# Supreme Court Clarifies Statute of Limitations for Private Securities Fraud Actions

On April 27, 2010, the United States Supreme Court held in *Merck & Co. v. Reynolds*[1] that the two-year statute of limitations for federal securities fraud that runs from discovery of "the facts constituting the violation" is not triggered until the plaintiff discovers, or a reasonably diligent plaintiff would have discovered, "the fact of scienter, 'a mental state embracing intent to deceive, manipulate, or defraud.'"[2] In so ruling, the Court largely swept away case law in the majority of the federal courts of appeals that had started the limitations period when a plaintiff was put on "inquiry notice" or encountered "storm warnings" of the possibility of fraud. The *Merck* decision addressed the "Catch-22" under which the statute of limitations could start to run before a plaintiff had the facts necessary to meet the heightened pleading requirements for federal securities fraud, which require plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[3]

The decision marked the first time the Supreme Court construed the provision of the Sarbanes-Oxley Act of 2002 that revised the statute of limitations for actions under § 10(b) of the Securities Exchange Act of 1934.[4] That legislation extended the prior judicially declared statute of limitations – the earlier of one year after discovery of the facts constituting the violation and three years after such violation[5] – to the earlier of two years after discovery and five years after the violation.[6] While liberalizing the discovery prong of the statute of limitations, *Merck* did not alter the statute's "unqualified bar" on actions instituted five years after a securities fraud violation has occurred.[7]

### *Prior Law: "Inquiry Notice" and "Storm Warnings"*

Prior to *Merck*, every court of appeals that had addressed the statute of limitations under Sarbanes-Oxley or its predecessor interpreted the word "discovery" to include not only facts a particular plaintiff actually discovered, but also the facts any reasonably diligent plaintiff *would* have discovered, and the Supreme Court affirmed this interpretation.[8] The lower courts, however, had employed widely divergent formulations of what a § 10(b) plaintiff had to find out to "discover" its claim and when the plaintiff was deemed to have "discovered" it.

Some circuits ruled that the statute of limitations began to run on the date when "storm warnings" of possible fraud put a plaintiff on "inquiry notice" of the need for investigation,[9] or when a plaintiff was aware of facts that would lead a reasonable person to investigate *and* consequently acquire actual knowledge of the defendant's misrepresentations.[10] Other circuits endorsed a test under which inquiry notice triggered a plaintiff's duty to investigate, and the running of the limitations clock began on the date the plaintiff, exercising reasonable diligence, should have discovered the facts underlying the alleged fraud.[11]

The Second Circuit's approach depended on whether a plaintiff had fulfilled its duty to investigate. If a plaintiff was placed on inquiry notice and failed to investigate, the statute of limitations was deemed to have started to run from the date the duty of inquiry arose.[12] If, however, the plaintiff had investigated, the limitations period commenced on the date a reasonably diligent plaintiff would have discovered the facts underlying its claim.[13]

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Yet other courts held that no duty to investigate arose, and the statute of limitations did not begin to run, until facts appeared that were "sufficiently probative of fraud – sufficiently advanced beyond the stage of a mere suspicion, sufficiently confirmed or substantiated – not only to incite the victim to investigate but also to enable him to tie up any loose ends and complete the investigation in time to file a timely suit."[14] The Third Circuit adopted a similar approach in *Merck*, holding that, in the context of a claim alleging falsely-held opinions or beliefs, the duty to investigate arises when a plaintiff has "sufficient information to suspect that the defendants engaged in culpable activity, i.e., that they did not hold those opinions or beliefs in earnest."[15]

### *The* Merck *Decision*

Affirming the Third Circuit's ruling, the Supreme Court held that a § 10(b) "cause of action accrues (1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, 'the facts constituting the violation' – whichever comes first," and that "the 'facts constituting the violation' include the fact of scienter . . . ."[16] The Court observed that the "'fact' of scienter 'constitut[es]' an important and necessary element of a § 10(b) 'violation'" – particularly given that Congress has enacted special heightened pleading requirements for the scienter element of § 10(b) cases.[17]

The Supreme Court rejected the approach, advocated by Merck, under which the limitations period would begin when "a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct a further inquiry,"[18] since "that point is not necessarily the point at which the plaintiff would already have discovered facts showing scienter or other 'facts constituting the violation.'"[19] The Court noted that "terms such as 'inquiry notice' and 'storm warnings' may be useful to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating," but emphasized that the limitations period does not begin to run until a plaintiff thereafter discovered, or could have discovered with reasonable diligence, the facts constituting the violation, including the defendant's scienter.[20]

The Court also rejected Merck's argument that "the court-created 'discovery rule' exception to ordinary statutes of limitations is not generally available to plaintiffs who fail to pursue their claims with reasonable diligence," pointing out that the statute itself "contains no indication that the limitations period should occur at some earlier moment before 'discovery,' when a plaintiff would have *begun* investigating . . . ."[21] The Court similarly rejected the argument that "even if the limitations period does generally begin at 'discovery,' it should nonetheless run from the point of 'inquiry notice' . . . where the actual plaintiff fails to undertake an investigation once placed on 'inquiry notice,'" reasoning that the statute "simply provides that 'discovery' is the event that triggers the 2-year limitations period" *regardless* of whether an actual plaintiff undertook a reasonably diligent investigation.[22]

However, although the Court refused to penalize a plaintiff who was placed on inquiry notice and failed to investigate, by declining to hold that the failure to investigate started the running of the statute of limitations, it noted that "[t]he limitations period puts plaintiffs who fail to investigate once on 'inquiry notice' at a disadvantage because it lapses two years after a reasonably diligent plaintiff would have discovered the necessary facts."[23] Accordingly, "[a] plaintiff who fails entirely to investigate or delays investigating may well not have discovered those facts by that time or, at least, may not have found sufficient facts by that time to be able to file a § 10(b) complaint that satisfies the applicable heightened pleading standards."[24]

### *How Will* Merck *Work in Practice?*

The inclusion of scienter among the facts that a plaintiff must discover (or would have discovered with reasonable diligence) before the limitations period begins to run is likely to afford many plaintiffs more time than they previously had to bring suit. Indeed, this is precisely the result the Supreme Court appears to have intended: the *Merck* decision reasons that "[i]t would . . . frustrate the very purpose of the discovery rule" if the limitations period for § 10(b) actions began to run before a plaintiff had discovered facts sufficient to satisfy the heightened pleading requirements for scienter.[25] But unlike determining when a plaintiff discovered or should have discovered the existence of a misrepresentation or omission, determining when a plaintiff discovered or should have discovered the defendant's culpable state of mind may turn out to be a far more difficult task for the courts.[26]

In addition, the Supreme Court left open whether "the facts constituting the violation" also include facts that show that the plaintiff has a right to recover against the defendant. The Court noted the suggestion in the United States' *amicus curiae* brief that the "facts concerning a plaintiff's reliance, loss, and loss causation are not among those that constitute 'the violation' and therefore need not be 'discover[ed]' for a claim to accrue,"[27] but expressly declined to opine on "the other facts [besides scienter] necessary to support a private §10(b) action."[28] Whether the statute of limitations starts to run when a plaintiff realizes it has been lied to, even though it has not yet suffered any loss, will undoubtedly be the subject of future litigation.

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1 No. 08-905, 2010 U.S. LEXIS 3671 (Apr. 27, 2010).
2 *Id.* at *8 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 n.12 (1976)).
3 15 U.S.C. § 78u-4(b)(2).
4 *See* Public Company Accounting and Investor Protection Act of 2002 [the "Sarbanes-Oxley Act of 2002"], Pub. L. No. 107-204, Title VIII, § 804, 116 Stat. 745, 801 (2002), codified at 28 U.S.C. § 1658(b).
5 *See Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991).
6 28 U.S.C. § 1658(b).
7 *Merck*, 2010 U.S. LEXIS 3671, at *29.
8 *See id*. at *25.
9 *See, e.g.*, *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001); *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162-63 (4th Cir. 1993).
10 *See, e.g.*, *Great Rivers Coop. v. Farmland Indus.*, 120 F.3d 893, 896 (8th Cir. 1997); *Jensen v. Snellings*, 841 F.2d 600, 606-07 (5th Cir. 1988).
11 *See, e.g.*, *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003); *Young v. Lepone*, 305 F.3d 1, 8-10 (1st Cir. 2002); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998).
12 *See, e.g.*, *Shah v. Meeker*, 435 F.3d 244, 251 (2d Cir. 2006).
13 *See, e.g.*, *LC Capital Partners, LP v. Frontier Ins. Group*, 318 F.3d 148, 154 (2d Cir. 2003).
14 *See Fujisawa Pharm. Co. v. Kapoor*, 115 F.3d 1332, 1335 (7th Cir. 1997).
15 *In re Merck & Co., Inc. Sec., Derivative & "ERISA" Litig.*, 543 F.3d 150, 164 (3d Cir. 2008), *aff'd sub nom. Merck & Co. v. Reynolds*, No. 08-905, 2010 U.S. LEXIS 3671 (Apr. 27, 2010); *see also Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 873, 878 (9th Cir. 2008).
16 *Merck*, 2010 U.S. LEXIS 3671, at *8.
17 *Id.* at *26-27.
18 *Id.* at *29 (quoting Brief for Petitioners at 20).
19 *Id.* at *30-31.
20 *Id.* at *34.
21 *Id.* at *31 (emphasis in original).
22 *Id.* at *31-32.
23 *Id*. at *32.
24 *Id*. at *32-33.
25 *Id.* at *27. Alternatively, plaintiffs might be prompted to file deficient claims; as the Third Circuit noted, Congress surely "did not envision a statute of limitations that would open the floodgates to a rush of premature securities litigation when its primary foray into this field in recent decades has been to deter poorly pleaded allegations of securities fraud." *Merck*, 543 F.3d at 164-65.
26 The Court rejected Merck's argument that "facts that tend to show a materially false or misleading statement (or material omission) are ordinarily sufficient to show scienter as well." *Merck*, 2010 U.S. LEXIS 3671, at *28.
27 *Id.* (quoting Brief for United States as *Amicus Curiae* Supporting Respondents at 12 n.1).
28 *Id.*