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David J. Libowsky, Esq.

Importance Of Recent U.S. Supreme Court Decision In *Merck & Co., Inc. v. Reynolds*

Section 804(b) of the Sarbanes-Oxley Act of 2002, 28 U.S.C. § 1658(b) (2010), defines the limitations period for a claim for violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5:

> A private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws ... may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.

28 U.S.C. § 1658(b) (2010).

The United States Supreme Court has now clarified when the statute of limitations accrues under Section 1658(b)(1) for a federal securities fraud claim: "(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. *Merck & Co, Inc. v. Reynolds*, 559 U.S.___, No. 08-905, 2010 U.S. LEXIS 3671, slip op. at 1 (Apr. 27, 2010).

The Merck court further held that "the 'facts constituting the violation' include the fact of scienter, a 'mental state embracing intent to deceive, manipulate, or defraud....' " *Id.* In so holding, the Supreme Court found that plaintiffs' claims for violation of Section 10(b) and Rule 10b-5 against defendant Merck & Co., Inc. ("Merck") were filed within two years of discovery of the facts constituting the violation and were therefore not time-barred.

The *Merck* decision is significant in several respects. First, for purposes of determining when a reasonably diligent plaintiff would have known the facts constituting the violation of Section 10(b)/Rule 10b-5, the Supreme Court held that facts relating to the defendant's scienter are relevant to this analysis, concluding that "facts showing scienter are among those that 'constitut[e] the violation.' " *Merck,* slip op. at 13. In rejecting Merck's argument that Section 1658(b)(1) does not require discovery of scienter-related facts, the Court observed that "the statute says that the limitations period does not begin to run until 'discovery of the *facts constituting the violation* ....' " *Merck,* slip op. at 12-13. The Court reasoned further that "[s]cienter is assuredly a 'fact.' " *Id.* at 13.

Moreover, "this 'fact' of scienter 'constitut[es]' an important and necessary element of a § 10(b) 'violation' " because a plaintiff "cannot recover without proving that a defendant made a material misstatement *with an intent to deceive*...," and "Congress has enacted special heightened pleading requirements for the scienter element of § 10(b) fraud cases." *Id.* at 12-13. Observing that "unless a § 10(b) plaintiff can set forth facts in the complaint showing that it is more likely than not that the defendant acted with the relevant

knowledge or intent, the claim will fail," the Supreme Court concluded that "it would therefore frustrate the very purpose of the discovery rule in this provision -- which, after all, specifically applies only in claims 'involv[ing] a claim of fraud, deceit, manipulation, or contrivance' ... -- if the limitations period began to run regardless of whether a plaintiff had discovered any facts suggesting scienter." *Id*. at 13.

Similarly, the Court rejected Merck's argument that "even if 'discovery' requires facts relating to scienter, facts that tend to show a materially false or misleading statement (or material omission) are ordinarily sufficient to show scienter as well." *Id*. at 14. In light of the "context specific" nature of the "relation of factual falsity and state of mind..." in a federal securities fraud claim, the Supreme Court held that "the statute may require 'discovery' of scienter-related facts beyond the facts that show a statement (or omission) to be materially false or misleading." *Id*. Further, the Court observed, any concern that such "requirement will give life to stale claims or subject defendants to liability for acts taken long ago..." should be allayed by "Congress' inclusion in [Section 1658(b)(2)] of an unqualified bar on actions instituted '5 years after such violation,' ... giving defendants total repose after five years...." *Id*.

The Supreme Court also rejected "inquiry notice" as constituting the point at which the statute of limitations begins to run on a federal securities fraud claim on the ground that "inquiry notice" is inconsistent with the language of Section 1658(b)(1), holding that "the 'discovery' of facts that put a plaintiff on 'inquiry notice' does not automatically begin the running of the limitations period." *Merck,* slip op. at 17. Merck argued that the limitations period on plaintiffs' claims, which were filed on November 6, 2003, began to run prior to November 2001, or more than two years before plaintiffs filed suit, "because by that point the plaintiffs were on 'inquiry notice.'" *Id*. at 14. The Court reasoned that "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.'" *Id*. at 15.

Pointing out that Section 1658(b)(1) states that "the plaintiff's claim accrues only after the 'discovery' of those latter facts," the Court found that "[n]othing in the text suggests that the limitations period can sometimes begin **before** 'discovery' can take place." *Id*. The Supreme Court rejected Merck's inquiry notice argument "because the statute contains no indication that the limitations period should occur at some earlier moment before 'discovery,' when a plaintiff would have **begun** investigating...." *Id*. at 15-16. Nor did Merck's alternative contention that the limitations period should run from the point of inquiry notice "where the actual plaintiff fails to undertake an investigation once placed on 'inquiry notice' " fare any better. The Court rejected this argument because "[w]e cannot reconcile it with the statute, which simply provides that 'discovery' is the event that triggers the 2-year limitations period -- for all plaintiffs." *Id*. at 16. In determining the point at which the plaintiff did discover, or a reasonably

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diligent plaintiff would have discovered, the facts constituting the violation, the Supreme Court observed that "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating." *Id.* at 17. The Court concluded, however, that "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." *Id.*

The *Merck* decision will likely make it more difficult to establish the defense to a claim for violation of Section 10(b) and Rule 10b-5 that the plaintiff did not file suit within two years of discovery of the facts constituting the violation. **First**, a defendant now has to show that a reasonably diligent plaintiff would have been able to discover facts relating to the defendant's scienter more than two years prior to filing suit, because discovery of facts showing a materially false or misleading statement is insufficient in and of itself to trigger the limitations period. Thus, the defendant must be able to demonstrate that a reasonably diligent plaintiff would have been in a position to discover facts relating to the defendant's culpable state of mind within two years of filing suit. **Second**, since mere inquiry notice of the Section 10(b)/Rule 10b-5 claim can no longer trigger the limitations period, evidence that the plaintiff possessed enough facts to have prompted him to further investigate his claim, but failed to do so, is insufficient to establish the statute of limitations defense.

Since whether the actual plaintiff undertook a reasonably diligent investigation is no longer determinative of whether the reasonably diligent plaintiff would have discovered the facts constituting the violation, a defendant will likely have to make a substantially greater showing as to what a reasonably diligent plaintiff would have been able to find out regarding the claim before the limitations defense can be established. Thus, while truly stale claims will continue to be barred by the five-year period of repose set forth in Section 1658(b)(2), the substantially enhanced burden that *Merck* now mandates, establishing that the suit was not filed within two years after a reasonably diligent plaintiff would have discovered the facts constituting the violation, will likely prolong the life of federal securities fraud claims that would otherwise have been time-barred. ■

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

David J. Libowsky, Esq.
dlibowsky@bressler.com

BRESSLER, AMERY & ROSS

A PROFESSIONAL CORPORATION

17 State Street
New York, NY 10004
212.425.9300

325 Columbia Turnpike
Florham Park, NJ 07932
973.514.1200

2801 SW 149th Avenue
Miramar, FL 33027
954.499.7979

www.bressler.com