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THE SUPREME COURT'S RULING IN *MERCK* INCREASES UNCERTAINTY IN ASSESSING SECURITIES FRAUD LITIGATION RISK

The United States Supreme Court's recent decision in *Merck & Co., Inc. v. Reynolds* effectively extends the statute of limitations for securities fraud class actions. Specifically, *Merck* resolves a split in the circuit courts by holding that the statute of limitations applicable to securities fraud actions should begin to run at the time that a plaintiff discovers, or a reasonably diligent plaintiff should have discovered, the facts resulting in the alleged violations of law. On first glance, *Merck* has little practical effect on securities fraud cases where plaintiff lawyers have traditionally "raced to the courthouse" following a large drop in a company's stock price. Yet, as plaintiff's lawyers are now more commonly delaying in filing securities fraud cases, the Court's decision in *Merck* may result in the survival of claims that could have otherwise been time barred. As a result, *Merck* is significant because public companies and their insurers will have increased difficulty determining their exposure to potential securities litigation after a large stock drop.

Merck affirmatively settles a circuit split in interpreting the statute of limitations provision pertaining to securities fraud actions brought under Section 10(b) of the Securities Exchange Act of 1934. The provision at issue states that a securities fraud complaint is timely if it is "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." Different circuit courts of appeal, however, had interpreted the provision in three different ways.

The Eleventh Circuit, for example, held that the clock begins running when information puts plaintiffs on "inquiry notice" of the need for further investigation into the possibility that the plaintiff's legal rights have been infringed. The Second Circuit, conversely, applied a modified "inquiry notice" rule—running the clock at the point of inquiry notice if a plaintiff fails to investigate, but, if an investigation is conducted, starting the clock at the time a reasonable plaintiff

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should have discovered the facts. In contrast, the Sixth Circuit, for example, followed the "discovery rule," meaning that the limitations period begins to run only when a reasonably diligent plaintiff, after being put on "inquiry notice," should have discovered the facts suggesting a violation actually occurred. In *Merck*, the Supreme Court sided with the Sixth Circuit's interpretation, effectively adopting the "discovery rule" for securities fraud actions brought in any circuit.

Merck centers on the company's marketing of Vioxx, an anti-inflammatory drug, similar to aspirin, ibuprofen, and naproxen and without negative gastrointestinal side effects. The primary issue before the Supreme Court was whether the statue of limitations began to run in September 2001, as Merck argued, or in October 2003, as the plaintiffs argued and with which the district court and Third Circuit agreed. The Supreme Court sided with the plaintiffs, holding that the plaintiffs could not have discovered facts supporting their *scienter* allegations until October 2003. The Court explained that it would be unfair if the limitations period began before a plaintiff discovered facts suggesting deliberate intent to deceive—the very facts required to state a claim, and facts that must be pled with particularity under the PSLRA.

In addition, the Court specifically rejected Merck's argument that the court should adopt an "inquiry notice" standard, that the statute of limitations clock should have started to run prior to November 2001, when plaintiffs possessed sufficient information to have warranted additional inquiry. The Court reasoned that "[t]he statute says that the plaintiff's claim accrues only after the 'discovery' of those latter facts. Nothing suggests that the limitations period can sometimes begin before 'discovery' can take place." The Court noted that the five-year statute of limitations remained in place and "should diminish the fear" that defendants could be subjected "to liability for acts taken long ago."

Until recently, the *Merck* decision would have had little practical effect because plaintiffs in securities fraud cases typically "raced to the courthouse" after a stock drop. Even after the adoption of the PSLRA, which was intended in part to prevent this practice, many plaintiffs typically filed complaints within weeks of the stock drop at issue. In short, statute of limitations is rarely an issue in securities fraud cases. Commentators have noted, however, that there has been a recent trend by plaintiffs' lawyers to delay filing securities fraud lawsuits. This includes a sharp increase in claims filed a year or later after the close of the alleged class period. For example, in February 2010, a securities fraud claim was filed against Nokia Corporation almost 18 months after the end of the alleged class period.

It is not entirely clear what is driving this new trend in delayed filings. Among the most common theories are that (1) plaintiffs' firms were consumed by the subprime meltdown and have now returned to their typical claims that they had previously "backburnered"; (2) the recent filings may reflect the plaintiffs' perception of the cases as relatively weaker than others; and (3) plaintiffs are conducting additional diligence to ensure claims survive past the motion to dismiss phase. Regardless of the cause, the impact of *Merck* must be viewed in light of this recent trend to a longer lag between the alleged wrongdoing and the filing of a claim.

Consequently, the apparent impact of *Merck*, given the recent willingness of plaintiffs to delay in filing claims, is that an increased number of these claims will now be considered timely filed where they may have otherwise been time barred. This is especially true in jurisdictions that formerly applied the "inquiry notice" rule. The less apparent impact, however, is the added uncertainty for a company in assessing its exposure to a securities fraud claim one to two years after any stock drop. Before the *Merck* decision and the

recent increase in delayed filings, a company could typically consider itself "in the clear" earlier than two years after any stock drop because of prior case filing patterns. Now, for an accurate risk assessment, internal company risk reviews should extend past the two-year mark and may require planning out to the five-year claim cutoff. Because of this increased exposure and the general uncertainty of defending older claims, the *Merck* decision could yield insurance rate increases for companies as D&O insurers attempt to protect themselves from these new uncertainties.

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