FRIDAY FORUM
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Supreme Court to Resolve Dispute Regarding Triggering the Statute of Limitations in Securities Fraud Actions

On May 26, 2009, the Supreme Court granted the pharmaceutical giant Merck's petition for a writ of certiorari regarding a securities fraud class action relating to the company's disclosures about the side-effects of its blockbuster pain medication, Vioxx.[1] As indicated in Merck's petition, the issue certified for the Court's review is the following:

> Did the Third Circuit err in holding, in accord with the Ninth Circuit but in contrast to nine other Courts of Appeals, that under the "inquiry notice" standard applicable to federal securities fraud claims, the statute of limitations does not begin to run until an investor receives evidence of scienter without the benefit of any investigation?[2]

While the foregoing question would appear to be quite limited in scope, in order to fully address the numerous issues imbedded therein (including fully resolving the dispute between Circuit Courts of Appeal regarding if, and when, inquiry notice triggers the statute of limitations), the Supreme Court very well may end up setting an entirely new standard regarding when the clock starts running on securities fraud actions.

I. Background

In 1991, the Supreme Court rendered its ruling in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*,[3] holding that all actions for securities fraud brought pursuant to Section 10(b) of the Securities Exchange Act of 1934, and the Securities and Exchange Commission Rule 10b-5 promulgated thereunder, must be brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

Congress later extended the statute of limitations for federal securities fraud claims as part of the Sarbanes-Oxley Act. Under Section 804(a) of the Sarbanes-Oxley Act, the fraud action must 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.[4]

Courts addressing the issue have held that the statute of limitations may be triggered by actual notice or constructive notice. Constructive notice depends on when a plaintiff is on "inquiry notice" of the alleged fraud. There is growing debate among the

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[1] *See,* http://www.supremecourtus.gov/orders/courtorders/052609zor.pdf
[2] Petition for a Writ of Certiorari, Merck & Co., Inc., et al. v. Reynolds, et al., No. 08-905 (Jan. 15, 2009)
[3] 501 U.S. 350, 364 (1991)
[4] 28 U.S.C. §1658(b)

circuits over when the statute of limitations begins to run under inquiry notice and what is necessary to establish inquiry notice. The circuits appear to fall within three loosely defined categories.

II. Circuit Court Approaches

A. Stringent Approach

In this camp one will find the Fourth and Eleventh Circuits, and in some respects the Fifth and Eighth Circuits as well. Under the approach taken by the Fourth and Eleventh Circuits, the statute of limitations will start to run from the moment publicly available information alerts an investor to the possibility of fraud (so called "storm warnings") such that a reasonable investor would be prompted to further investigate the matter.[5] The Fifth and Eighth Circuits also start the clock running upon sufficient storm warnings, but only if a reasonably diligent inquiry following such storm warnings would have revealed facts to support a claim for fraud within the limitations period.[6]

B. Intermediary Approach

The First, Sixth and Tenth Circuits engage a fairly similar standard as that described above, but with one important difference. Instead of starting the clock at the time storm warnings should have elicited an inquiry or investigation by a reasonably diligent investor, these circuits will not start the clock until the date plaintiff's investigation could have discovered the facts underlying the alleged fraud.[7] The Seventh Circuit essentially ascribes to the same theory, however, the seminal decision establishing the rule condenses it into one phrase: when should the plaintiff, exercising reasonable diligence, have possessed facts sufficiently probative of fraud - sufficiently advanced beyond the stage of mere suspicion, sufficiently confirmed or substantiated - not only to incite investigation but also to enable him to tie up loose ends and complete the investigation in time to actually file suit?[8]

Lastly, the Second Circuit employs a variation of this approach whereby a plaintiff who fails to conduct any investigation after sufficient storm warnings will trigger the running of the statute from the date the duty to investigate arose (i.e. the Stringent Approach). However, for plaintiffs who do investigate following sufficient storm warnings, the statute will not begin to run until the date when a reasonably diligent

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[5] *See, e.g.,* Grippo v. Perazzo, 357 F.3d 1218, 1224 (11th Cir. 2004); Franze v. Equitable Assurance, 296 F.3d 1250, 1254-55 (11th Cir. 2002); Theoharous v. Fong, 256 F.3d 1219, 1228 (11th Cir. 2001);Brumbaugh v. Princeton Partners, 985 F.2d 157, 161-63 (4th Cir. 1992).
[6] *See, e.g.,* Jensen v. Snellings, 841 F.2d 600, 606-08 (5th Cir. 1988); Great Rivers Coop. of Southeastern Iowa v. Farmland Indus., 120 F.3d 893, 896-99 (8th Cir. 1997). *See also, e.g.,* Bodenhamer v. Shearson Lehman Hutton, Inc., 998 F.2d 1013 (5th Cir. 1993) (unpublished opinion).
[7] *See, e.g.,* Sterlin v. Biomune Systems, 154 F.3d 1191, 1200-04 (10th Cir. 1998); New England Health Care Employees Pension Fund v. Ernst & Young, LLP, 336 F.3d 495, 501 (6th Cir. 2003); Young v. Lepone, et al., 305 F.3d 1, 8-12 (1st Cir. 2002).
[8] F*ujisawa Pharmaceutical Co., Ltd. v. Kapoor, 115 F.3d 1332, 1335 (7th Cir. 1997).*

investor would have discovered the facts underlying the alleged fraud (i.e. the Intermediary Approach).[9]

C. Relaxed Approach

Until the 2008 Ninth Circuit decision in *Betz v. Trainer Wortham & Co.*,[10] it appeared that, except for some variations on the theme, all of the circuits to have addressed the issue were in agreement that inquiry notice (i.e. the duty incumbent upon plaintiff to investigate) could trigger the running of the statute of limitations, and that the duty to investigate could and would often be based upon when publicly available information indicated the "possibility" that investors had been misled. However, in *Betz*, the court broke from this interpretation in holding that no duty to investigate, and consequently no triggering of the statute, occurs until plaintiff has specific evidence supporting each element of a securities fraud cause of action without having to conduct any investigation whatsoever. Some have described this approach as "the securities fraud falling from the sky and landing in your lap" approach.

The salient underlying facts of *Betz* are as follows. In 1999, Heide Betz, a retired art dealer, sold her house for $2.2 million. She was thereafter introduced to an employee of investment firm, Trainer Wortham, who recommended that Betz invest the proceeds from the sale of her house with the firm. Betz was assured that if she invested her $2.2 million with Trainer Wortham, in essence the principal would be absolutely protected from devaluation. Betz invested. However, between February 2000 and July 2001, Betz received 29 statements each which reflected a principal balance less than the initial investment. Upon inquiry, Betz was initially told that the decrease in value was due to certain withdrawals she had made (purportedly based upon representations by Trainer that such withdrawals would not affect the principal) and that the market would recover and restore her initial investment balance within a year. Following additional losses, Betz was told that her account had been seriously mismanaged and that Trainer "would take care of her account because it was the right thing to do." Following this assurance, Betz was later told that nothing would be done about her account balance by the firm. Shortly thereafter, on July 11, 2003, Betz filed suit for securities fraud.

Defendants moved for summary judgment arguing that Betz was on inquiry notice of the fraud prior to July 11, 2001, two years before her suit was filed and, therefore, Betz had not complied with the two-year statute of limitations. Defendants' motion was granted and the action was taken up on appeal. In reversing and remanding to the District Court, the Ninth Circuit expressed its agreement with "its ten sister Circuits" that the statute of limitations can be triggered by both actual notice and inquiry notice. Thereafter, the court indicated that it would follow the approach set forth by the Tenth Circuit or, in other words, the Intermediary Approach. However, in its application of this approach to the facts of the *Betz* matter, the Ninth Circuit took a huge step past the Intermediary Approach when it stated that:

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[9] *See, e.g.,* Shah v. Meeker, 435 F.3d 244, 249-52 (2d Cir. 2006); LC Capital Partners, LP v. Frontier Ins. Group, Inc., 318 F.3d 148, 154-56 (2d Cir. 2003).

[10] Initial opinion found at 504 F.3d 1017 (9th Cir. 2007) and amended at 519 F.3d 863 (9th Cir. 2008)

> Likewise, Castro's [the employee of Trainer] statement that there was a serious problem with Betz' portfolio did nothing more than indicate that the defendants had not been able to make good on their promise of at least $15,000 a month of interest income. Because such a statement provided no evidence that the defendants had intentionally or deliberately and recklessly mislead Betz as Silicon Graphics requires to state a claim for securities fraud, a rational jury could conclude that, upon hearing such a statement, a reasonable investor would not have initiated further inquiry into the existence of fraud.[11]

Accordingly, in terms of inquiry notice, in order to trigger the running of the statute of limitations in the Ninth Circuit following *Betz*, there must be storm warnings sufficient to elicit an investigation by plaintiff, which if diligently conducted, would have revealed facts to support each element of a cause of action for securities fraud, including specifically in this instance, scienter.[12] This newly delineated approach instituted by the Ninth Circuit brings us to the present question at the center of the Merck appeal.

III. Third Circuit Decision in *Merck*

In *Merck*, plaintiff alleged that the pharmaceutical company issued numerous misrepresentations regarding the safety and commercial viability of its block-buster pain medication, Vioxx. Plaintiff alleged that these misstatements were revealed in September 2004, when Merck withdrew Vioxx from the market due to a correlation between the drug and serious cardiovascular side-effects. Merck stock plummeted $12 per share that day. On November 6, 2003 the first lawsuit of what became the Multi-District In re: Merck Securities Litigation action was filed in Louisiana. Once transferred to the District Court for New Jersey, consolidated and re-filed under a Consolidated Complaint, defendants moved to dismiss the action for failure to bring suit within the two-year statute of limitations.

In granting defendants' motion, the District Court employed the approach used by the Second Circuit which is a blend of the Stringent Approach and Intermediary Approach, depending on whether plaintiff conducts an investigation following sufficient storm warnings. In *Merck*, the District Court found that there were sufficient storm warnings to trigger a duty to investigate, including product liability and personal injury lawsuits regarding Vioxx filed in May 2001, a posting on the FDA's website in September 2001 which warned Merck that its marketing regarding Vioxx and cardiovascular side-effects was misleading, and a *New York Times* article published on October 9, 2001 wherein a Merck scientist purportedly stated that Vioxx may raise the risk of cardiovascular problems. However, plaintiff conducted no investigation and, as

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[11] 504 F.3d at 1026-27

[12] Defendants in *Betz* also sought a writ of certiorari from the Supreme Court, which the Court has essentially placed on hold pending the outcome of the Merck Petition.

such, the statute of limitations began running from the date the duty to investigate was manifest, October 9, 2001. Because the first securities fraud action was not filed until more than two-years later, November 6, 2003, all claims were time barred.[13]

In reversing, the Third Circuit held that in order for a storm warning to trigger the duty to investigate, such storm warning had to have a significantly negative impact on Merck's stock price (akin to loss causation). Because the purported storm warnings (described above) had little affect on Merck's stock price, no duty to investigate would therefore arise unless plaintiff had knowledge that Merck acted with scienter regarding its previous misleading disclosures (echoing the Ninth Circuit in *Betz*). The Third Circuit further found that there was no reason for an investor to suspect that Merck did not believe that Vioxx actually reduced heart attacks (Merck's stated position at the time) prior to a Harvard study in October 2003 which indicated that Vioxx, as compared with a similar drug, increased heart attacks. Accordingly, the Third Circuit concluded that plaintiff's duty to investigate had not been triggered prior to November 6, 2001, and, therefore, no violation of the statute of limitations had occurred.[14]

IV. Merck's Petition to the Supreme Court

Merck's petition argues that the standards being employed in the Third and Ninth Circuits inappropriately do away with inquiry notice all together, which contravenes Congressional intent when it codified the two-year statute of limitations.[15] Merck argues that a standard which requires no investigation until plaintiff fortuitously obtains facts to support each element of its claim for securities fraud, would not seem to leave much for plaintiff **to** investigate before filing its claim. Next, Merck argues that the standards employed by the Third and Ninth Circuits encourage plaintiffs to essentially "bury their heads in the sand," instead of conducting diligent investigations in the face of clear, even if not complete (i.e. no obvious scienter or loss causation), indications that there might be something askew regarding the prior disclosures by a public company.

Lastly, these new standards place defendants in the untenable position of having to choose whether to challenge a plaintiff's claim based on statute of limitations grounds or seek dismissal of the claim for failing to sufficiently plead the elements of securities fraud (a step taken in almost every securities fraud action). Namely, because challenging plaintiff on statute of limitations grounds pursuant to the Third and Ninth Circuit standards would require defendants to argue that plaintiff had facts sufficient to support the elements of securities fraud but failed to file suit within two-years of obtaining this information, defendants would be risking making an admission that plaintiff's complaint sufficiently pleads the elements of securities fraud, thereby prejudicing defendants' ability to challenge the complaint on sufficiency grounds. On the other hand, in order to

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[13] 483 F. Supp.2d 407 (D.N.J. 2007)
[14] 543 F.3d 150 (3d Cir. 2008)
[15] A review of the legislative history of the codified statute of limitations states that the discovery provision is not intended to change then-existing decisional law and quotes the Second Circuit stating that, "when the circumstances would suggest to an investor of ordinary intelligence that she has been defrauded, a duty to investigate arises, and knowledge will be imputed to the investor who does not make such an inquiry" 107 P.L. 204, Title VIII, § 804, 116 Stat. 745 (July 30, 2002).

avoid potential waiver regarding sufficiency of the complaint, defendants may be forced to forego potential defenses based on the statute of limitations.

V. What Will the Supreme Court Do?

Predicting Supreme Court decisions is never an easy task; however, there are a few points of interest which may serve to provide guidance on this particular issue.

First, the plain language of 28 U.S.C. §1658(b) states that securities fraud claims must be brought within two years after the discovery of the facts **constituting the violation**. Thus, the question is: what constitutes the violation? In *Dura Pharmaceuticals, Inc. v. Broudo*,[16] the Supreme Court clearly held that in order to state a cause of action for violation of Section 10(b) and Rule 10b-5, plaintiffs must plead specific facts demonstrating that defendant made material misrepresentations of material fact, with scienter, upon which plaintiff justifiably relied and which caused injury to plaintiff. Hence, plaintiff in the instant dispute may argue that the plain language of the statute of limitations, read along side the plain language of what is required for a securities fraud action, results in only one conclusion: that the statute cannot be triggered until plaintiff discovers facts constituting the violation, or in other words, specific facts demonstrating falsity, materiality, scienter and loss causation.

However, because the probability of a plaintiff (or entire class of shareholders) having possession of facts sufficient to file a securities fraud action but waiting more than two years to actually file suit is so exceedingly remote, in upholding the Third and Ninth Circuits the Supreme Court would, as Merck argues, be effectively doing away with the two-year statute of limitations. Because a ruling of this nature would essentially render that part of 28 U.S.C. §1658(b) meaningless, it is highly unlikely that the Court will simply rubber-stamp the Third and Ninth Circuit approaches.

That the Third and Ninth Circuit approaches will simply be rubber-stamped is made even more unlikely by the current composition of the Court. Even setting aside for the moment the potential impact the current nominee to the high bench, Sonia Sotomayor, may have if confirmed,[17] there will still be a conservative, pro-business majority of justices. Accordingly, it would be a relative coup were the plaintiffs bar able to extract such a pro-plaintiff ruling from a pro-business leaning Court.

In the end, the more likely outcome from this dispute will find the High Court crafting an approach different from any of those found in the three categories described above, but integrating bits and pieces from each as the majority sees fit. Certainly, the exponential advances in the internet, on-line investing and access to information since the last time the Supreme Court addressed this issue in the *Lampf* case circa 1991, should

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[16] 544 U.S. 336 (2005)

[17] There is no guarantee that nominee Sotomayor, seen as liberal leaning, would grant plaintiffs broader access to the courts by upholding the Third Circuit in this dispute. In her 11 years on the Second Circuit Court of Appeals, she has sided more than once with corporate defendants, including cases involving alleged securities fraud.

play a prominent role in how the justices view an investor's duty to investigate, if any, following "storm warnings." It should be exceedingly interesting to see how the Court navigates the "constitutes the violation" language of the codified statute of limitations without ending up with a standard which essentially obviates the statute of limitations completely, leaving corporate defendants protected only by the five-year statute of repose, which dictates that regardless of a plaintiff's compliance with the statute of limitations, no action for securities fraud can be brought more than five years after the violation (i.e. the false and misleading disclosures).

The matter is expected to be argued during the Supreme Court term commencing in October 2009. A decision will not likely be issued until spring or summer 2010.

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