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SECOND CIRCUIT CONFIRMS CONTRACTION OF STATUTE OF LIMITATIONS DEFENSE BY *MERCK & CO. v. REYNOLDS*

In *Merck & Co. v. Reynolds*, 130 S. Ct. 1784 (2010), the Supreme Court held that the statute of limitations on a private securities fraud claim does not begin to run until a plaintiff "did in fact discover" or a "reasonably diligent plaintiff would have discovered" the facts constituting the violation. In so holding, the Supreme Court abrogated the rule that a plaintiff could be on "inquiry notice" when available public information would have led a reasonable investor to investigate whether a fraud had occured. It also specifically held that scienter was one of the facts that had to be discovered to start the statute of limitations running.

One concern defense counsel thus began to have after *Merck* was whether the decision might force defendants seeking to dismiss securities fraud claims to choose whether to argue that the claims against them were time-barred or that the plaintiffs had not properly alleged scienter. *See* Milbank Litigation Securities Litigation Update, May 3, 2010. In *City of Pontiac General Employees' Retirement System v. MBIA, Inc.,* 2011 WL 677404 (2d Cir. Feb. 28, 2011), the United States Court of Appeals for the Second Circuit began to address those issues in a way that suggests that, in fact, defendants will have to choose between moving to dismiss based on statute of limitations defenses and failure to plead scienter. In *MBIA*, the Second Circuit held that "a securities fraud statute of limitations cannot begin to run until the plaintiff discovers – or a reasonably diligent plaintiff would have discovered – the facts constituting scienter." The court further held that a fact is deemed "discovered" only when "a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint."

Background

MBIA arose out of bond insurer MBIA, Inc.'s 2005 decision to restate its financials for 1998 through 2003 to treat a prior transaction as a loan instead of as income. In 1998, one of MBIA's bond insurance customers defaulted on its obligations, requiring MBIA to pay $170 million and threatening to impair MBIA's credit rating. To avoid this, MBIA allegedly made a deal with three European reinsurance companies to reinsure MBIA on the defaulted bonds *nunc pro tunc*. In exchange, MBIA paid the reinsurers $3.85 million and committed to purchasing additional reinsurance for certain other companies over a six-year period at a premium of $297 million. MBIA booked this transaction as income from 1998 through 2003.

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As the court noted, "several times in later years," press reports discussed this transaction, with some suggesting that it "was more a loan than a reinsurance contract." In early 2005, MBIA restated its financials for 1998 through 2003 to treat the transaction as a loan instead of income. Shortly thereafter, the plaintiffs filed a class action complaint alleging securities fraud.

MBIA moved to dismiss the complaint on the grounds that (1) the plaintiffs' claims were untimely, (2) the complaint did not satisfy the pleading requirements of Fed. R. Civ. P. 9(b), and (3) the statute of repose had run. The district court concluded that the plaintiffs' claims were time-barred because the class was on inquiry notice of the claims in the complaint no later than December 2002, but did not commence the action until more than two years after that date.

Effect of *Merck*

Before *Merck*, the Second Circuit rule was that a plaintiff was on inquiry notice when "public information would lead a reasonable investor to investigate the possibility of fraud." If the plaintiff never investigated, the statute of limitations began running "the day the plaintiff should have begun investigating." The Second Circuit first noted that *Merck* had disposed of the inquiry notice rule in favor of a rule that the statute of limitations begins running only when a reasonable investor conducting a timely investigation would have uncovered the facts constituting the violation alleged in the complaint. The Second Circuit noted that *Merck* had left two questions unresolved:

- What facts constitute a securities fraud violation for purposes of starting the statute of limitations?
- With regard to any of those facts, how much information does a reasonable investor need to have about it before it is deemed discovered for the purposes of starting the statute of limitations?

Like the Supreme Court in *Merck*, the Second Circuit declined to attempt to list all the facts necessary to constitute a securities law violation. Instead, the court held only that facts establishing scienter are among those that constitute the violation and may require inquiry.

Turning to the second question, the Circuit held that a fact will not be deemed discovered for statute of limitations purposes "until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint." The Second Circuit relied on the fact that the Supreme Court framed the *Merck* decision in terms of the information a plaintiff would need to plead to survive a motion to dismiss. This is a critical issue for defendants, because it may mean that in order to move to dismiss a claim as time-barred, a defendant would have to argue that sufficient facts were publicly known to enable a reasonably diligent plaintiff to plead scienter years before a case was filed, essentially turning an argument that a claim was time-barred into a potential concession that a plaintiff could plead scienter. In other words, whereas before *Merck*, defendants could argue that a claim was time-barred *and* that the plaintiff had failed to plead scienter adequately, that option may no longer be available in most (perhaps all) securities fraud cases. Because both the Supreme Court and the Second Circuit declined to specify what other elements this new standard applies to, it remains to be seen what other choices *Merck* may force defendants to make in arguing that claims should be dismissed.

Beyond stating that the information available to a plaintiff with respect to scienter must be sufficient for the plaintiff to survive a motion to dismiss, the Second Circuit declined to specify the nature of the information a plaintiff must have uncovered before a fact is deemed "discovered" for statute of limitations purposes. The Second Circuit remanded to the district court to determine whether the record permitted a conclusion that the limitations period had run.

When the Statute of Limitations Starts to Run Versus When Plaintiffs Purchased Their Securities

Another unusual aspect of *MBIA* was that the district court seems to have held that the limitations period began running in December 2002, approximately eight months before the class period alleged in the complaint started. The Second Circuit held that a limitations period could not begin running before anyone in the proposed class actually bought stock in the company at issue. It did, however, leave open the possibility that this argument could be rephrased in terms of reasonable reliance or transaction causation as opposed to a limitations defense. If enough information was publicly available that a reasonably diligent investor would have been able to discover the alleged fraud, it stands to reason that a defendant might have a good argument that a proposed class member who bought or sold after that information was disclosed could not have reasonably relied on the allegedly fraudulent statements. Similarly, a defendant might have a good argument that if the public (and thus the markets) were actually aware of the truth behind allegedly fraudulent statements, those statements could not have caused members of the proposed class to purchase or sell securities. Either would support dismissal, and the Second Circuit left it to the district court in the first instance to address both issues.

Conclusion

The *MBIA* decision is additional confirmation that *Merck* is generally not a defendant-friendly decision and may limit the arguments defendants could make in seeking to dismiss federal securities fraud claims.

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