

## Predicting SCOTUS In Merck V. Reynolds

*Law360, New York (February 16, 2010)* -- On Nov. 30, 2009, the U.S. Supreme Court heard oral argument in the case of Merck & Co. v. Reynolds, Case No. 09-905. The case involves the application of 28 U.S.C. § 1658(b), which sets the statute of limitations for federal securities fraud claims as the shorter of: (1) two years after “the discovery of the facts constituting the violation”; or (2) five years “after such violation.”

The core issue on appeal concerns the first prong of Section 1658(b), and involves the meaning of the phrase “after discovery,” whether principles of “inquiry notice” should be incorporated into the phrase, and if so, what form of inquiry notice standard should be applied.

Predicting the outcome of cases before the Supreme Court is always a speculative game, but we believe it is interesting to look at this case in terms of possible outcomes, not only through the eyes of the parties, but of the various constituencies who have lined up to support their favored approach to inquiry notice under the statute.

### Background

The background of the Merck case, which involves claims about the popular drug Vioxx, has been widely reported.[1]

In short, Merck filed a motion to dismiss a shareholder suit, arguing that a Warning Letter publicly issued by the FDA in 2001, together with publicity surrounding it and other lawsuits filed in the same period, should have put investors on notice of a potential fraud claim, and that the plaintiffs had failed to file the action within two years of such notice.

Citing Third Circuit precedent, the district court dismissed the suit, ruling that “a reasonable investor in Merck would have discovered this public, company-specific information [in the Warning Letter] and recognized it as a storm warning of fraud.”[2]

The shareholder plaintiffs appealed to the Third Circuit. Interestingly, the Third Circuit conducted a thorough examination of its own precedent, which it conceded was ambiguous as to the application of inquiry notice principles.[3]

Ultimately, the court reversed, reasoning that because the plaintiffs’ claim was based on Merck’s allegedly false statements of opinion as to the safety of Vioxx, in order to have sufficient inquiry notice, there needed to be publicly known information suggesting not only that the opinions were untrue, but that they were not honestly believed by Merck.

In other words, the FDA Warning Letter did not give investors sufficient reason to suspect that Merck’s misstatements were made with scienter.

While noting that the Warning Letter itself did not trigger a sufficient “storm warning,” the Third Circuit adopted the position that a later public event, the publication of the results of a Boston hospital study in the Wall Street Journal in 2003, was the operative trigger for inquiry notice because for the first time it suggested that Merck’s reassurances to the public regarding the safety of Vioxx were not honestly held.

### **Summary of the Parties’ Arguments**

On first blush, this case would appear to turn on a factual determination of which public information, for example the FDA Warning Letter or the Wall Street Journal article, correctly triggered inquiry notice.

Indeed, this was the principal argument advanced by the shareholders before the Supreme Court — that under the particular facts of this case, no “storm warnings” were present at all outside of the two-year window preceding their filing of the action.

Because this case arose on a Rule 12(b)(6) motion to dismiss, rather than summary judgment, there are many disputed facts. But, the main legal dispute is a stark one: whether a shareholder’s duty to investigate a possible fraud claim is triggered by inquiry notice of a material misstatement alone, or inquiry notice of facts that give rise to suspicion that the defendant has acted with scienter (i.e., that the fraud was intentional or reckless).

Highlighting this disagreement, Merck argued for certiorari by, in part, trumpeting a split in the Circuits as to this very issue. Only the Third and Ninth Circuits would postpone the statute of limitations from running until inquiry notice of facts leading to scienter is present.

The balance of the Circuits apply a number of differing — but stricter from the perspective of the plaintiff — standards that would generally require the investigation to begin with inquiry notice of the misstatement alone.

### **Oral Argument Before the Court**

Merck’s argument to the Supreme Court centered on the notion that shareholders, with suspicion of fraud triggered by the FDA Warning Letter concerning the drug, had sufficient time to investigate all the necessary facts (including evidence of scienter) and file a well-pleaded complaint for securities fraud under Section 10(b) within two years.

Questions posed by Justices Antonin Scalia and Ruth Bader Ginsburg, however, suggested skepticism toward Merck’s argument, alluding to the fact that Merck’s responses to questions about the safety of Vioxx after the Warning Letter was issued may have served to throw even diligent potential plaintiffs off the trail.

In a particularly colorful illustration, Justice Breyer posed a hypothetical that assumed the sole witness with evidence of scienter was jailed in Burma and unable to be interviewed by the potential plaintiff until after the statute had run. Under Merck’s theory, either the limitations period would run, or the plaintiff would have to file a complaint that lacked evidence of scienter.

At oral argument, the shareholders attempted to advance the argument that the word “discovery” in the statute means actual discovery, shunning the concept of inquiry notice in its entirety.

The shareholders were quick to concede, however, that in practice there is no difference between the standard of actual notice and inquiry notice in a fraud-on-the-market case, as the substantive violation is judged by the totality of the information available in the public domain.

Turning to the inquiry notice issue, the justices raised several questions showing concern for the practical concerns raised by the competing notice standards. Justices Ginsberg and Sonia Sotomayor asked questions that forced counsel for the shareholders to defend whether they had filed an improper complaint, i.e, before plaintiffs had evidence of scienter.

Justice Samuel Alito questioned why, if the standard for inquiry notice were to be linked to the PSLRA pleading standard, such that “[a]t that point, the plaintiff has everything that’s necessary to file a complaint,” a potential plaintiff would need an additional two years to file suit?

### **Positions of Amicus Curiae**

A wide array of parties — mostly representatives of plaintiffs or defendants that have a stake in the practical effects of the outcome on future securities litigation — have lodged some 15 amicus curiae briefs with the court.

The amici line up in favor of the shareholder plaintiffs, two to one, including the United States, who urges the adoption of the “proper” construction of Section 1658(b) as necessary to support “[m]eritorious private securities-fraud actions.” Such actions, the government posits, “are an essential supplement to criminal prosecutions and civil enforcement actions brought by the United States and the ... SEC.”

Joining the government in support of the shareholder plaintiffs were the National Association of Shareholder and Consumer Attorneys, the State of Ohio and 25 other States and Commonwealths, the AARP and the Detective’s Endowment Association Annuity Fund, a group of six state pension fund and retirement association administrators; the Council of Institutional Investors, the National Coordinating Committee for Multiemployer Plans, Change to Win and Change to Win Investment Group and Dr. Harlan M. Krumholz and Dr. Joseph S. Ross.

On the other side, supporting Merck’s position, appeared DRI — The Voice of the Defense Bar, the Washington Legal Foundation, the Securities Industry and Financial Markets Association, the U.S. Chamber of Commerce, the Pharmaceutical and Research Manufacturers of America, and a group of faculty from various law and business schools. The intense interest in the case begs the question — who stands to gain the most from a decision either way?

A decision affirming the Third Circuit, and embracing the arguments supported by the shareholders and the government, could — depending on how far it goes — not only overturn a significant amount of established precedent across the country, but would ease the pressure on potential plaintiffs, from a practical standpoint, to discover evidence of scienter sufficient to meet the pleading requirements under the PSLRA, which is often hidden from public view.

If the court reverses, holding in favor of Merck, and adopts an inquiry notice standard that requires investors to begin investigating upon notice that material misstatements may have occurred, shareholders would be placed on the horns of a significant dilemma.

With a maximum of two years to investigate their claim, and perhaps encountering difficulty finding evidence of scienter, shareholders might choose to run the risk of filing a specious and unsupported claim (at least as to the allegations of scienter) rather than facing the more serious risk of losing the claim from the outset as being barred by the statute of limitations.

Moreover, under any standard based on constructive rather than actual notice, the clock starts for all investors at the same time, leaving particular shareholder who receives the information later that much less time to act.

Allowing plaintiffs to wait until evidence of scienter materializes before putting them on the clock for filing suit should, in theory, result in lawsuits that are fewer in number, but better in quality, as claims that lack sufficient allegations of scienter would tend not to be filed.

On the other hand, allowing plaintiffs additional time to identify scienter may well extend the “sword” that hangs over defendants and increase the number of suits that litigate “stale” facts.

We are doubtful, however, that the adoption of the more lenient standard of inquiry notice would impact either the number of suits filed, or the number of suits that survive a motion to dismiss on the grounds that scienter was not adequately pleaded.

In practice, we have observed that the converse is often true: the longer the plaintiffs’ bar has lived with a potential theory of liability, the more likely they are to pursue it, despite its shortcomings.

Observers should not lose sight of the practical implications of these possible outcomes on how a securities fraud case under Section 10(b) will actually be litigated. If the court embraces constructive notice as opposed to actual notice, as we think it will, the onus will remain on determining the date upon which a the plaintiff should have been on notice to investigate a possible fraud.

From that point, which in most cases will be the first public disclosure of a material misstatement, the plaintiff could have an absolute two-year period to investigate and bring its claim, which would be a workable and easy-to-apply standard.

Any standard that requires a subjective analysis of the reasonableness of the plaintiff’s investigation would be more difficult to apply and would consume significant judicial resources, perhaps fostering evidentiary hearings on the threshold statute of limitations issue. Defendant would have to be permitted to put the plaintiff’s investigatory conduct “on trial.”

In hindsight, it will usually be possible to construct a far more diligent investigation than the one that plaintiff can prove it conducted. This is not necessarily unjustified. There exists a long-standing basis in the law to demand that plaintiffs be put to the test, as the discovery rule is a benefit conferred on plaintiffs by application of equitable principles that require the recipient of the benefit to act in good faith.

Yet, in the real world of high-stakes litigation, the question of whether a plaintiff conducted a good-faith investigation will likely be a hard-fought proposition, itself requiring substantial discovery.

## **Conclusion**

The issues in the case are complicated and intertwined with other securities litigation jurisprudence, particularly as surrounds pleading requirements under the PSLRA. If we were to offer a prediction, it would be two-fold.

First, it is reasonable to expect that the holding in this case will be narrowly confined to fraud-on-the-market cases, as this was the case presented.

Second, we expect the court to adopt an inquiry notice standard that is in harmony with the PSLRA, such that “discovery of the facts constituting the violation” includes facts giving rise to suspicion of both a misstatement and scienter.

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*The opinions expressed are those of the authors and do not necessarily reflect the views of Portfolio Media, publisher of Law360.*

[1] See, e.g., Some Justices Voice Skepticism of Merck in Vioxx Case, Wall Street Journal (Dec. 1, 2009); High Court Seems Unconvinced by Merck in Vioxx Arguments, National Law Journal (Dec. 1, 2009).

[2] Reynolds v. Merck & Co., 483 F.Supp.2d 407, 419 (D. NJ 2007).

[3] Merck & Co. v. Reynolds, 543 F.3d 150, 162-65 (3d Cir. 2008).