WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

SUPREME COURT TO REVIEW "INQUIRY NOTICE" STANDARD FOR SECURITIES FRAUD ACTIONS

This week the United States Supreme Court granted certiorari in *Merck & Co., Inc. v. Reynolds*, a case involving the issue of "inquiry notice" under the statute of limitations in private securities fraud actions. The Supreme Court has not considered limitations issues in the securities fraud context since its decision in *Lampf* almost 20 years ago, when it adopted a uniform statute of limitations for private securities fraud actions.[1] The appeal presents a much anticipated opportunity for the Supreme Court to resolve a circuit split over when the statute of limitations begins to run on a securities fraud claim under the inquiry notice standard, and the proper scope of investors' obligation to investigate potential fraud.

Under section 804(a) of the Sarbanes-Oxley Act of 2002, a federal securities law claim under section 10(b) of the Securities Exchange Act of 1934 (and Rule 10 b-5 promulgated thereunder) must be brought no later than the earlier of five years after the violation or two years "after discovery of the facts constituting the violation."[2] There is broad agreement among the Courts of Appeal that the two-year statute of limitations is triggered once investors have constructive or inquiry notice of their claims. In recent years, however, there has been a growing disparity among the circuits as to precisely when the statute of limitations begins to run under the inquiry notice standard. In some circuits, the statute begins to run from the moment the plaintiff has actual or constructive notice of the possibility that the defendant has made a material inaccurate statement. In other circuits, the statute of limitations does not start to run until the plaintiff has inquiry notice *and* would have discovered facts sufficient to bring suit, had it investigated further. Under that latter standard, if the plaintiff fails to conduct any investigation, the statute runs from the date the duty to inquire arose, or, if the plaintiff conducts an inadequate investigation, the statute runs from the date when it ought to have discovered the fraud.

In *Merck*, the Third Circuit adopted a third approach, joining the Ninth Circuit[3] in holding that no duty to inquire arises, and the two-year limitations period does not begin, until investors are on notice that the defendant acted with *scienter* — *i.e.*, that the representations alleged to constitute the fraud were not only false, but knowingly false when made. Both Courts base this requirement on the heightened pleading standard introduced by the Private Securities Litigation

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[1] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

[2] 28 U.S.C. § 1658(b).

[3] *See Betz v. Trainer Wortham & Co.,* 519 F.3d 863 (9th Cir. 2008), *petition for cert. filed* (U.S. May 27, 2008) (No. 07-1489).

Reform Act of 1995 ("PSLRA"), which requires securities fraud plaintiffs to plead with particularity both the facts constituting the alleged misrepresentation and the facts evidencing defendants' *scienter*.[4]

Plaintiffs in *Merck* allege that the company and certain of its officers and directors violated the securities laws by misrepresenting the safety profile and commercial viability of Vioxx, a prescription pain medication that was approved by the Food and Drug Administration in 1999 and withdrawn from the market in 2004 due to safety concerns. Defendants moved to dismiss the complaint, arguing in part that plaintiffs' claims were barred by the two-year statute of limitations because they had been placed on inquiry notice of the inaccuracy of the alleged misrepresentations more than two years before commencing suit but never made any inquiry. The District Court agreed, reasoning that publicly available materials — including a "warning letter" the FDA posted on its website stating that Merck's "promotional activities and materials" for marketing Vioxx were "false, lacking in fair balance, or otherwise misleading," an article in a leading medical journal that raised a "cautionary flag" about the risks associated with drugs like Vioxx, a story in *The New York Times* reporting on "troubling questions" with respect to Vioxx's safety, and a number of product liability complaints alleging that Vioxx was harmful — constituted "storm warnings" sufficient to start the limitations period running.[5]

In a divided opinion, the Third Circuit reversed.[6] Given the level of particularity required by the PSLRA, the majority held, the duty to inquire does not arise absent notice that defendant acted with *scienter*. Applying that standard, the Third Circuit held that the publicly available information of which the District Court took judicial notice was insufficient to trigger the duty to inquire because it did not suggest that defendants knew that their statements regarding Vioxx were false. Plaintiffs' claims, therefore, were not time-barred.

Only the Third and Ninth Circuits have adopted such a plaintiff-friendly standard, one which premises the scope of constructive notice on the heightened pleading requirements set forth in the PSLRA and permits investors to defer inquiry even after they have notice of the inaccuracy of representations on which they claim to have relied. Should the Supreme Court hold that evidence of *scienter* is required before the statute of limitations begins to run, time-bar dismissals of securities fraud claims will almost certainly become very difficult to obtain. That would be an unwelcome development for defendants, for whom the statute of limitations has provided a meaningful avenue to secure early dismissal of stale claims and avoid the burden and expense securities fraud litigation increasingly entails. It would also be a boon to plaintiffs, who, absent clear indications of fraudulent intent, would effectively be relieved of any burden to

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[4] *See, e.g., Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

[5] *In re Merck & Co. Secs., Derivative & "ERISA" Litig.*, 483 F. Supp. 2d 407 (D.N.J. 2007).

[6] *In re Merck & Co. Secs., Derivative & "ERISA" Litig.*, 543 F.3d 150 (3d Cir. 2008), *cert. granted* (U.S. May 26, 2009) (No. 08-905).

investigate potential fraud claims promptly, although they must still meet the PSLRA's stringent pleading requirements to state a claim for fraud. No matter what standard the Court chooses to adopt, its decision in *Merck* should provide much-needed guidance to the lower courts on this critically important area of securities law and eliminate the forum-shopping for a favorable statute that the lack of uniformity in the law now encourages.

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If you have any questions about this memorandum, please contact Mary Eaton (212-728-8626, meaton@willkie.com), Roger Netzer (212-728-8249, rnetzer@willkie.com), or the attorney with whom you regularly work.

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