securities Fraud Begins to Run*

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On April 27, 2010, the Supreme Court issued its decision in *Merck & Co., Inc. v. Reynolds*, 599 U.S. _____ (2010), holding that a securities fraud claim against pharmaceutical manufacturer Merck & Co. under Section 10(b) of the Securities Exchange Act of 1934 was timely filed despite possible earlier "storm warnings." The Court, relying on earlier precedent and the statute of limitations in 28 U.S.C. § 1658(b), determined that "the limitations period does not begin to run until the plaintiff . . . 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."

Background

In the mid-1990s, Merck developed Vioxx as a pain suppressor and anti-inflammatory drug, similar to aspirin, ibuprofen, and naproxen. As compared to comparable drugs, Vioxx users suffered fewer gastrointestinal side effects. In March 2000, however, Merck announced the results of the VIGOR study, which compared the effects of Vioxx to naproxen and showed an increased heart attack risk for users of Vioxx. Merck asserted that the VIGOR results could be explained by a unique benefit of naproxen rather than a harm caused by Vioxx (an assertion that later became known as the "naproxen hypothesis").

Throughout 2001, Vioxx and the naproxen hypothesis had been the subject of public debate involving Merck and the FDA. In February 2001, the FDA considered Merck's request to change the Vioxx label to reflect the drug's positive gastrointestinal side effects, though the cardiovascular findings of the VIGOR study were also discussed. Based on the VIGOR study, in May 2001, a group of plaintiffs brought a products-liability lawsuit against Merck, claiming that "Merck's own research" demonstrated an increased heart attack risk for users of Vioxx. Then, in August 2001, the *Journal of the American Medical Association* called for "a trial specifically assessing [Vioxx's] cardiovascular risk."

In September 2001, the FDA sent Merck a warning letter stating that Merck's Vioxx marketing was "false, lacking in fair balance, or otherwise misleading," though it acknowledged that the naproxen hypothesis was a possible explanation for the VIGOR study results. Following the FDA's letter, more products-liability lawsuits were filed and Merck's share price fell 6.6% over several days (though it would rebound by October 1). Finally, on October 9, 2001, a *New York Times* article said that Merck

had reexamined its own data and "found no evidence that Vioxx increased the risk of heart attacks." The president of Merck Research Laboratories was quoted in the article as positing the "two possible interpretations": "Naproxen lowers the heart attack rate, or Vioxx raises it."

Nearly two years later, however, the *Wall Street Journal* published the results of a study indicating that longer-term Vioxx users were more likely to have suffered a heart attack than those given a different painkiller or no painkiller at all. On November 6, 2003, plaintiffs filed a class-action complaint based on Merck's prior statements about the safety of Vioxx, including its explanation for the VIGOR study results.

Merck moved to dismiss the complaint based on the applicable statute of limitations. Merck argued that the plaintiffs knew or should have known the "facts constituting the violation" at least as of November 6, 2001 – two years prior to filing the complaint. The District Court granted the motion holding that the March 2000 VIGOR study, the September 2001 FDA letter, and the October 2001 *New York Times* article should have alerted the plaintiffs to a "possibility" that Merck had made knowing misrepresentations regarding Vioxx. A divided Court of Appeals for the Third Circuit reversed that decision, reasoning that the pre-November 2001 studies and public disclosures could be considered "storm warnings," but none suggested Merck acted with *scienter* in its explanations of the VIGOR results. Thus, these events could not trigger the limitations period. The Supreme Court affirmed the Court of Appeals' decision.

Discovery Starts the Limitations Period

Prior to addressing the arguments raised on appeal, the Court first examined the meaning of the word "discovery" as it appeared in the statute of limitations (28 U.S.C. § 1658(b)). After citing to and relying upon long-established precedent, the Court held that "discovery" in the statute refers not only to *actual* discovery but also "the facts that a reasonably diligent plaintiff would have discovered."

The Court then turned to the arguments raised by Merck. First, the Court rejected Merck's claim that "discovery" of *scienter*-related facts was not necessary, and held that the statutory language requiring "facts constituting the violation" included the facts supporting the "necessary element" of *scienter*. Due to the heightened pleading requirements for *scienter* under a Section 10(b) claim, the Court reasoned that the discovery rule would be undermined if the two-year limitations period began to run regardless of whether a plaintiff discovered or should have discovered any facts related to *scienter*. In reaching that conclusion, however, the Court explicitly did not address whether discovery of other elements of a Section 10(b) claim that do not constitute the "violation," such as a plaintiff's reliance and loss causation, were also necessary to begin the limitations period.

Second, and on a related issue, the Court also disagreed with Merck's assertion that facts demonstrating a material misrepresentation are sufficient to show *scienter.* The Court determined that, for purposes of a Section 10(b) claim, the "relation of factual falsity and state of mind" was "more context specific" such that a misrepresentation does not automatically demonstrate *scienter*. Plaintiffs must discover (and later plead) relevant facts beyond those that show a statement to be false or misleading. Addressing Merck's "fear" that the stated discovery ruling would give life to stale claims, the Court noted that the five-year statute of repose is an "unqualified bar on actions" filed five years after a violation.

Finally, the Court rejected Merck's argument that the limitations period begins to run at the point of "inquiry notice" – "the point where the facts would lead a reasonably diligent plaintiff to investigate

further." The Court reasoned that the time when a plaintiff is placed on inquiry notice is not necessarily the same as when a plaintiff would have discovered facts constituting the violation. The Court agreed that terms like "inquiry notice" and "storm warnings" may be useful in identifying "a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating." However, the statutory language requires actual or constructive "discovery" as the event triggering the statute of limitations, not the mere initiation of an investigation or inquiry.

Conclusion

Based on a superficial reading, the Court's decision may be interpreted solely as making it more difficult for a securities fraud complaint to be dismissed on statute of limitations grounds. Upon closer examination, however, *Merck* actually demonstrates the Court's continued and unique alignment in analyzing securities cases.

Beginning with its decision five years ago in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Court has interpreted the securities laws in a manner that makes it more difficult to successfully bring or maintain securities class action lawsuits. In this case, the Court's decision will continue a trend strictly interpreting statutory language and will leave existing law in several circuits, including the Ninth Circuit, unchanged. Although the Court ultimately rejected Merck's limitations defense and allowed a securities fraud action to continue, it relied on the necessity and importance of pleading facts demonstrating *scienter* in reaching that conclusion.

Further, the Court reiterated that the mere existence of a material misrepresentation alone does not demonstrate *scienter* also exists. Plaintiffs must allege additional facts beyond those demonstrating falsity to establish *scienter*. Thus, the Court's decision can be seen as an extension of *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007), and the Private Securities Litigation Reform Act of 1995, which raised the pleading threshold in requiring plaintiffs to state with particularity "facts giving rise to a strong inference of [*scienter*]."

Finally, the Court emphasized that events placing a plaintiff on "inquiry notice" are relevant to determine when a reasonably diligent plaintiff would have begun an investigation into the alleged fraud. Accordingly, "storm warnings" and other public disclosures will continue to play a role in limitations defenses.

After *Merck*, defendants should not hesitate to pursue limitations defenses when available using "storm warnings" as relevant evidence to establish the initiation of the limitations period. Alternatively, where a limitations defense is not available, defendants can still use the Court's reasoning that a material misrepresentation alone does not establish *scienter* to weaken a plaintiff's argument on the merits as well.

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