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WSGR ALERT

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SUPREME COURT DECISION NARROWS STATUTE OF LIMITATIONS DEFENSE

On Tuesday, April 27, 2010, the United States Supreme Court established that the statute of limitations in a securities fraud action does not begin to run until plaintiffs discover the facts establishing all the elements of the violation, including *scienter* (i.e., a fraudulent state of mind). In *Merck & Co., Inc. v. Reynolds*, the Court rejected the argument that the limitations period begins to run when plaintiffs are put on "inquiry notice" that a violation has occurred. Although the Court asserted that the limitations period begins to run when a reasonably diligent plaintiff *could have* discovered the facts establishing the violation, the probable effect of the ruling is that courts will not start the clock on the limitations period until the facts of an alleged violation actually have been discovered. Thus, there likely will be an increase in securities fraud filings as plaintiffs pursue claims that previously would have been time barred under the "inquiry notice" rule.

Background

The action alleged that Merck committed securities fraud by misleading investors about safety issues concerning the company's drug Vioxx (thereby causing the investors to overestimate Vioxx's commercial prospects). Under the applicable statute of limitations, a private claim alleging securities fraud "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). The complaint against Merck had been filed on November 6, 2003. Thus, at issue was whether the plaintiffs should have discovered the facts of the violation more than two years before the filing, or prior to November 6, 2001. The district court dismissed the action after finding that certain events prior to that date should have put plaintiffs on notice that fraud may have occurred. The Court of Appeals for the Third Circuit reversed, holding that while those events may have constituted "storm warnings," they did not suggest much by way of *scienter*, and thus did not put the plaintiffs on "inquiry notice" requiring them to investigate further. The Supreme Court granted certiorari to resolve inconsistencies in the standards applied by various lower courts to determine when the statute of limitations begins to run. Some courts had held that inquiry notice was sufficient, while others required actual disclosure of facts that would alert a reasonable plaintiff to the violation.

Holding

The Court held that the phrase "after the discovery of the facts constituting the violation," as used in § 1658(b), means actual or constructive discovery—i.e., when reasonably diligent plaintiffs could have discovered the facts of the violation. The Court rejected Merck's argument that the limitations period should begin to run when plaintiffs were put on inquiry notice that a violation may have occurred. The Court explained that since an investigation into securities fraud could take years to uncover the relevant facts, allowing the limitations period to begin to run when plaintiffs are put on inquiry notice might reward concealment of fraud by preventing a diligent plaintiff from completing an investigation within the limitations period. The Court found that its own precedent, the practice of several lower courts, and the likely intent of Congress suggest that discovery in the securities fraud context occurs when a plaintiff could have uncovered the facts of the violation.

The Court further held that the "facts constituting the violation" means facts regarding *all* elements of the violation. Thus, facts establishing *scienter*, or that a false statement was made knowingly or with severe recklessness, also must be discoverable before the limitations period will begin to run. Additionally, the Court rejected the argument that any material misstatement or omission should suggest *scienter*. Rather, the Court held that there must be some additional information that could lead a reasonable investor to conclude that the defendants acted with *scienter*. Accordingly, the Court held that Merck's shareholders could not have discovered whether Merck's comments regarding Vioxx were intentionally misleading prior to November 2001.

Implications

The Court's decision narrows the statute of limitations defense in securities actions by raising the disclosure bar required to start the statutory period. In other words, in some cases companies will have a more difficult time establishing that the relevant facts were knowable to plaintiffs more than two years prior to the filing of the suit. Although the Court purports to adopt a constructive discovery rule—whereby the limitation period begins to run when the plaintiffs *could have* discovered the relevant facts—in reality, it may turn out that lower courts will be reluctant to engage in such hypothetical calculations. In practice, courts likely will look to the specific facts that actually were known

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to plaintiffs or otherwise obviously available, including the facts (or lack thereof) that establish *scienter*. Thus, plaintiffs are now more likely to assert claims that might have been time barred under a "notice inquiry" rule. Depending on the interpretation that the lower courts give to *Merck*, potential securities defendants face much greater uncertainty concerning the running of the statute of limitations.

For more information regarding the *Merck* case or other securities fraud litigation matters, please contact a member of Wilson Sonsini Goodrich & Rosati's securities litigation department.

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650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com