To read the transcript of the oral argument in *Merck & Co, Inc. v. Reynolds, et al.*, please click here.

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The Supreme Court Considers the 'Inquiry Notice' Standard in Federal Securities Fraud Cases

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The Supreme Court heard oral arguments yesterday in *Merck & Co, Inc. v. Reynolds*, No. 08-905, a case in which the Court may clarify what constitutes discovery of facts supporting a federal securities fraud claim for purposes of the statute of limitations. Specifically, the Court in *Reynolds* is poised to resolve a circuit split concerning whether the Third Circuit erred in holding, in accord with the Ninth Circuit but in contrast to most of the 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 investigation." *In re Merck & Co., Inc. Litigation*, 543 F.3d 150, 161 (3rd. Cir. 2008). Under 28 U.S.C. § 1658(b), claims of "fraud, deceit, manipulation or contrivance" concerning the Securities Exchange Act of 1934 can be made either "[two] years after the discovery of the facts constituting the violation," or "[five] years after such violation," whichever is earlier. In contrast, the other circuits have held that "a plaintiff who suspects the possibility that the defendant has engaged in wrongdoing is on inquiry notice and thereafter must exercise reasonable diligence in investigating his potential claim," and therefore the limitations period is triggered by not only actual, but also constructive, notice of the facts constituting the violation.

BACKGROUND

The *Reynolds* appeal relates to Merck & Co., Inc.'s ("Merck's") marketing of Vioxx, one of a class of anti-inflammatory medicines known as "COX-2 inhibitors." Vioxx shared the anti-inflammatory properties of drugs such as ibuprofen and naproxen, but did not carry the risk of gastrointestinal damage associated with those drugs. Merck sought to capitalize on this by emphasizing the drug's safety and its commercial prospects through press releases and other public statements.

Beginning in January 1999, Merck initiated Vioxx Gastrointestinal Outcomes Research ("VIGOR") to compare the effectiveness of Vioxx to that of naproxen. The company publicized the results of the study on March 27, 2000, which showed that users taking Vioxx had a higher incidence of heart attack than users of naproxen. *In re Merck Litigation*, 483 F.Supp.2d 407, 410 (2007). Although Merck did not perform any studies to verify its theory, Merck hypothesized that naproxen decreased the risk of heart attack ("naproxen hypothesis"), not that Vioxx increased the risk of heart attack. Merck therefore did not disclose warnings concerning an increased risk of heart attack associated with Vioxx.

In September 2001, the Food and Drug Administration ("FDA") sent Merck a warning letter, stating that Merck's "promotional activities and materials" for the

"So outside of [information in the public domain], how would constructive knowledge or constructive discovery be any different [from actual knowledge]?"

JUSTICE SOTOMAYOR

marketing of Vioxx were "false, lacking in fair balance, or otherwise misleading" (the "Warning Letter"). The media and securities analysts covered the Warning Letter extensively. 483 F.Supp.2d at 411.

On October 30, 2003, *The Wall Street Journal* published an article addressing a Harvard-affiliated Brigham and Women's Hospital in Boston study ("Harvard Study"), which had found an increased risk of heart attack in patients taking Vioxx compared with patients taking either Celebrex or a placebo. The Third Circuit opinion states that "during this time, Merck's stock price dropped below the S & P 500 Index, and did not rise above that index during the remainder of the class period." 543 F.3d at 159. On September 30, 2004, Merck withdrew Vioxx from the market. Its stock price dropped more than $12 per share that day, closing at $33.00, down 27% from the previous day's close.

Beginning on November 6, 2003, various plaintiffs, including Respondent Richard Reynolds, sued Merck in federal district courts throughout the country, claiming, *inter alia*, that the company had violated Section 10(b) of the Securities and Exchange Act of 1934. Merck moved to dismiss plaintiffs' securities-fraud claim on the ground that it was time-barred because plaintiffs were on inquiry notice of the claim before November 6, 2001, more than two years prior to the filing of their initial complaints. Judge Stanley Chesler of the District Court of New Jersey granted Merck's motion to dismiss on the basis that the claim was time-barred. The court found that "sufficient storm warning" had put plaintiffs on inquiry notice more than two years before the filing of Respondents' complaints.

On appeal, the Third Circuit reversed the District Court's dismissal and remanded, holding that the District Court "acted prematurely in finding as a matter of law that [Respondents] were on inquiry notice of the alleged fraud before October 9, 2001." The Third Circuit viewed the Warning Letter simply as an instruction that Merck warn health care professionals and consumers that Merck had never proven the naproxen hypothesis in a clinical study. The court reasoned that the FDA's description was "quite similar" to information previously released by Merck, and thus did not put investors on notice of the defendant's allegedly fraudulent activities. The Third Circuit similarly rejected Merck's contention that the FDA's actions were analogous to allegations of accounting fraud issued by the SEC, distinguishing the standards governing the activities of the regulatory agencies.

"[I]f actual knowledge means things that the plaintiff doesn't actually know, then I don't know what the difference is between actual knowledge and constructive knowledge."

JUSTICE ALITO

Of note, the Third Circuit gave weight to its observation that the Warning Letter had little effect on the market, noting "[a]lthough the lack of significant movement in Merck's stock price following the FDA warning letter is not conclusive, it supports a conclusion that the letter did not constitute a sufficient suggestion of securities fraud to trigger a storm warning." 543 F.3d 171. Merck's stock price dipped slightly following the issuance of the Warning Letter before closing higher just a week and a half later. Although recognizing this lack of effect to be inconclusive, the Third Circuit nevertheless stated that this observation supported its conclusion that the Warning Letter did "not constitute a sufficient suggestion of securities fraud to trigger a 'storm warning' of culpable activity under the securities laws." Instead, the Third Circuit found the subsequent Harvard Study to be sufficient notice to investors that Merck did not believe in the naproxen hypothesis, and that its marketing and representations relating to Vioxx were fraudulent.

"You have to have specific evidence of scienter. And there is nothing here to indicate that the plaintiffs had that."

JUSTICE KENNEDY

SUMMARY OF THE NOVEMBER 30 ARGUMENT

The Supreme Court heard oral argument yesterday from Petitioner Merck, Respondents, and the United States. Petitioner argued that plaintiffs should be deemed to be on inquiry notice of a securities fraud claim when they have imputed knowledge of facts supporting such a claim. According to Petitioner, the statutory standard of "discovery of the facts" does not require that a plaintiff need not possess information specifically relating to scienter to be on inquiry notice; rather, it is sufficient for a plaintiff who suspects the possibility of wrongdoing to be on inquiry notice, requiring the plaintiff to exercise reasonable diligence in investigating his or her potential claim.

Justice Ginsburg began by asking, "How would the most diligent plaintiffs have gone about finding out whether Merck really had no good faith belief in this so-called Naproxen hypothesis?" Petitioner responded that the public domain contained considerable information "suggesting the possibility that Petitioners had engaged in securities fraud when they made [the] statements [at issue]." Petitioners argued that this information was sufficient to place Respondents on inquiry notice of their claims, triggering their duty to investigate.

Then, Justice Scalia asked whether "there is substantial evidence of fraud when there is simply substantial evidence of inaccuracy . . . . You can misrepresent something without having scienter to defraud." Justice Kennedy stated that "the companies can't have it both ways. You have to have specific evidence of scienter. And there is nothing here to indicate that the plaintiffs had that" evidence to trigger the statute of limitations.

Justice Stevens pressed the Petitioner, noting, "In the text of the statute it says 'two years after discovery,' and you argue it should mean 'two years after he should have discovered' and that period is being measured by a date from inquiry notice, which is not mentioned in the statute at all." Petitioner conceded that the phrases "inquiry notice" and "after he should have discovered" did not appear in the statute, but argued that its interpretation would constitute a "fairly modest step."

Justice Sotomayor then asked Petitioner to distinguish actual knowledge from constructive knowledge: "So outside of [information in the public domain], how would constructive knowledge or constructive discovery be any different?" Petitioner replied that, if the Court were going to adopt an "actual knowledge" standard, such a standard must include information in the public domain. Justice Alito then observed that it would be "a meaningless distinction" if actual knowledge were to include knowledge in the public domain of which a plaintiff is not actually aware.

Respondents, on the other hand, argued that the Court should apply the "normal and well-established meaning" of the word "discovery," i.e., that the statute of limitations should begin to run only when plaintiffs actually discovered fraud. In response, Justice Scalia noted that Respondents' definition of actual discovery also included some forms of constructive discovery.

As an aside, Justice Kennedy mentioned that, even accepting Respondents' pleading standard, "there is some problem with the allegation that there was fraud, because Merck did not disclose that the hypothesis was only hypothetical." Respondents' reply was that the analyst who reviewed the FDA Warning Letter concluded that the letter did not constitute a change from Merck's prior statements.

"In the text of the statute it says 'two years after discovery,' and you argue it should mean 'two years after he should have discovered.'"

JUSTICE STEVENS

The United States argued that the statute's two-year limitations period begins to run only after the plaintiff discovers or should have discovered facts demonstrating that all elements of a securities-fraud violation can be established, including scienter. Under the Government's standard, inquiry notice identifies when a reasonable plaintiff would begin investigating a possible violation. Suspicion of scienter is necessary for inquiry notice, though it may arise from suspicion of falsity.

On rebuttal, Petitioner emphasized the narrow issue before the Court: whether a plaintiff must possess information specifically relating to a defendant's scienter to be on "inquiry notice." As Petitioner walked through elements of a 10b-5 claim, Justice Ginsburg inquired as to what injury Respondents had suffered at the time of the Warning Letter. In response, Petitioner admitted that Respondents may not have suffered injury at the time of the Warning Letter, but that the statute of limitations in question "refers to the facts constituting a violation of section 10(b), not all the elements of a private cause of action."

IMPLICATIONS

In deciding this case, the Court may clarify the appropriate standard for evaluating what constitutes "inquiry notice" under 28 U.S.C. § 1658(b). The Third and Ninth Circuits have interpreted inquiry notice narrowly, requiring potential plaintiffs to be aware of evidence of scienter before the two-year period of limitations begins to run. See, e.g., Benak v. Alliance Capital Mgmt, L.P., 435 F.3d 396, 400 (3d Cir. 2006); Betz v. Trainer Wortham & Co., 519 F.3d 863, 869 (9th Cir. 2008) (cert. granted). Other Courts of Appeal have found sufficient notice to putative plaintiffs when they possess sufficient information, or such information is otherwise in the public domain, to cause a reasonable investor to suspect the possibility that the defendant has engaged in securities fraud. See, e.g., Great Rivers Coop. Of S.E. Iowa v. Farmland Indus., Inc., 120 F.3d 893, 896 (8th Cir. 1997); Law v. Medco Research, Inc., 113 F.3d 781, 785 (7th Cir. 1997); Howard v. Haddad, 962 F.2d 328, 330 (4th Cir. 1992) (Powell, J.); Sterlin v. Biomune Sys., 154 F.3d 1191, 1996 (10th Cir. 1998); Jensen v. Snellings, 841 F.2d 600, 607 (5th Cir. 1988).

If the Supreme Court adopts the narrower interpretation of inquiry notice, defendants would have a more difficult time arguing that plaintiffs are barred from bringing 10b-5 claims on the grounds that the statute of limitations had run. In the event the Supreme Court were to reverse the Third Circuit and adopt the broader standard for "inquiry notice," defendants would have a greater chance of successfully arguing that plaintiffs failed to bring suit within the appropriate time frame. Such a result might also encourage plaintiffs to file actions earlier in order to avoid dismissal based on statute of limitations grounds.

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