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Expert Analysis

Revisiting the Limitations Period For Securities Fraud

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In the last several years, the U.S. Supreme Court has addressed several difficult federal securities fraud issues, resolving circuit splits and providing greater certainty and uniformity. Now the Court appears poised to wade into another murky issue—when the statute of limitations applicable to a federal securities fraud claim begins to run. This issue was last addressed by the Court nearly 20 years ago in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991), when it held that the limitations period should be governed by a nationwide uniform standard: one year "after discovery of the facts constituting the violation" or three years after the violation. After *Lampf*, Congress changed the limitations periods to two and five years, respectively, but retained *Lampf's* trigger for the shorter limitations period: "discovery of the facts constituting the violation." 28 U.S.C. §1658(b).

The Court has now granted certiorari in a case raising the issue of when the statute of limitations begins to run for securities fraud claims under the "inquiry notice" standard. *In re Merck & Co. Secs., Deriv. & "ERISA" Litig.*[1] The circuit courts agree that a limitations period triggered by "discovery" of an alleged violation commences when a plaintiff either actually or constructively discovers the relevant facts.

Constructive discovery is a two-step analysis: First, when did the plaintiff receive sufficient information of possible wrongdoing such that a reasonable investor would undertake an investigation to determine if a legal claim exists ("inquiry notice") and second, when thereafter, in the exercise of reasonable diligence, should the plaintiff have discovered the facts constituting the violation. This latter date should trigger the limitations period.

> The Court is likely to reaffirm that the limitations period commences only after actual or imputed discovery of the facts.

The 'Merck' Case

In *Merck*, the U.S. Court of Appeals for the Third Circuit, in a split decision, held an investor is not on inquiry notice of a potential fraud claim until the investor has knowledge of a possible fraud, including scienter. The court held that even widely publicized misstatements by Merck about the safety of its drug Vioxx were insufficient to give rise to a duty to investigate without evidence that its misstatements were intentional. The United States Court of Appeals for the Ninth Circuit also recently required evidence of scienter for inquiry notice, in *Betz v. Trainer Wortham & Co.*, 519 F.3d 863 (9th Cir. 2008), and a certiorari petition is pending.

The misstatements in *Merck* arose after Vioxx studies made public by at least 2000, indicated that Vioxx was associated with a higher incidence of heart attacks than competing drugs using Naproxen. Two possible explanations existed: Vioxx caused more heart attacks or Naproxen prevented them. Merck repeatedly expressed its view that Naproxen lowered the heart attack risks until the FDA warned Merck, in September 2001, that its marketing materials were "false" because no substantial evidence existed supporting that assertion, and Merck failed to provide the other reasonable explanation, that Vioxx caused more heart attacks. The warning letter received widespread coverage by media and securities analysts, and consumer lawsuits were filed both before and after the FDA letter. An October 2001 New York Times article reported that a Merck scientist admitted Merck had insufficient findings to resolve the issue. An October 2003 Harvard study indicated that Vioxx, as compared with a similar drug, increased heart attacks. In September 2004, Merck withdrew Vioxx from the market.

Securities lawsuits were filed in

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November 2003. The district court dismissed the claims as time-barred, holding that an "overwhelming collection of information signaling deceit by Merck with respect to the safety of VIOXX" existed at the time of the October 2001 New York Times article and placed plaintiffs on inquiry notice of possible fraud which plaintiffs failed to investigate.[2]

The Third Circuit reversed, finding that misstatements alone were insufficient "storm warnings" of culpable activity under the securities laws where those misstatements related to beliefs or opinions, given the requirement to demonstrate that misstatements of opinion were issued "without a genuine belief or reasonable basis."[3] The court found there was no reason for an investor to suspect that Merck did not believe Naproxen reduced heart attacks until the November 2003 Harvard study.[4] In rejecting October 2001 inquiry notice, the court also considered the absence of any large stock price movement or changes in analyst ratings.[5] Finding no inquiry notice, *Merck* never reached the issue of when a reasonable investigation would have provided facts sufficient to file a complaint.

Judge Roth, dissenting, found the FDA warning letter alone, and the total mix of information in the public realm, provided more than adequate "storm warnings" and concluded: "I cannot see how a reasonable investor could not be aware of the *possibility* that Merck had been fraudulently misrepresenting the cardiovascular safety of Vioxx."[6] Under Judge Roth's formulation of inquiry notice, the limitations period begins when information alerts a reasonable investor to the possibility of the general fraudulent scheme alleged in the complaint, "particularly since" the plaintiffs failed to demonstrate either a diligent investigation or that "they were unable to uncover pertinent information during the time period."[7]

Analysis

Confusion reigns in the circuit courts, compounded by the fact-specific nature of the issues. In some circuits, the statute begins to run as soon as a plaintiff receives storm warnings of possible fraud (Fourth and Eleventh circuits). In some, the statute runs from inquiry notice if a reasonably diligent inquiry could have uncovered the facts underlying the fraud claims within the limitations period (Fifth and Eighth circuits). In others, the statute begins to run only at the time a plaintiff using reasonable diligence could have discovered the facts underlying its claim. (First, Sixth and Tenth circuits). In the Second Circuit, a plaintiff on inquiry notice must actually conduct an investigation or the limitations period will be deemed to run from the date the duty to investigate arose. This also is the Third Circuit rule.

Confusion reigns in the circuit courts, compounded by the fact-specific nature of the issues. In the Second Circuit, a plaintiff on inquiry notice must actually conduct an investigation or the limitations period will be deemed to run from the date the duty to investigate arose.

The statutory language plainly states a plaintiff has two years "after discovery of the facts constituting the violation" to file suit, from which it appears the limitations period cannot begin to run until a claim that would withstand dismissal may be stated. "Inquiry notice" connotes a point in time before all the facts are known and thus cannot be the starting date for the limitations period. Thus, no basis exists to start the limitations period upon inquiry notice as some circuit courts have held. As *Lampf* observed in finding equitable tolling "fundamentally inconsistent" with the limitations structure: "The one-year period, *by its terms*, begins after discovery of the facts constituting the violation, making tolling unnecessary."[8]

Thus, whatever triggers inquiry notice, the limitations period should never begin to run until an investor discovers or should have discovered the facts constituting the violation. If the misstatements by Merck had triggered inquiry notice, a reasonable investigation would not have uncovered evidence of scienter, according to the Third Circuit, until the Harvard Study two years later and therefore, assuming an investigation, the action would not have been barred.

The problem in *Merck* was that Third Circuit precedent required an investigation but none had been conducted, thus making inquiry notice the crucial date. If the Third Circuit had found evidence of falsity, rather than fraud, sufficient for inquiry notice, and then applied its pre-existing rule that inquiry notice triggers the limitations period where no investigation is undertaken, the court might have deemed the suit untimely.[9]

The Solicitor General argued in *Betz*, as amicus on certiorari, that imputing knowledge as of the inquiry notice date where no investigation is conducted is inconsistent with both the plain text of Section 1658(b) and *Lampf's* rejection of equitable tolling. However, the legislative history of Section 1658(b) states that the discovery provision was not intended to change then-existing decisional law and specifically quotes the Second Circuit: "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."[10] Thus, although not in the statutory language, the Court could nonetheless adopt that rule. Indeed, a duty to investigate without such an early imputed knowledge concept would be meaningless.

Regarding the trigger for inquiry notice, the Solicitor General agreed with *Betz* and *Merck* that evidence of scienter is required. "Because scienter is an essential element of a securities-fraud claim, there is no logical basis for concluding that a reliably diligent investor would have undertaken further inquiry if the facts before him did not suggest that the defendant had acted with the requisite state of mind."[11] However, in many cases whether inquiry notice requires scienter "will be utterly irrelevant" because a misstatement concerning a matter exclusively within the knowledge or control of the speaker suggests scienter and thus will automatically constitute inquiry notice.[12]

Indeed most courts have articulated the inquiry notice standard as involving "fraud," thus necessarily suggesting evidence of scienter, although only *Betz* and *Merck* have directly addressed, and expressly required, evidence of scienter. It was the opinion nature of the *Merck* misstatements which gave rise to specific consideration of scienter. A comparison to the misstatements in *Betz* is instructive in this regard.

In *Betz*, a brokerage client was told her investment principal was risk-free. After monthly statements reflected rapid principal decline, upon inquiring she was informed that her principal would return when market conditions improved. Despite the seemingly obvious fact she had been lied to, *Betz* found no evidence of scienter.[13] Reviewing these facts one could conclude not only that the plaintiff had information indicating the misstatements were intentional but that she was on actual—not constructive—notice of the fraud.[14]

In *Merck*, however, because the misstatements involved Merck's belief, the sincerity of that belief was the relevant issue and misstatements alone arguably did not evidence the scienter necessary to trigger inquiry notice of a fraud claim. While the nature of the misstatement may be relevant to assess the requirements for inquiry notice, the problem appears more to concern how individual judges see the facts.

The Supreme Court's Task

Resolution of competing policy issues, often the enunciated bases for recent securities fraud decisions, is likely to play a significant role in the outcome here. On one side, an investor must have sufficient time to file a fully formed, sustainable complaint, under the heightened pleading requirements of the Private Securities Litigation Reform Act which requires class plaintiffs to state with particularity facts giving rise to a strong inference of fraud.

Merck acknowledges such a policy motive, observing: "It is ironic that the dissent, although noting what might be viewed as Merck's misrepresentations, would apply the Statute of Limitations to deprive plaintiffs of the opportunity to prove a viable case against Merck for such misrepresentations."[15] Providing time to investigate is important to permit an investor to uncover fraud, but meeting the heightened pleading requirements is equally important to position courts to distinguish between well-founded and frivolous cases at the pleading stage.[16]

On the other side of the policy equation is Congress' desire "to limit the opportunistic use of federal securities law to protect investors against market risk" by imposing a duty on plaintiffs to take prompt steps to uncover fraud.[17] Merck argues that now in the Third Circuit "a plaintiff is not obligated to ask a single question until it has evidence of scienter, materiality, and loss causation—that is, until it has in hand a nearly fully formed cause of action."[18] Such a requirement conflicts with the goals of inquiry notice: to encourage investors to investigate possible fraud, to discourage "a wait-and-see" approach, and to ensure fairness to defendants against claims that have been allowed to slumber.[19]

A definition of "discovery of the facts constituting the violation" appears to be easy: when the facts necessary for a sustainable complaint are in hand. Doing away with inquiry notice entirely would solve much, if not all, of the existing confusion. However, the Supreme Court's view of the competing policy issues is likely to inform its decisions regarding whether to keep inquiry notice and, if so, in what form, and whether to impose upon investors an actual duty to investigate and if so, what consequences follow a failure to do so. Reading the tea leaves, the Court is likely to reaffirm that the limitations period commences only after actual or imputed discovery of the facts, and may well formulate broad guidance for inquiry notice that provides an incentive to investigate fraud at an early stage, and imposes a duty to investigate, failing which imputed knowledge would bar claims.

1. 543 F.3d 150 (3d Cir. 2008), cert. granted, (U.S. May 26, 2009) (No. 08-905).
2. 483 F.Supp.2d 407, 419 (D.N.J. 2007).
3. 543 F.3d at 166.
4. Id. at 172.
5. Id. at 168.
6. Id. at 177 (emphasis in original).
7. Id. at 178.
8. 501 U.S. at 363 (emphasis added).
9. See Brief for the United States as amicus curiae, p. 18, n.6.
10. S. Rep. 107-146, 2002 WL 863249, *29 (Leg. Hist.). The remainder of the brief legislative history sheds little light on the issue noting (inconsistently) both that the "discovery" limitations period begins to run when a plaintiff is on inquiry notice of a fraud and that it begins to run after discovery should have been made by the exercise of reasonable diligence.
11. U.S. amicus, p. 8.
12. U.S. amicus, p. 18.
13. 519 F. 3d at 878. The Court went on to find that a jury trial was required to determine whether a reasonable investor would have initiated a further inquiry and, if so, would have discovered the fraud in light of "active assurances from the highest levels of the securities firm that there was no problem with her account and all would made right." Id. The issue whether reassuring statements may dissipate storm warnings was also present in *Merck*. 543 F.3d at 167.
14. See U.S. amicus, p. 5; order denying petition for rehearing en banc, 519 F.3d 863, 866 (Kozinski, J. dissenting).
15. 543 F.3d at 172.
16. *Tellabs Inc. v. Makor Issues & Rights, Ltd.*, 127 S. Ct. 2499, 2510 (2007).
17. 2002 WL 863249 at *29.
18. Petition for a writ of certiorari, filed Jan. 15, 2009, p. 24.
19. Id. p. 28.

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