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Alexandra Russo
Pace University School of Law, arusso@law.pace.edu

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Alexandra Russo*

Introduction

With millions of dollars to gain or lose, security fraud cases are hard fought and vehemently defended. To lose out on those millions over a discrepancy in timing is a disappointing and unfulfilling culmination to the long, hard road blazed by plaintiffs bringing Rule 10b-5 or § 10(b) security fraud actions.[1] 28 U.S.C. § 1658(b) provides that in order to be timely a securities fraud complaint must be filed no more than "(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." In the past, courts often applied the "inquiry notice" standard to security fraud cases, which "permitted defendants to successfully move to dismiss claims filed more than two years after sufficient 'storm warning' suggesting that fraud was possible, including alleged corrective disclosures."[2] Unfortunately for plaintiffs, this meant that the clock started ticking at "the point 'at which a plaintiff possesse[d] a quantum of information sufficiently suggestive of wrongdoing.'"[3] In the recent United States Supreme Court case, *Merck & Co. v. Reynolds*,[4] plaintiffs have finally been given a boon. The Court decisively "rejected "inquiry notice" as having any weight on when the limitations period begins to run."[5] Rejecting the inquiry notice standard,

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1. Evan Hill, *The Rule 10b-5 Suit: Loss Causation Pleading Standards in Private Securities Fraud Claims After* Dura Pharmaceuticals, Inc. v. Broudo, 78 FORDHAM L. REV. 2659, 2664-65 (2010).

2. Michele Rose et al., Merck & Co. v. Reynolds: *Time Runs out for Inquiry Notice*, LEXISNEXIS EMERGING ISSUES ANALYSIS, Jun. 15, 2010, at 2.

3. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1797 (2010) (quoting Brief for Petitioners at 20, *Merck*, 130 S. Ct. 1784 (No. 08-905), 2009 WL 2459589, at *20).

4. 130 S. Ct. 1784.

5. Melissa Maleske, *High Court Rules for Plaintiffs in* Merck v. Reynolds, INSIDECOUNSEL (July 2010), http://www.insidecounsel.com/Issues/2010/July-2010/Pages/High-court-rules-for-plaintiffs-in-Merck-v-Reynolds-.aspx.

the Court held in *Merck* that, "[t]he cause of action accrues only '(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.'"[6] Restricting "discovery" to the acquisition of actual knowledge of the fraud, or to when the fraud "would have [been] discovered," renders a defendant's demonstration that the statute of limitations had been running for long enough so as to time bar a plaintiff's claim significantly more difficult.

Through this ruling in *Merck*, "the Court [] significantly altered the availability of the statute of limitations defense for defendants on a motion to dismiss, and potentially opened the door for more cases pursuing stale claims."[7] The likely result is uncertainty for companies trying to evaluate what claims no longer need to be considered in terms of assessing their overall liability and their Director and Officer (D&O) liability insurance policies. Greater amounts of security fraud claims will lead to more frequent settlements for which insurance providers are responsible. As a result, rates and premiums charged to corporations for the provision of D&O liability insurance will undoubtedly increase. But will plaintiffs in security fraud suits truly use *Merck* as a crutch on which to lean in their crusade to reclaim the millions they believe to be rightfully theirs?

This Comment will trace the history of *Merck*, culminating in the Supreme Court's extension of the statute of limitations periods for private security fraud suits, and discuss the impact this holding will have on future security fraud litigation, both for investor-plaintiffs and issuer-defendants. Part I will examine the facts and procedural history of *Merck*, which began in the United States District Court for the District of New Jersey and ultimately reached the Supreme Court of the United States. This procedural background will illuminate the various interpretations existing prior to *Merck* regarding the events that trigger the statute of limitations period. Part II identifies the core regulations decidedly interpreted by the Supreme Court in *Merck*, their application to security fraud suits, and the extent of the existing circuit split. Part III extricates the essential holdings of *Merck*, namely the discovery

6. Gov't Regulatory & Criminal Investigations Grp., *"Storm Warnings" Dissipate: SCOTUS Announces Test for Statute of Limitations in Securities Fraud Suits*, SUBJECT TO INQUIRY BLOG [hereinafter *Storm Warnings*] (May 13, 2010), http://www.subjecttoinquiry.com/securities-litigation/storm-warnings-dissipate-scotus-announces-test-for-statute-of-limitations-in-securities-fraud-suits/.

7. Rose et al., *supra* note 2, at 1.

requirement of scienter as a fact constituting a violation, and the rejection of inquiry notice as "discovery" so as to trigger the statute of limitations. Finally, Part IV advances several potential implications for the decision, including increased numbers of private security fraud suits and difficulty for corporations in assessing risk for purposes of D&O liability insurance.

I. Factual Background and Procedural History

Merck involved a securities fraud claim brought under § 10(b) of the Securities Exchange Act of 1934 by a group of Merck & Co.'s investors.[8] The complaint was filed against Merck & Co. for misrepresentation of Merck's pain-killing drug Vioxx.[9] The investors "contend[ed] [] the company knowingly misrepresented the risk of using Vioxx, and that when the risks were disclosed the company's share price fell."[10]

A. *Factual Background Leading Up to Suit*

In the mid-1990s, Merck developed the pain inhibiting anti-inflammatory drug Vioxx.[11] Vioxx, like other similar anti-inflammatory drugs such as aspirin and ibuprofen, stifles the body's production of an enzyme called COX-2 (cyclooxygenase-2).[12] Unlike these other anti-inflammatory medications, however, "Vioxx does not inhibit production of a second enzyme called COX-1 (cyclooxygenase-1) . . . [which] plays a part in the functioning of the gastrointestinal tract and also in platelet aggregation (associated with blood clots)."[13] Vioxx was approved for

8. *Merck*, 130 S. Ct. at 1790.

9. Andrew B. Weissman et al., *What Does* Merck & Co. v. Reynolds *Mean for the Future of the Statute of Limitations Defense in Securities Fraud Litigation?*, WILMERHALE (May 4, 2010), http://www.wilmerhale.com/what_does_imerck__co_v_reynoldsi_mean_for_the_future_of_the_statute_of_limitations_defense_in_securities_fraud_litigation_05-04-2010/.

10. Kevin LaCroix, *U.S. Supreme Court Allows Merck Vioxx Securities Suit to Proceed*, THE D & O DIARY BLOG (Apr. 27, 2010), http://www.dandodiary.com/2010/04/articles/securities-litigation/us-supreme-court-allows-merck-vioxx-securities-suit-to-proceed/.

11. *Merck*, 130 S. Ct. at 1790.

12. *Id.*

13. *Id.*

prescription use by the FDA in 1999.[14]

Shortly after FDA approval, the 2000 "VIGOR" study was conducted, analyzing and comparing the results and effects of Vioxx and other anti-inflammatory medications.[15] Merck announced the results of the "VIGOR" study via press release, which stated that the study showed "persons taking Vioxx suffered fewer gastrointestinal side effects."[16] However, the study also "found patients taking Vioxx suffered heart attacks at a higher rate than those taking a different painkiller."[17] Merck acknowledged the adverse cardiovascular effects of Vioxx in their press release, but suggested that "VIGOR's troubling cardiovascular findings might be due to the absence of a benefit conferred by naproxen rather than due to a harm caused by Vioxx."[18] This focus on a lack of benefit in naproxen rather than a possible problem with Vioxx "later became known as the 'naproxen hypothesis.'"[19]

In May 2001, following Merck's 2000 press release deemphasizing Vioxx's cardiovascular risks, "a group of plaintiffs filed a products-liability lawsuit against Merck, claiming that 'Merck's own research' had demonstrated that 'users of Vioxx were four times as likely to suffer heart attacks as compared to other less expensive, medications.'"[20] Shortly thereafter, "[i]n August 2001, the Journal of the American Medical Association wrote that the available data [on Vioxx] raised a 'cautionary flag.'"[21] Again, "Merck issued a press release stating that it stood 'behind the overall and cardiovascular safety profile . . . of Vioxx.'"[22]

On September 21, 2001, a warning letter sent from the FDA to Merck was released to the public.[23] This warning letter would later serve

14. *Id.*

15. *Id.*

16. *Id.*

17. Merck & Co. v. Reynolds, WEIL, GOSTSHALL & MANGES (Apr. 29, 2010), http://www.weil.com/merck-v-reynolds/; *see also Merck*, 130 S. Ct. at 1791 ("But the study also revealed that approximately 4 out of every 1,000 participants who took Vioxx suffered heart attacks, compared to only 1 per 1,000 participants who took naproxen.").

18. *Merck*, 130 S. Ct. at 1791.

19. *Id.*

20. *Id.* (quoting J.A. Vol. II at 869, *Merck*, 130 S. Ct. 1784 (No. 08-905), 2009 WL 2475437, at *869).

21. *Id.* (quoting J.A. Vol. I at 332, *Merck*, 130 S. Ct. 1784 (No. 08-905), 2009 WL 2475435, at *332).

22. *Id.* (quoting J.A. Vol. I, *supra* note 21, at 437).

23. *Id.*

as a focal point for the Supreme Court's discussion on when the statute of limitations began to run against Merck's investors. The 2001 warning letter required Merck to "send healthcare providers a corrective letter"[24] in light of the fact that, "Merck's Vioxx marketing was 'false, lacking in fair balance, or otherwise misleading'" with respect to cardiovascular risks.[25] "Merck's share price fell by 6.6% over several days" but rebounded by October 1, 2001.[26]

Nearly two years later, in October of 2003, the Wall Street Journal published results of another Vioxx study that concluded "those given Vioxx for 30-to-90 days were 37% more likely to have suffered a heart attack than those given either a different painkiller or no painkiller at all."[27] One year after this article, on September 30, 2004, "Merck withdrew Vioxx from the market . . . [stating] a new study had found 'an increased risk of confirmed cardiovascular events beginning after 18 months of continuous therapy.'"[28] A Merck representative characterized the results as "totally unexpected."[29] "Merck's shares fell by 27% the same day."[30]

After Vioxx's withdrawal from the market, the Wall Street Journal published another article discussing internal Merck communications. The November 1, 2004 article described "internal Merck e-mails and marketing materials as well as interviews with outside scientists show[ing] that the company fought forcefully for years to keep safety concerns from destroying the drug's commercial prospects."[31] An early email from Merck's head of research "said that the VIGOR "results showed that the cardiovascular events 'are clearly there.'"[32] Moreover, the email "also said that Merck had given its salespeople instructions to 'DODGE' questions about Vioxx's cardiovascular effects."[33] A complaint was filed by several investors on November 6, 2003 against Merck & Co. for the knowing misrepresentation of the pain-killing drug

24. *Id.*
25. *Id.* (quoting J.A. Vol. I, *supra* note 21, at 339).
26. *Id.* at 1791-92.
27. *Id.* at 1792.
28. *Id*. (quoting J.A. Vol. I, *supra* note 21, at 182).
29. *Id.* (internal quotation marks omitted).
30. *Id.*
31. *Id.* (J.A. Vol. I, *supra* note 21, at 189) (internal quotation marks omitted).
32. *Id.* (J.A. Vol. I, *supra* note 21, at 192).
33. *Id.* (internal quotation marks omitted).

Vioxx.[34]

In defense of the securities fraud claim, "Merck argued that the investors' claims were invalid because they filed them more than two years after the investors should have been put on notice of any alleged fraud."[35] Merck asserted that several incidents occurring more than two years prior to the suit, including the 2001 Journal of the American Medical Association article, were sufficient to have "alerted the plaintiffs to a '*possibility* that Merck had knowingly misrepresented material facts.'"[36] Principally, Merck contended the November 2001 public release of the September 2001 warning letter sent by the FDA to Merck describing "Vioxx's marketing as 'false, lacking fair balance, or otherwise misleading' in light of conflicting views within the industry about whether Vioxx increased heart attack risk."[37] According to Merck, this should have put the plaintiffs on notice.[38]

B. *Procedural History*

The District Court granted Merck's motion for dismissal on the grounds that the investors' claim was "barred by the two-year statute of limitations" provided for in 28 U.S.C. § 1658(b)(1).[39] The District Court found the public release of the FDA's November 2001 letter to Merck sufficient to put to plaintiff on inquiry notice, therefore satisfying the statutory requirement of "discovery."[40]

On appeal, the United States Court of Appeals for the Third Circuit reversed the District Court's ruling and found the investors' complaint to be timely. In overruling the District Court, the Court of Appeals held that, while many of the actions "prior to filing constituted 'storm warning,' the events did not suggest scienter, and consequently did not put the plaintiffs on 'inquiry notice.'"[41] Critical to the holding was the Court's finding that the March 2001 VIGOR study, the September 2001

34. Weissman et al., *supra* note 9.

35. Maleske, *supra* note 5.

36. *Merck*, 130 S. Ct. at 1793 (emphasis in original) (quoting *In re* Merck & Co., 483 F. Supp. 2d 407, 423 (D.N.J. 2007)).

37. Weissman et al., *supra* note 9 (quoting *Merck*, 130 S. Ct. at 1791).

38. *Id.*

39. *Id.*

40. *See* Merck, 130 S. Ct. at 1793; *see also id.*

41. LaCroix, *supra* note 10 (quoting *In re* Merck & Co., 543 F.3d 150, 172 (3d Cir. 2008)).

FDA warning letter, and Merck's October 2001 response[42] did not suggest that Merck acted with scienter, which is "a necessary element under § 10(b)."[43] Absent scienter, the "storm warning" events of 2001, two years before the filing of the complaint, did not put the plaintiffs on inquiry notice of a potential § 10(b) violation so as to constitute "discovery" and trigger the statute of limitations.[44] Merck filed for certiorari, challenging the Court of Appeals ruling that the investors' action was not barred by § 1658(b)(1).

The Supreme Court affirmed the ruling of the Court of Appeals for the Third Circuit, effectively resolving the existing circuit split as to the interpretations of "discovery" and whether and when inquiry notice triggers the statute of limitations in securities fraud suits. The Supreme Court addressed and clarified three main points: the definition and scope of the word "discovery" in § 1658(b)(1);[45] the element of scienter, and whether it is a "fact constituting the violation";[46] and the concept of "inquiry notice."[47] In its elucidating discussion of these areas, which had produced the most variation between circuits, the Supreme Court formulated the "essential principles for applying § 1658(b)(1) to securities fraud claims."[48]

II. Core Regulations At Issue In *Merck*

A. *28 U.S.C. § 1658(b)(1), §10(b), and Rule 10b-5*

The *Merck* decision illustrates the modern necessity of a decisive ruling addressing circuit court splits on the statute of limitations in securities fraud suits. What once may have had little impact in the field now is of paramount importance "as plaintiff's lawyers are . . . more commonly delaying in filing securities fraud cases."[49] 28 U.S.C. §

42. *Merck*, 130 S. Ct. at 1792.

43. Weissman et al., *supra* note 9 (quoting *In re Merck & Co.*, 543 F.3d at 172).

44. *Id.*; *see also Merck*, 130 S. Ct. at 1793 (stating: "unless a § 10(b) plaintiff can set forth facts in the complaint showing that it is 'at least as likely as' not that the defendant acted with the relevant knowledge or intent, the claim will fail.").

45. *Merck*, 130 S. Ct. at 1793-97.

46. 28 U.S.C. § 1658(b)(1) (2002); *see Merck*, 130 S. Ct. at 1797-98.

47. *See Merck*, 130 S. Ct. at 1798-99.

48. Weissman et al., *supra* note 9.

49. Patricia J. Villreal et al., *The Supreme Court's Ruling in* Merck *Increases Uncertainty in Assessing Securities Fraud Litigation Risk*, JONES DAY (Aug. 2010),

1658(b) provides that in order to be timely, a securities fraud complaint must be filed no more than "(1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."[50] Actions brought under § 10(b) of the Securities Exchange Act of 1934 are subject to the statutory limitations imposed by § 1658(b)(1).[51] SEC Rule 10b-5, now codified at 17 C.F.R. § 240.10b-5, was enacted pursuant to §10(b) of the 1934 Act.[52] Rule 10b-5, Employment of Manipulative and Deceptive Practices, provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[53]

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http://www.jonesday.com/supreme_court_ruling_in_merck/.

50. 28 U.S.C. § 1658(b); *see also* Kasner et al., *U.S. Supreme Court Addresses Statute of Limitations for Securities Fraud Actions*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES (May 3, 2010), http://www.skadden.com/content/Publications/Publications2062_0.pdf.

51. Weissman et al., *supra* note 9.

52. Hill, *supra* note 1, at 2666 ("Section 10(b) of the '34 Act is the foremost antifraud provision in U.S. securities law and is utilized through its primary mechanism of enforcement, SEC Rule 10b-5.").

53. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2011); *see* Securities Exchange Act of 1934, 15 U.S.C. § 78j (2010):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the

SEC "Rule 10b-5 is the foremost investor protection tool available to those who have been cheated in the securities marketplace."[54] Together, SEC Rule 10b-5 and § 10(b) of the 1934 Exchange Act are the principal tools for plaintiffs in securities actions.[55] These provisions are so frequently utilized for litigation "because they are 'the so called "catchall" fraud provision[s]' that broadly 'prohibit the making of false and misleading statements or omissions in connection with the purchase and sale of securities.'"[56] Since Rule 10b-5 is essentially the enforcement provision of § 10(b), "[p]laintiffs thus employ Rule 10b-5 in tandem with section 10(b) when alleging securities fraud."[57]

B. *Circuit Split*

Since Rule 10b-5 and § 10(b) provide plaintiffs with an initial cause of action in securities fraud litigation, voluminous amounts of judicial discussion exist on the subject. However, neither rule provides "guidance as to how courts should evaluate claims alleging their violation."[58] Moreover, the limitation guidelines of the regulations are equally as ambiguous.[59] As such, "the elements required to prove section 10(b) and

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> mails, or of any facility of any national securities exchange—
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> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities- based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. § 78j(a)(2)(b).

54. Hill, *supra* note 1, at 2661.

55. *Id.* at 2662.

56. *Id.* (alteration in original) (quoting S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683).

57. *Id.* at 2667.

58. *Id.* at 2668.

59. *See* Michael A. Collora & David M. Osborne, *Statute of Limitations and Eligibility Issues in Securities Arbitration*, COLLORA LLP, http://www.collorallp.com/law-articles/securities/arbitration-statute-limitations-eligibility.aspx (last visited Oct. 20, 2011).

Rule 10b-5 violations are almost entirely judicially constructed."[60] In the absence of a governing interpretation, "the circuit courts relied on the Rules of Decision Act (28 U.S.C. § 1652) to borrow various limitations from analogous statutes of repose . . . [which] created conflict, confusion, unfairness, and an onslaught of litigation."[61] In an effort to standardize statute of limitation rulings, the Supreme Court held that "causes of action under Section 10(b) and Rule 10b-5 must be brought within one year after the discovery of the facts constituting the violation and within three years after the violation actually occurred."[62] In 2002, however, federal legislation formally established the official statute of limitations for securities fraud suits. Congress enacted the Sarbanes-Oxley Act, "which extended the statute of limitations for claims of securities fraud, deceit or manipulation to the earlier of two years after the discovery of the facts constituting the violation or five years after such violation."[63] The provisions of Sarbanes-Oxley presently govern statute of limitation periods for security fraud suits.[64]

Determining the triggering event for the two-year statute of limitations period has proven complicated. The precise events starting the two-year period are difficult to establish because "discovery of the facts constituting the violation is a fluid concept."[65] As such, circuit courts have created various definitions of "discovery," and therefore apply different standards to determine when the statute of limitations begins to run. Specifically, the discrepancies arise over what acts constitute "storm warnings" or "inquiry notice" sufficient to state that the plaintiff is privy to information and knowledge that rise to the level of "discovery."

The United States Court of Appeals for the Eleventh Circuit defined "inquiry notice" as "the term used for knowledge of facts that would lead a reasonable person to begin investigating the possibility that his legal

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60. *Id.*

61. *Id.*

62. *Id.* (citing Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 360 (1991)).

63. *Id.*

64. *Id.* ("The Sarbanes-Oxley Act of 2002 . . . extend[s] the statute of limitations for securities claims . . . ."); *see also Glossary of Terms*, PARKER WAICHMAN LLP, http://www.statutes-of-limitations.com/content/glossary-of-terms (last visited Nov. 4, 2011) ("§ 804 of the Sarbanes-Oxley Act . . . sets the statute of limitations for private security fraud cases . . . .").

65. Collora & Osborne, *supra* note 59 (internal quotation marks omitted).

rights had been infringed."[66] That court has 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."[67] In contrast, the United States Court of Appeals for the Second Circuit held that "'duty of inquiry' arises once 'circumstances would suggest to an investor of ordinary intelligence the probability that she had been defrauded.'"[68] The Second Circuit therefore differs in its application of "inquiry notice" from the Eleventh Circuit in that it "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 should have discovered the facts."[69] Generally, the inquiry notice standards seems to have the common element that, at least, "the plaintiff has been presented with evidence suggesting the possibility of fraud."[70]

Applying yet another variation of the inquiry notice standard, the United States Court of Appeals for the Seventh Circuit introduces the concept of interpreting the statute of limitations as an affirmative defense. The Seventh Circuit held that "[t]he facts constituting such notice must be sufficien[t] . . . to incite the victim to investigate [and] to enable him to tie up any loose ends and complete the investigation in time to file a timely suit."[71] The court is careful not to focus solely on the statute of limitations, which can "precipitate premature and groundless suits, as plaintiffs rush to beat the deadline without being able to obtain good evidence of fraud."[72] While applying the inquiry notice standard, the Seventh Circuit considers that the "statute of limitations bar is an

66. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1797 (2010) (quoting Franze v. Equitable Assurance, 296 F.3d 1250, 1254 (11th Cir. 2002)) (internal quotation marks omitted).

67. Villareal et al., *supra* note 49.

68. *Merck*, 130 S. Ct. at 1797 (quoting Dodds v. Cigna Sec., Inc., 12 F.3d 346, 350 (2d Cir. 1993)).

69. Villareal et al., *supra* note 49.

70. Collora & Osborne, *supra* note 59 (quoting Harner v. Prudential-Bache Sec., Inc., Nos. 92-1353, 92-1910, 1994 WL 49487135, at *4 (6th Cir. 1994)) (internal quotation marks omitted); *see* Great Rivers Coop. of Se. Iowa v. Farmland Indus., Inc., 120 F.3d 893, 896 (8th Cir. 1997) ("Inquiry notice exists when the victim is aware of facts that would lead a reasonable person to investigate and consequently acquire actual knowledge of the defendant's misrepresentations."); *see also* Villareal et al., *supra* note 49.

71. Fujisawa Pharm Co. v. Kapoor, 115 F.3d 1332, 1335-36 (7th Cir. 1997).

72. Law v. Medco Research, 113 F.3d 781, 786 (7th Cir. 1997).

affirmative defense that must be proven by the defendant."[73] This burden of proof placed on the defendants requires establishment that "the statute of limitations has run, . . . [and] that a reasonably diligent investor would have brought suit before [the current] suit was actually filed."[74] The possibility for conflicting results among circuit courts, even within the inquiry notice standard alone, points to the urgency of the Supreme Court's decisive ruling in *Merck*.

III. Essential Holdings of *Merck*

A. *Discovery*

In *Merck*, the Supreme Court first determined whether the word "discovery" is limited "to a plaintiffs' *actual* discovery of certain facts,"[75] or if it also applies to "the facts that a reasonably diligent plaintiff would have discovered."[76] The Court examined legislative history and prior case law interpreting "discovery," and determined "that the word 'discovery' in the statute includes not only the *actual* discovery of the facts constituting the violation, but also the *constructive* discovery of such facts."[77] Due to the nature of fraud, which in itself may impede a potential plaintiff from actually discovering it by virtue of the "defendant's deceptive conduct,"[78] courts have recognized for more than a century "that '[f]raud is deemed to be discovered . . . when, in the exercise of reasonable diligence, it could have been discovered.'"[79] Therefore, allowing this "constructive discovery (the 'reasonably diligent plaintiff' standard) [i]s consistent with the statute's language, which was modeled on language used in prior cases that recognized constructive discovery."[80]

73. Collora & Osborne, *supra* note 59.

74. *Medco*, 113 F.3d at 786.

75. *Merck*, 130 S. Ct. at 1793 (emphasis in original).

76. *Id.*

77. Michael P. Carroll et al., Merck & Co. v. Reynolds*: U.S. Supreme Court Clarifies Statute of Limitations in Securities Fraud Cases*, DAVIS POLK (Apr. 28, 2010), http://www.davispolk.com/files/Publication/7a565c12-2620-4e55-94b5-04ef3ca7efb7/Presentation/PublicationAttachment/56bc2fce-3e43-4ba5-80c2-07b31461e37d/042810_Merck.html (emphasis in original).

78. *Merck*, 130 S. Ct. at 1793.

79. *Id.* at 1794 (alteration in original) (quoting 2 H. WOOD, LIMITATIONS OF ACTIONS § 276b(11) (4th ed. 1916)).

80. Weissman et al., *supra* note 9.

B. *Scienter*

Once it established that the "discovery requirement includes constructive discovery," the Court moved on to a discussion of scienter, and whether scienter is a "fact[] constituting the violation"[81] so as to be "discovered." The statute of limitations provided for in § 1658(b)(1) stipulates "that the limitations period does not begin to run until 'discovery of the *facts constituting the violation*.'"[82] The Court held that scienter, for § 10(b) actions, "refers to 'a mental state embracing intent to deceive, manipulate, or defraud,'"[83] and is undoubtedly a "fact,"[84] that "'constitut[es]' an important and necessary element of a § 10(b) 'violation.'"[85] If scienter were not a fact constituting the violation that would be discovered to trigger the running of the statute of limitations, as "long as a defendant concealed for two years that he made a misstatement with an intent to deceive, the limitations period would expire before the plaintiff had actually 'discover[ed]' the fraud."[86] Therefore, it would cut against the policy reasons for creating these "heightened pleading requirements for the scienter element of § 10(b) fraud cases"[87] to allow the statute of limitations to begin running before a plaintiff uncovered a defendant's intentional deception; "it would be unfair if the limitations period began before a plaintiff discovered facts suggesting deliberate intent to deceive."[88]

C. *Inquiry Notice*

Finally, the Court turned to a discussion of the applicability and functionality of "inquiry notice" in § 10(b) claims. Merck argued that the statute of limitations began to run prior to November 2001 because the

81. 28 U.S.C. § 1658(b)(1) (2002).
82. *Merck*, 130 S. Ct. at 1796 (alteration in original) (quoting 28 U.S.C. § 1658(b)(1)).
83. *Id.* at 1796 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976)).
84. *Id.* at 1796 (internal quotation marks omitted).
85. *Id.*
86. *Id.* (alteration in original).
87. *Id.*
88. Villareal et al., *supra* note 49.

plaintiffs were on "inquiry notice."[89] In their argument, Merck used "'inquiry notice' to refer to the point 'at which a plaintiff possesses a quantum of information sufficiently suggestive of wrongdoing that he should conduct a further inquiry.'"[90] The Court accepted this general understanding of the term, and characterized "inquiry notice" as "the point where the facts would lead a reasonably diligent plaintiff to investigate further."[91] However, "[t]he Court observed that the point in time at which a plaintiff is placed on inquiry notice does not necessarily coincide with when a reasonably diligent plaintiff would have discovered 'facts constituting the violation,' as required by the statute."[92] Therefore, the Court refused to accept Merck's argument on the basis that the language of the statute demands the statute run upon "discovery," not before.[93]

While "inquiry notice" might, and should, induce a plaintiff to delve deeper into an investigation of wrongdoing, the wrongdoing is not yet "discovered." 28 U.S.C. § 1658(b)(1) explicitly states that the limitations period begins running at the time of "discovery." As such, there is "no indication that the limitations period should occur at some earlier moment before 'discovery'" and so the Court held that it could not accept "inquiry notice" as an event triggering the statute of limitations alone.[94] If, however, a plaintiff is put on "inquiry notice" and then declines further investigation, he finds no solace in the law. The inclusion of an objective standard, the reasonable diligent plaintiff, in the definition of inquiry notice, ensures that the statute of limitations works against "plaintiffs who fail to investigate once on 'inquiry notice.'"[95] The applicable two-year statute of limitations in § 1658(b)(1) "lapses two years after a reasonably diligent plaintiff would have discovered the necessary facts."[96] The Court concluded that, although terms like "inquiry notice" and "storm warnings" may have utility in identifying "a time when the facts would have prompted a reasonably diligent plaintiff

89. *Merck*, 130 S. Ct. at 1797.

90. *Id.* (quoting Brief for Petitioners at 20, *Merck*, 130 S. Ct. 1784 (No. 08-905), 2009 WL 2459589, at *20).

91. *Id.*

92. Weissman et al., *supra* note 9.

93. *Merck*, 130 S. Ct. at 1797.

94. *Id.*

95. *Id.* at 1798.

96. *Id.*

to begin investigating,"[97] "the 'discovery' of facts that put a plaintiff on 'inquiry notice' does not automatically begin the running of the limitations period."[98]

IV. Securities Fraud Litigation Post-*Merck*

A change in the statute of limitations provisions for securities fraud suits would have likely held little importance in the past. Few cases would have run the risk of becoming time barred since "plaintiff lawyers . . . traditionally 'raced to the courthouse' following a large drop in a company's stock price."[99] This expeditious filing of securities fraud complaints rendered statute of limitation concerns substantially irrelevant. In recent years, however, there has been a significant increase in the number of security fraud cases being filed at a delayed rate. "[S]ince the second half of 2009, there have been an increasing number of case filings in which the filing date has come well after the proposed class period cutoff date."[100] This figure "includes a sharp increase in claims filed a year or later after the close of the alleged class period."[101] As such, the reasonable expectation following *Merck* is the emergence of a large number of otherwise "stale" securities fraud cases relying on the more relaxed statute of limitations interpretation for Rule 10b-5 claims.

Coupled with the recent trend towards delayed filings, the ruling in *Merck* that "Section 10(b) is not triggered until the claimants have, or with reasonable diligence could have had, knowledge of the facts constituting the violation, including in particular facts constituting scienter"[102] will likely herald a deluge of securities claims previously time-barred; however, few cases have been filed in reliance on *Merck* until recently.[103]

97. *Id.*

98. *Id.*

99. Villareal et al., *supra* note 49.

100. LaCroix, *supra* note 10.

101. Villareal et al., *supra* note 49 ("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.").

102. Kevin LaCroix, *When is a Securities Suit Stale?*, THE D & O DIARY BLOG (Sept. 20, 2010), http://www.dandodiary.com/2010/09/articles/securities-litigation/when-is-a-securities-suit-stale/.

103. *Id.*

A. *D&O Liability*

The repercussions of *Merck* will also be felt in the area of D&O liability and insurance. D&O insurance "provides financial protection for the directors and officers of [a] company in the event [it is] sued in conjunction with the performance of [its] duties as they relate to the company."[104] As a result of a company's D&O liability insurance policy, "the insurance company has agreed to stand in the shoes of its allegedly wrongdoing insureds to the full extent of its policy's limits of liability."[105] Since the limits of the policy will determine the level of coverage the directors and officers are entitled to, "[t]he key to properly structuring a D&O insurance and corporate indemnification program is recognizing the activities that pose the greatest threat of liability to directors and officers . . . [such as] securities fraud class action lawsuits."[106] With a greater number of security fraud actions now considered timely under the *Merck* standard, directors and officers will face a higher potential for having claims brought against them.

Underwriters and insurance providers must reevaluate policies given that a greater number of securities fraud claims may now be brought against corporations (and its directors and officers). This "uncertainty about when events in the past [are] so long gone that companies can be sure that they are 'out of the woods' about past problems" presents considerable difficulty to insurance policy underwriters trying to assess risk levels.[107] Given that "securities fraud class actions pose the greatest potential danger of monetary liability to directors and officers," insurers will have to look further into a company's past to determine the likelihood of such actions being brought, and thus adjust the coverage and rates accordingly.[108] This practice will prove particularly problematic for companies that have

104. *Directors & Officers Insurance*, INSUREPRO, http://www.insurepro.net/pdf/directorsandofficers.pdf (last visited Oct. 20, 2011).

105. John H. Mathias, Jr. & Timothy W. Burns, *Conserving D&O Insurance Policies in Securities Fraud Litigation: A Common Interest of Policyholders and Institutional Shareholder Claimants*, 14 COVERAGE 4 (2004), *available at* http://www.jenner.com/files/tbl_s20Publications%5CRelatedDocumentsPDFs1252%5C821%5CConserving_D&O_Insurance_Policies.PDF.

106. Francis G. Coleman, *Complete Guide to D&O Insurance: Special Report Risk and Liability*, NACD DIRECTORSHIP (June 1, 2007), http://www.directorship.com/complete-guide-to-do-insurance/.

107. LaCroix, *supra* note 102.

108. Coleman, *supra* note 106.

faced issues in the past; if cases in reliance on *Merck* prevail, "underwriters will be compelled to extend their scrutiny of a particular company far into the past, with no sure way of knowing how far back is far enough."[109] As a result, sticky situations that would otherwise have been insulated from fraud claims may now be included when underwriters assess the risk associated with that particular entity. Higher premiums and narrower scopes of D&O liability policies for securities fraud action seem likely outcomes as a result of *Merck*.

Yet most, if not all, D&O liability insurance policies contain a fraud exclusion provision.[110] These provisions of "D&O policies, which have a primary purpose of protecting directors and officers against securities fraud lawsuits, provide no coverage if the director, the officer, or the company is found liable in a final judgment for deliberate securities fraud."[111] These policies only deny coverage "if there were a final adjudication that fraud was indeed committed in the underlying securities fraud litigation."[112] Therefore, if it is never formally decreed in court that the plaintiffs committed fraud, the fraud exclusion provision is inapplicable. "In other words, if the securities fraud case were to settle, the exclusion would not apply."[113] Given the expensive nature of securities fraud suits, the ability to stay within the confines of a liability policy provides a tremendous incentive for companies to settle outside of court. As a result of such fraud exclusion provisions in D&O insurance policies, "there appears to have been only one state and three federal securities lawsuits against directors and officers to have gone to trial in the last thirteen years."[114] Given this boon to plaintiffs (that they theoretically are given a larger window in which to file securities fraud claims), it would seem that *Merck* will induce a greater number of potential frivolous lawsuits to be filed in hopes of a settlement.

That "[t]o prevail at trial is to risk forfeiture of the D&O insurance proceeds," security fraud defendants are unlikely to brave the harrows of a full trial.[115] Certainly, "[t]he amount and scope of coverage may lead to significant changes in litigation strategy" on the part of corporate

109. LaCroix, *supra* note 102.
110. Coleman, *supra* note 106.
111. Mathias & Burns, *supra* note 105.
112. Coleman, *supra* note 106.
113. *Id.*
114. Mathias & Burns, *supra* note 105.
115. *Id.*

defendants.[116] Not only do the intricacies of D&O liability promote settlement, the effects of *Merck* do as well. As a result of the Court's rejection of the inquiry notice standard, "it will no longer be sufficient for defense counsel to simply argue for the existence of 'storm warnings' or to make common law-like 'inquiry notice' arguments."[117] Rather than continuously assert motions to dismiss, *Merck* forces "defense counsel . . . to prove at what point a reasonably diligent plaintiff would have discovered 'the facts constituting the violation'—including scienter"[118] so as to warrant dismissal on statute of limitations grounds; "the days of merely arguing that a plaintiff could see the storm approaching and had a duty to investigate further are over."[119]

B. *Litigation Concerns*

The most likely result of *Merck's* plaintiff-friendly language is that "the number of § 10(b) complaints dismissed under the two-year statute of limitations will likely fall."[120] Since "the Court limited the circumstances in which defendants may avail themselves of a statute of limitations defense in cases involving alleged misstatements that are more than 2 years old," defendants will either be forced to settle more often or take their chances in the courts.[121] However, with a larger number of settlements on their plate, companies may take their chances in the courtroom. Since either actual *or* constructive notice (what facts a "reasonably diligent plaintiff" would have discovered) is acceptable under the *Merck* standard, "motions to dismiss on statute of limitations grounds will likely continue to be litigated based on the objective facts in the public record."[122] In any of the above scenarios, *Merck* will prove costly for companies faced with securities fraud claims; either defense costs, settlement fees or downright judgments, *Merck* serves as a powerful weapon sheathed in the holsters of Rule 10b-5 and § 10(b) plaintiffs.

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116. *Id.*

117. *Storm Warnings*, *supra* note 6.

118. *Id.* ("In a Section 10(b) case, constructive knowledge of facts constituting a misstatement or omission, without more, may not be sufficient to begin the running of the statute.").

119. *Id.*

120. Weissman et al., *supra* note 9.

121. Carroll et al., *supra* note 77.

122. *Id.*

The results of this increased burden of proof on defendants will often mean that the accrual date of the statute of limitations could be pushed out.[123] The "elevated hurdle for plaintiffs" set out in *Merck* establishes that alleging a defendant's scienter creates a heightened pleading standard.[124] Ultimately, the ruling is plaintiff-friendly in that "the rejection of the inquiry notice standard and the requirement of facts establishing scienter makes it more difficult to trigger the limitations period in the first instance."[125] Without such a restrictive time limit, plaintiff's lawyers will undoubtedly have more time to prepare cases, and more cases will be viable for trial.[126] While an extended time period for filing security fraud claims may seem positive, many other problems are likely to arise.

Plaintiffs, less vulnerable to the motion to dismiss, may exacerbate the trend in delayed filings discussed earlier and sit even longer on potential suits.[127] Intentional delays in filing could have several added benefits to security fraud plaintiffs, such as to "increase the settlement value of their claims" or, if the plaintiffs "believe the company's stock prices will decline, in an effort to claim larger losses and, therefore, receive increased settlements or damage awards."[128] While this could prove problematic for corporations because they will be faced with larger settlement demands and trumped-up loss charges, the ruling in *Merck* will not have such widespread effects as anticipated.

Firstly, the scope and application of *Merck* will not leave defendants without recourse. If a "plaintiff's complaint itself sets forth facts showing that the elements of the violation . . . occurred and were knowable more than two years prior to filing," defendants will likely be successful in asserting a motion to dismiss.[129] Since constructive notice also triggers the limitations period, "asserting the statute of limitations defense at the

123. *Id.*

124. Maleske, *supra* note 5.

125. Rose et al., *supra* note 2.

126. Ralphe V. De Martino & Jennifer H. Unhoch, *United States: U.S. Supreme Court Addresses the Statute of Limitations for Private Federal Securities Fraud Claims*, MONDAQ (May 24, 2010), http://www.mondaq.com/unitedstates/article.asp?articleid=101200 ("The *Merck* decision is likely to result in a reduction of the number of private securities fraud cases dismissed on statute of limitations grounds, and plaintiff lawyers will arguably have more time to commence securities fraud actions.").

127. *See* LaCroix, *supra* note 10.

128. De Martino & Unhoch, *supra* note 126.

129. Rose et al., *supra* note 2.

pleading stage based upon documents that may be considered by the court on judicial notice (i.e., documents incorporated in to the complaint and public filings) is not foreclosed."[130] Secondly, "the opinion appears to reinforce the stringency of the requirement to plead facts that support 'a strong inference' of scienter with particularity under the Private Securities Litigation Reform Act of 1995 (PSLRA)."[131] Plaintiffs may have greater difficulty pleading facts (before discovery) that demonstrate the requisite scienter on the part of the defendant.

While clearly a victory for plaintiffs, the ruling in *Merck* may prove less overreaching than anticipated. As a matter of application, the ruling may not be completely detrimental to "corporate defendants in Section 10(b) private securities class actions [since] the impact of *Merck* will likely be narrow within the securities fraud realm due to the case's novel circumstances."[132] Though the Supreme Court has settled a badly divided circuit split on the issue of "discovery" for security fraud suits, there are still many other cases that will not fall into the mold of *Merck* so as to be bound by the holding. Corporate defendants, stripped somewhat of their powerful motion to dismiss, will undoubtedly fight to differentiate each case from *Merck.* In the absence of a similar set of factual circumstances, lower courts may be reluctant to stick closely to *Merck* and side supportively with defendants. Overall, however, the impact of *Merck* will be felt—it just remains to be seen how much.

Conclusion

Merck's essential holdings will certainly play a significant role in the future of securities law and litigation. The Court's rejection of "Merck's argument that Sarbanes-Oxley does not require 'discovery' of scienter-related facts, holding that scienter is 'assuredly a "fact,"' and that scienter is an important and necessary element of a Section 10(b) claim" changes the playing field for plaintiffs and defendants alike in

130. *Id.*

131. Carroll et al., *supra* note 77 (discussing 15 U.S.C. § 78u-4(b)(2)(A) (2010), which requires plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

132. Maleske, *supra* note 5; *see also* Barry J. Mandel & Joseph D. Edmondson, Jr., *Predicting SCOTUS In* Merck v. Reynolds, LAW360.COM (Feb. 16, 2010), http://www.foley.com/files/tbl_s31Publications/FileUpload137/6826/SCOTUSlaw360.pdf ("First, it is reasonable to expect [in *Merck*] that the holding in this case will be narrowly confined to fraud-on-the-market cases, as this was the case presented.").

security fraud cases.[133] This determination instructs lower courts that notice can be both actual *and* constructive,[134] and that "notice . . . of facts showing a mere misstatement or omission will not start the running of the statute of limitations."[135] The ruling of scienter as a fact has strong policy support given "that it would be unfair if the limitations period began before a plaintiff discovered facts suggesting deliberate intent to deceive."[136] These determinations will enable plaintiffs to extend the period in which they have to file claims for security fraud given the more expansive approach the Supreme Court adopted. Plaintiffs will have a less difficult time showing they have neither actual nor constructive knowledge of facts constituting "discovery," and defendants will have a more difficult time showing that the plaintiffs should have discovered the facts. As a result, there *should* be a greater number of cases filed in response to *Merck.* Though the case's holding may have a narrow application, it still provides plaintiffs with a useful tool in the security fraud arena. When a powerful tool is provided, it is usually taken advantage of; the trend in delayed filing will likely increase as plaintiffs use *Merck* to strategize and maximize the results of their efforts.

The likely increase in the number of cases now capable of being brought for security fraud as a result of *Merck's* "discovery" definition will impact D&O liability the greatest. Companies purchasing security fraud liability "expect that D&O insurers will be closely involved in providing the financial resources for resolving big damages securities fraud litigation, even though it involves allegations of serious wrongdoing."[137] In order for insurance providers to continue to meet such expectations, they need to have the ability to accurately determine a given entity's risk level. Under the new *Merck* standards, it will be very difficult for companies to create an accurate portrait of their liability landscape. Instances or occurrences of a potentially problematic nature will become red flagged and be considered "risky" for the purposes of determining the level of security fraud coverage needed. Consequently, the rates and premiums paid by companies in order to maintain these insurance policies will rise significantly. Moreover, insurance policies may be crafted that are ultimately inadequate to compensate for "stale"

133. *Storm Warnings*, *supra* note 6.
134. Carroll et al., *supra* note 77.
135. *Storm Warnings*, *supra* note 6.
136. Villareal et al., *supra* note 49.
137. Mathias & Burns, *supra* note 105.

claims not reinvigorated under *Merck's* "discovery" analysis.

Whether on the litigation end or the D&O liability end, *Merck* is now the governing precedent on security fraud cases. Lower courts have yet to conform or rebel against the Supreme Court's resolution of the fractured circuit split, but it will be interesting to see whether there can be resolution among the varying interpretations that have existed among the circuits for so long. Lower courts may use the narrowly tailored application of *Merck* to their advantage and avoid departing from a standard of "discovery" analysis they prefer. Whether *Merck* changes litigation outcomes at any stage of adjudication is uncertain; the impact on D&O liability, however, is clear. As long as there are millions of dollars to be gained and lost from security fraud litigation, whoever is suffering damages will be sure to mitigate.