No. 08-905

In the Supreme Court of the United States

MERCK & CO., INC., et al.,

Petitioners,

v.

RICHARD REYNOLDS, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF OF OHIO AND 25 OTHER STATES AND COMMONWEALTHS AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Under 28 U.S.C. § 1658(b)(1), a limitations period of two years for a private securities-fraud action commences with "the discovery of the facts constituting the violation." The questions presented are:

1. Whether a reasonable Merck investor should have discovered petitioners' statements were material misrepresentations of belief and opinion as charged in respondents' complaint earlier than November 6, 2001?

2. Whether scienter is among the "facts constituting [a] violation" within the meaning of § 1658(B)(1); and, if so, whether a reasonable Merck investor should have discovered petitioners' fraudulent intent earlier than November 6, 2001?

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STATEMENT OF AMICI INTEREST

The amici States have a direct interest in the outcome of this appeal. To begin with, the amici States themselves are investors, representing some of the largest institutional investors in the world. As such, the States have a strong interest in protecting their citizens from securities fraud.

To that end, Congress has unmistakably favored large institutional investors like the States in securities-fraud litigation. When it was enacted in 1995, the Private Securities Litigation Reform Act ("PSLRA"), Pub. L. No. 104-67, 109 Stat.737, 15 U.S.C. § 78u-4(a)(3), et seq., shifted the focus and responsibility for private securities class actions to large institutional investors such as state pension funds. The statute's lead-plaintiff provision, 15 U.S.C. § 78u-4(a)(3)(B), directs courts to prefer "the most sophisticated investor available and willing to so serve in a putative securities class action." *Berger v. Compaq Computer Corp.*, 279 F.3d 313 (5th Cir. 2002) (per curiam); see also H.R. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 733. Congress sensibly believed that, because these investors were among America's largest shareholders and stood to benefit the most from reforms that encouraged meritorious securities-fraud litigation, S. Rep. No. 104-98, at 36 (1995), reprinted in 1995 U.S.C.C.A.N. 714; H.R. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 712-13, giving them lead-plaintiff status would balance the interests of the class with the long-term interests of the company and its public investors. S. Rep. No. 104-98, at 34 (1995), reprinted in 1995 U.S.C.C.A.N 713. This preference also allows larger investors

with greater resources to look out for the interests of smaller, individual investors.

As a result, courts often appoint public pension funds to a lead-plaintiff position because the entities are stable, have the largest losses associated with the alleged fraud, and are financially able to commit substantial resources to litigation. For instance, a district court recently designated state pension funds, including Ohio's, among three lead plaintiffs in a suit concerning Bank of America's merger with Merrill Lynch, explaining that the funds "have the greatest financial interest in the outcome of the case, their interests appear to be otherwise aligned with those of the putative class, and they have retained competent and experienced counsel." *In re Bank of Am. Corp. Sec., Deriv. & ERISA Litig.*, No. 09-MDL-2058, 2009 U.S. Dist. Lexis 56009, at *24 (S.D.N.Y. June 30, 2009); see also *In re Cardinal Health, Inc. Sec. Litig.*, 226 F.R.D. 298, 311 (S.D. Ohio 2005); *In re Vicuron Pharms., Inc. Sec. Litig.*, 225 F.R.D. 508, 512 (E.D. Pa. 2004).

The amici States also have a stake in the integrity and competitiveness of the securities markets from the vantage point of public protection. For the markets to function properly, fraudulent actors of all types must be deterred. The States accordingly are keenly interested in ensuring that the securities laws continue to guard against fraudulent activity.

SUMMARY OF ARGUMENT

For all of Petitioner Merck & Co.'s discussion of scienter, this case easily can and should be resolved on a different theory. Merck acknowledges that equitable principles apply here, but what Merck does not say is that this case fits neatly within the well-settled "words of comfort" doctrine. Widely recognized by federal and state courts both within and outside of the securities-fraud context, this equitable doctrine holds that a company's reassuring statements—its words of comfort—can offset any negative events or information (commonly called "storm warnings") that would trigger the accrual of a securities-fraud claim.

The Third Circuit's analysis below is fully consistent with the words-of-comfort doctrine. The court correctly found that sufficient factual questions exist to deny Merck's motion to dismiss on limitations-period grounds. Namely, Merck's repeated and detailed public assertions about the naproxen hypothesis may have allayed any concerns that a reasonable investor would have had about the higher incidence of cardiovascular events related to its drug Vioxx.

Even if Merck's words of comfort did not mitigate the storm warnings (assuming any existed) about the naproxen hypothesis, however, there is another reason to affirm the Third Circuit's opinion. The statute of limitations does not begin to run on a securities-fraud claim until the point at which a reasonable investor conducting a reasonably diligent inquiry would have uncovered the fraud. See, e.g., *Wyser-Pratte Mgmt. Co., Inc. v. Telxon Corp.*, 413 F.3d 553, 562-63 (6th Cir. 2005). That objective

standard advances Congress's intent to reduce strike suits by favoring large institutional investors, such as public pension funds, that cannot, and should not, be expected constantly to undertake actual investigations of storm warnings. And when the objective test is applied to this case, at the very least, a factual question exists on the question of when Respondents' claim accrued.

ARGUMENT

A. Words of comfort allayed any potential storm warnings regarding the safety of Vioxx.

All parties and the Third Circuit appear to agree on the basic securities-fraud concepts at issue in this case—inquiry notice and storm warnings. As Merck puts it, "a plaintiff is on inquiry notice when he receives so-called 'storm warnings': *i.e.*, when there was sufficient information in the plaintiff's possession, or in the public domain, to cause a reasonable investor to suspect the possibility that the defendant had engaged in securities fraud." Pet. Br. at 21; accord Pet. App. 23a-24a; Opp. to Cert. at 15. The circuit courts widely agree on this analytical framework. See *Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 876 (9th Cir. 2008); *Staehr v. Hartford Fin. Servs. Group, Inc.*, 547 F.3d 406, 411 (2d Cir. 2008); *Sudo Props., Inc. v. Terrebone Parish Consol. Gov't*, 503 F.3d 371, 376 (5th Cir. 2007); *Tello v. Dean Witter Reynolds, Inc.*, 410 F.3d 1275, 1283 (11th Cir. 2005) ("*Tello I*"); *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 (1st Cir. 2002); *Ritchey v. Horner*, 244 F.3d 635, 638-39 (8th Cir. 2001); *Kauther SDN BHD v.*

Sternberg, 149 F.3d 659, 670 (7th Cir. 1998); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1198 (10th Cir. 1998); *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993).

Despite this agreement, Merck maintains that the Third Circuit's approach "would essentially render the principle of inquiry notice a dead letter." Pet. Br. at 14. Yet it is reversal, not affirmance, that would change the landscape of federal securities litigation. The Third Circuit simply applied longstanding equitable principles to find that Merck's public and repeated assurances regarding the safety of Vioxx raised questions about the degree to which reasonable investors should have been on inquiry notice. That analysis fits easily within the widely recognized words-of-comfort doctrine.

1. Federal courts widely recognize that words of comfort may allay storm warnings of fraud.

The words-of-comfort doctrine is a well-settled exception to the inquiry-notice rule. Simply put, the doctrine holds that a defendant's reassuring statements or persistent denials may mitigate negative events or disclosures to such a degree that a plaintiff is not on sufficient notice to investigate the possibility of fraud.

The inquiry-notice rule is founded on the proposition that an investor has a duty of inquiry "when the circumstances would suggest to an investor of ordinary intelligence that she has been defrauded." *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993). But a defendant's actions can mitigate that duty. Specifically, "[t]here are

occasions when, despite the presence of some ominous indicators, investors may not be considered to have been placed on inquiry notice because the warnings signs are accompanied by reliable *words of comfort* from management." *LC Capital Partners, L.P. v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 155 (2d Cir. 2003) (emphasis added). "Such statements are among the factors that must be considered when evaluating whether" a reasonable investor would have been on inquiry notice. *Id.*

The Second Circuit has described the type of statements that qualify as words of comfort, explaining that "reassuring statements will prevent the emergence of a duty to inquire or dissipate such a duty only if an investor of ordinary intelligence would reasonably rely on the statements to allay the investor's concern." *Id.* Whether statements rise to this level "will depend in large part on how significant the company's disclosed problems are, how likely they are of a recurring nature, and how substantial are the 'reassuring' steps announced to avoid their recurrence." *Id.* For instance, "'[s]tatements of cautious optimism, reiterations of the goal of providing income to investors, and explanations for past poor performance'" are not enough. *Id.* (citing *Farr v. Shearson Lehman Hutton, Inc.*, 755 F. Supp. 1219, 1228 (S.D.N.Y. 1991)).

The lower courts widely agree on the words-of-comfort doctrine in the securities-fraud context. The Fifth Circuit, for instance, has held that a jury question existed regarding inquiry notice where the defendant's representations counteracted negative information available to investors. See *Sudo Props.*, 503 F.3d at 376-77. The Ninth Circuit has taken the

same approach. *Gray v. First Winthrop Corp.*, 82 F.3d 877, 882-83 (9th Cir. 1996) (holding that a jury should determine if the statute of limitations had run where all negative financial information was coupled with defendant's reassurances of the health of the investment). Other courts are similarly "reluctant to find that the plaintiffs were on inquiry notice of their claims" where "there is a mix of information available to the plaintiffs such that any negative statements are tempered by positive statements from a company's management and others." *In re DaimlerChrysler AG Sec. Litig.*, 269 F. Supp. 2d 508, 514 (D. Del. 2003); see, e.g., *In re Moody's Corp. Sec. Litig.*, 599 F. Supp. 2d 493, 506 (S.D.N.Y. 2009); *Cohen v. N.W. Growth Corp.*, 385 F. Supp. 2d 935, 946 (D.S.D. 2005); *In re Dynegy, Inc. Sec. Litig.*, 339 F. Supp. 2d 804, 850 (S.D. Tex. 2004); *Bovee v. Coopers & Lybrand*, 320 F. Supp. 2d 646, 655-56 (S.D. Ohio 2004); *Fugman v. Apogenex, Inc.* 961 F. Supp. 1190, 1196-98 (N.D. Ill. 1997).

Courts also recognize the principle that words of comfort dissipate storm warnings outside of the securities-fraud context. Petitioners acknowledge that, at common law, statute of limitations for fraud claims are subject to equitable principles such as the discovery rule. Pet. Br. at 16. The words-of-comfort doctrine is simply an extension of equitable principles recognizing that a defendant should not benefit from a limitations bar by falsely reassuring a plaintiff that no fraud occurred. See *Dodds*, 12 F.3d at 350 (explaining that equitable tolling will stay the running of the statute of limitations only so long as the plaintiff has "exercised reasonable care and diligence in seeking to learn the facts which would disclose fraud") (citing *Arneil v. Ramsey*, 550 F.2d

774, 781 (2d Cir. 1977) (quoting *Morgan v. Koch*, 419 F.2d 933, 997 (7th Cir. 1969))); see also *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, 1436-37 (9th Cir. 1984). The doctrine is therefore applied in a wide range of federal and state cases.

Words of comfort frequently toll the limitations period in the malpractice context. In medical malpractice actions brought under the Federal Tort Claims Act, for instance, federal courts consistently toll the statute of limitations for plaintiffs who reasonably relied on the assurances of physicians alleged to have committed malpractice. See, e.g., *McDonald v. United States*, 843 F.2d 247, 248-49 (6th Cir. 1988); *Colleen v. United States*, 843 F.2d 329 (9th Cir. 1987); *Raddatz v. United States*, 750 F.2d 791, 796 (9th Cir. 1984). State courts likewise hold in medical malpractice cases that reasonable assurances by the alleged wrongdoer may toll the statute of limitations. See, e.g., *Gaston v. Parsons*, 864 P.2d 1319, 1324 (Or. 1994); *Herr v. Robinson Mem'l Hosp.*, 550 N.E.2d 159, 161-62 (Ohio 1990). Similarly, in legal malpractice actions, a lawyer's false assurances can delay the point at which a client can reasonably discover the lawyer's malpractice, thereby tolling the statute of limitations. See, e.g., *Frederick Rd. Ltd. P'ship v. Brown & Sturm*, 756 A.2d 963, 976 (Md. Ct. App. 2000); *Hoeck v. Schwabe, Williamson & Wyatt*, 945 P.2d 534, 538 (Or. Ct. App. 1997); *Koch v. Gross*, 582 N.E.2d 51, 54 (Ohio Ct. App. 1990).

The rule holds true for other tort claims as well. For example, reliance on the defendant's assurances can toll the statute of limitations in products-liability

actions. See, e.g., *Reed v. Gen. Motors Corp.*, 400 So.2d 919, 920-21 (La. Ct. App. 1981) (holding that the limitations period for a car owner did not accrue at the time of an accident because after repairing the car, the seller assured the owner that no problem existed and that there would be no future problems). State courts apply a similar analysis to breach-of-warranty claims. See, e.g., *Forest Grove Brick Works, Inc. v. Strickland*, 559 P.2d 502, 506 (Or. 1977) (reversing grant of summary judgment for seller of defective industrial vacuum pump where seller's continued false assurances to buyer that the pump would meet his needs created a question as to whether the statute of limitations on buyer's claim had run).

In the same vein, both federal and state Racketeer Influenced and Corrupt Organizations ("RICO") laws consider the effect of a defendant's reassurances to determine when a claim accrues. Federal courts addressing RICO claims suggest that assurances made by an investment's promoter or manager may toll the limitations period depending on the surrounding storm warnings. See, e.g., *Cetel v. Kirwan Fin. Group, Inc.*, 460 F.3d 494, 508-09 (3d Cir. 2006). In a state RICO action, assurances by a broker created an issue of fact as to whether the broker lulled investors into a false sense of security, precluding the investors from discovering that they may have a cause of action against the broker. *Penuel v. Titan/Value Equities Group*, 872 P.2d 28, 31-32 (Or. Ct. App. 1994).

The words-of-comfort doctrine is therefore in step with broader equitable principles that have long governed the limitations-period analysis for

securities-fraud claims. Courts routinely determine that the statute of limitations on a plaintiff's securities-fraud claim has not begun to run because a company's reassuring statements gave investors a reason not to investigate further.

2. The existence of inquiry notice is a highly fact-bound inquiry that is inappropriate for determination on a motion to dismiss.

Whether storm warnings sufficed to trigger the limitations period—or whether, on the other hand, words of comfort prevented a claim from accruing—is a highly factual determination. As such, the determination is rarely appropriate for resolution on a Rule 12(b)(6) motion to dismiss.

The federal courts of appeals have recognized "the fact-specific nature of the limitations defense, particularly where the claim is foreclosed by inquiry notice." *Lentell v. Merrill Lynch & Co.,* 396 F.3d 161, 169 (2d Cir. 2005). As Judge Posner has explained, "the facts constituting [inquiry] notice must be 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." *Fujisawa Pharm. Co. v. Kapoor*, 115 F.3d 1332, 1335 (7th Cir. 1997).

Given the fact-intensive nature of this inquiry, many appeals courts have held that resolution of inquiry notice at the pleading stage, and prior to substantial discovery, is often inappropriate. See *Sudo Props.*, 503 F.3d at 376 ("The 'fact-intensive'

inquiry of what constitutes inquiry notice 'is typically appropriate for consideration by a jury.'") (citation omitted); *La Grasta v. First Union Sec. Inc.*¸ 358 F.3d 840, 848 (11th Cir. 2004) ("Whether a plaintiff had sufficient facts to place him on inquiry notice of a claim for securities fraud . . . is a question of fact, and as such is often inappropriate for resolution on a motion to dismiss under Rule 12(b)(6)." (quoting *Marks v. CDW Computer Ctrs., Inc.*, 122 F.3d 363, 367 (7th Cir. 1997)); *LC Capital Partners, L.P.*, 318 F.3d at 156 ("We recognize whether a plaintiff had sufficient facts to place it on inquiry notice is often inappropriate for resolution on a motion to dismiss.") (internal quotes and citations omitted); *Kauther SDN BHD*, 149 F.3d at 669 (noting that "because the question of whether a plaintiff had sufficient facts to place it on inquiry notice of a claim for securities fraud is one of fact, it may be inappropriate for resolution on a motion to dismiss under Rule 12(b)(6)") (internal quotations omitted). Other decisions are in accord. See *Bovee*, 216 F.R.D. at 611; *Nappier v. PricewaterhouseCoopers LLP*, 227 F. Supp. 2d 263, 274-75 (D.N.J. 2002); *Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1292 (D. Utah 1999).

To determine whether a plaintiff investor was on inquiry notice, then, a court must undertake a highly fact-bound analysis and ordinarily should allow further factual development beyond a motion to dismiss. The Third Circuit did precisely that in this case.

3. This case fits neatly within the words-of-comfort doctrine and withstands a motion to dismiss.

The Third Circuit's analysis is fully consistent with equitable tolling principles generally and the words-of-comfort doctrine specifically.

The Third Circuit carefully documented the ways Merck misled investors. The court noted that, as early as 1999, Merck began the Vioxx Gastrointestinal Outcomes Research ("VIGOR") study, which compared Vioxx to a comparator drug, naproxen. The VIGOR study indicated that "Vioxx users had a higher incidence of [cardiovascular] events than naproxen users." Pet. App. 6a. In response to the VIGOR study, Merck touted the "naproxen hypothesis" in a press release, asserting that Vioxx would be expected to have significantly favorable effects. Pet. App. 7a.

The Third Circuit also observed the host of ways in which Merck, between January 1999 and April 2002, countered a number of public disclosures regarding the higher incidence of heart attacks occurring in Vioxx users with public assertions that Vioxx was safe, and that the protective effects of naproxen explained the increased rate of cardiovascular events. See Pet. App. 36a-39a, 44a-46a. It was not until one year later, on November 1, 2004, that Merck's repeated confidence in the naproxen hypothesis was questioned by a *Wall Street Journal* article publishing e-mail excerpts from Merck scientists and executives discussing the adverse cardiovascular side effects of Vioxx. Pet. App. 18a-19a. See also Joint Appendix ("J.A.") at 191-97 (discussing contents of Merck's internal

e-mails. The Third Circuit noted in particular that Petitioner Scolnik, Merck's then-top scientist, asserted in a March 2000 e-mail (written shortly after the VIGOR study) that Vioxx's higher incidence of cardiovascular events "is a shame but it is a low incidence and it is mechanism based as we worried it was." Pet. App. 6a; J.A. at 192.

After reciting these reassurances and others, the Third Circuit noted the settled legal principles explained above—"that reassurances can dissipate apparent storm warnings if an investor of ordinary intelligence would reasonably rely on them to allay investor's concerns." Pet. App. 36a n.14 (citing *Benak v. Alliance Capital Mgmt., L.P.*, 435 F.3d 396, 402 n.16 (3d Cir. 2006)). The court concluded that "the District Court acted prematurely in finding as a matter of law that Appellants were on inquiry notice of the alleged fraud before October 9, 2001. As of that date, market analysts, scientists, the press, and even the FDA agreed that the naproxen hypothesis was "plausible, at the very least." Pet. App. 46a. "On the record before" it, the court found that investors had "no reason to suspect that Merck did not believe the naproxen hypothesis until the Harvard study in 2003 revealed an increased risk of heart attacks in patients taking Vioxx." Pet. App. 47a. Dismissal under Rule 12(b)(6), the court held, was therefore inappropriate. Pet App. at 48a.

The Third Circuit's analysis comports with other federal court decisions denying similar dismissal motions. See, e.g., *Sudo Props.*, 503 F.3d at 377-78; *In re Tyco Int'l, Ltd. MDL*, MDL No. 02-1335-B, 2004 U.S. Dist. Lexis 20733, at *57 (D.N.H. Oct. 14, 2004) (explaining that "a dispute about

whether sufficient storm warnings were present to deny the plaintiff the benefit of the discovery rule generally will not be resolvable on a motion to dismiss, unless it is plain from the complaint itself that the plaintiffs' claims are time-barred"); *In re Global Crossing, Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 204 (S.D.N.Y. 2003) (denying defendants' motion to dismiss and noting that whether a plaintiff is on inquiry notice is a "question of fact for ultimate resolution at trial (or on summary judgment if the factual record permits only one conclusion)"). The Complaint alleges that the naproxen hypothesis, aggressively touted by Merck, was the primary reason the investment community continued to believe the drug did not cause the cardiovascular events associated with it. Under the words-of-comfort doctrine, those allegations suffice to survive a defendant's motion to dismiss.

B. A reasonable investor performing a reasonably diligent investigation would not have uncovered Merck's fraud.

Federal courts generally use a two-step analysis to determine whether the statute of limitations for securities-fraud claims has started to run. See Pet. Br. at 18-19; Resp't. Br. in Opp'n. to Cert. at 9. As explained above, the first step is the inquiry-notice analysis—a highly fact-bound, objective determination as to whether a reasonable investor would have a duty to inquire into possible securities fraud. Because the words-of-comfort doctrine does not change the applicable standards for the inquiry-notice prong of the analysis, the Court can affirm the Third Circuit on this first step and leave it at that.

If the Court chooses to reach it, however, there is a second step—the investigation prong. Under that prong, the circuit courts generally hold that the statute of limitations on a securities-fraud claim does not begin to run unless a reasonably diligent investigation could have uncovered the specifics of the alleged fraud. Merck argues that the rule should be purely subjective—that "the limitations period begins to run from the date of inquiry notice" unless the plaintiff *actually* conducted a "reasonably diligent investigation" that failed to uncover the fraud. Pet. Br. at 39. Because Merck's preferred approach is inconsistent with the policies underlying the securities laws, however, the Court instead should agree with the majority of circuits and hold that a securities-fraud claim does not accrue until a *reasonable investor* performing a *reasonably diligent investigation* would have discovered the specifics of the fraud.

1. The purpose and policies underlying the securities laws require that a claim not accrue until a reasonably diligent investigation would have exposed the fraud.

The policies underlying the federal securities laws require a careful balance between protecting companies from unsupported or frivolous securities laws claims on the one hand, and allowing investors to seek recovery for losses from fraud on the other. See *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007). In that vein, this Court's recent decisions have attempted to balance the competing interests of the plaintiff-investors and defendant-companies. See, e.g., *id.* at 322

(describing the PSLRA as having "twin goals: to curb frivolous, lawyer-driven litigation, while preserving investor's ability to recover on meritorious claims"); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 81 (2006); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005).

That balance is reflected in part in the statute of limitations. In the wake of the Enron scandal, Congress enacted Section 804 of the Public Company Accounting Reform and Investor Protection Act of 2002, better known as the Sarbanes-Oxley Act. Pub. L. No. 107-204, § 804, 116 Stat. 745, 801 (codified in part at 28 U.S.C. § 1658 (2002)). One of Congress's purposes in enacting that law was to give plaintiffs additional time, in light of the complexity of securities-fraud cases, to investigate their claims. See, e.g., S. Rep. No. 107-146, at 17 (2002) (noting that "the current short statute of limitations may insulate the worst offenders from accountability" and could be considered "an invitation to take sophisticated steps to conceal the deceit").

The core purpose of the securities laws—to protect investors—is vindicated by the statute-of-limitations rule that the circuit courts follow. Ten federal appeals courts agree that "the limitation period begins to run only when a reasonably diligent investigation should have discovered the fraud." *New England Health Care Employees Pension Fund*, 336 F.3d 495, 501 (6th Cir. 2003); accord *Betz*, 519 F.3d at 870-71; *Sudo Props.*, 503 F.3d at 376; *Benak*, 435 F.3d at 400; *Tello I*, 410 F.3d at 1285-88, vacated on other grounds, *Tello v. Dean Witter Reynolds, Inc.*, 494 F.3d 956, 968 (11th Cir. 2007) ("*Tello II*"); *LC Capital Partners, L.P.*, 318 F.3d at 154; *Young*, 305

F.3d at 10; *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998); *Marks*, 122 F.3d at 367-68; *Great Rivers Coop. of S.W. Iowa v. Farmland Indus.*, 120 F.3d 893, 896 (8th Cir. 1997). As the Ninth Circuit has explained, a contrary rule would encourage premature, baseless suits because it would "requir[e] plaintiffs to sue before they can discover the facts underlying their claims." *Betz*, 519 F.3d at 870; accord *Lentell*, 396 F.3d at 168. The reasonable-investigation rule, by contrast, "reflect[s] an 'appropriate balance' between competing interests," *Wyser-Pratte Mgmt.*, 413 F.3d at 563, and "treats both plaintiffs and defendants even-handedly." *Young*, 305 F.3d at 9.

The reasonable-investigation approach also comports with broader equitable principles outside the securities-fraud context. Under the "discovery rule" common in state law, a limitations period does not begin to run until the injured party should have become aware of his injury through the exercise of reasonable diligence. In Ohio, for instance, courts have applied the discovery rule to toll the statute of limitations for various causes of action—including wrongful adoption, negligent credentialing of a physician, exposure to toxic gas, sexual abuse of children, and wrongful death—without requiring an actual investigation by plaintiffs. See *Harris v. Liston*, 714 N.E.2d 377, 378, 380 (Ohio 1999). Federal courts agree that the discovery rule "postpones the beginning of the limitations period from the date a plaintiff was wronged until the date a plaintiff discovers that he or she was injured." *Oshiver v. Levin, Fishbein, Sedran & Berman*, 38 F.3d 1380, 1386 (3d Cir. 1994); see, e.g., *Local 219 Plumbing & Pipefitting Indus. Pension Fund v. Buck*

Consultants, L.L.C., 311 F. App'x 827, 829 (6th Cir. 2009); *Walker v. Epps*, 550 F.3d 407, 414 (5th Cir. 2008); *Podobnik v. U.S. Postal Serv.*, 409 F.3d 584, 590 (3d Cir. 2005).

Merck has not cited a single circuit court decision departing from the reasonable-investigation rule. Even the Fourth Circuit's statute-of-limitations analysis, which applies once a plaintiff is on inquiry notice, acknowledges that the occurrence of a reasonably diligent investigation may be an important consideration in determining whether such notice is triggered. See *Brumbaugh*, 985 F.2d at 162 ("The objective standard of due diligence requires reasonable investigation of the possibility of misrepresentation once an individual has been placed on inquiry notice of wrongdoing."). Accordingly, given the agreement among the circuits and the strong policy considerations underlying such a rule, the Court should hold that the clock does not begin to tick on a securities-fraud claim until a reasonably diligent investigation would have uncovered the alleged fraud.

2. The reasonable-investigation rule should be applied objectively from the perspective of a reasonable investor.

There remains the question whether the reasonable-investigation rule should be objective or subjective in nature. Merck advocates a subjective test that asks whether the plaintiff herself *actually* undertook a reasonably diligent investigation. Pet. Br. at 43, 44 n.13. The weight of the case law and strong policy considerations, however, militate in favor of an objective test that asks whether a

reasonable investor would have performed a reasonable investigation.

Although some variations exist under the reasonable-investor approach, most circuit courts agree that the investigation prong does not require that the actual plaintiff perform a reasonably diligent investigation. Some circuits conduct a purely objective inquiry, considering whether the reasonable investor, performing a reasonably diligent investigation, should have discovered the fraud. E.g., *New England Health Care Employees Pension Fund*, 336 F.3d at 501. In other circuits, the analysis is both subjective and objective: whether a reasonable investor, standing in the shoes of the actual plaintiff, would have exposed the fraud upon a reasonably diligent investigation. Those courts assess "the plaintiff's particular circumstances" but do not require that the actual plaintiff perform an actual investigation. *Betz*, 519 F.3d at 871; see also *Tello I*, 410 F.3d at 1283-84; *Sterlin*, 154 F.3d at 1201-02; *Marks*, 122 F.3d at 368; *Great Rivers Coop.*, 120 F.3d at 897.

Even those circuits that look to what the plaintiff actually did still ask what a reasonable investor's reasonable investigation would have uncovered. The Second and Third Circuits have indicated that the investigation prong requires the actual investor to "make some inquiry"; then, upon such a showing, the limitations-period begins to run on the date a "reasonable investor in the exercise of reasonable diligence should have discovered the fraud." *LC Capital Partners, L.P.*, 318 F.3d at 154; accord *Benak*, 435 F.3d at 400-01.

The reasonable-investor analysis fits with the purpose and policies underlying the securities laws. One of Congress's chief goals in enacting the PSLRA was to favor just what the reasonable-investor standard focuses on—*reasonable investors*. Congress designed the PSLRA to curtail securities class actions brought by "professional plaintiffs," litigants who repeatedly asserted "frivolous" fraud claims against corporations in the hope of negotiating quick settlements. H.R. Rep. No. 104-369, at 32-33 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 731-32; *Dabit*, 547 U.S. at 81 (noting that Congress intended the PSLRA to combat "perceived abuses of the class-action vehicle"). Rampant "strike" suits created a host of problems. For instance, because lead counsel "historically chos[e] the lead plaintiff," *In re Cendent Corp. Sec. Litig.*, 404 F.3d 173, 192 (3d Cir. 2005), speed in the selection process replaced diligence. Attorneys for handpicked clients would attempt to secure lead-counsel appointments by filing hastily drafted, cookie-cutter complaints before legitimate claimants could sue.

Congress sought to remedy this problem by giving preference to large institutional investors—particularly public pension funds—as lead plaintiffs in major securities litigation. The aim was to "ensure that parties with significant financial interests in the litigation would oversee securities actions and control the management of such suits." *In re Bank of Am.*, 2009 U.S. Dist. Lexis 56009, at *24 (citation omitted); see also H.R. Rep. No. 104-369, at 32 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 731. The PSLRA accordingly increased the likelihood that institutional investors would serve as lead plaintiffs in securities class actions, decreasing

the number of these abusive suits. See *Tellabs*, 551 U.S. at 320-321; H.R. Rep. No. 104-369, at 34 (1995), reprinted in 1995 U.S.C.C.A.N. 733. In fact, public funds have been at the forefront of the largest investor recoveries ever awarded in securities-fraud litigation under the PSLRA. See, e.g., *In re Enron Corp. Sec. Litig.*, 206 F.R.D. 427, 458-59 (S.D. Tex. 2002); *Albert Fadem Trust v. Worldcom*, 2002 U.S. Dist. Lexis 15005, at *6 (S.D.N.Y. Aug. 15, 2002); see also Sec. Class Action Servs., RiskMetrics Group, *Top 100 Settlements Report* (2008), available at http://www.riskmetrics.com/knowledge/docs/SCAS100_2008 (last visited Oct. 15, 2009).

A limitations-period analysis that requires actual investigation is not consistent with this statutory preference for institutional investors. Fiduciary duties oblige the trustees of public funds to prudently invest fund assets, encouraging growth while minimizing risk. Although fraud monitoring is essential to fulfilling this responsibility, it cannot become trustees' tireless pursuit. Given the prohibitive costs of in-house fraud monitoring, public funds inherently depend upon third-party market professionals to analyze the value of fund investments. (Smaller individual investors, of course, lack the resources to rely on asset managers.)

Adopted in 2005, the statutory duties and internal policies and expenditures of the Ohio Public Employees' Retirement System ("OPERS") illustrate how such funds operate. Ohio law instructs the OPERS board of directors to invest its funds with "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these

matters would use in the conduct of an enterprise of a like character and with like aims." Ohio Rev. Code § 145.11(A) (2009). In keeping with these duties, the OPERS board of trustees is statutorily required to designate a chief investment officer to oversee the fund's investment officers, whose duties specifically include "the adoption, implementation, and enforcement of written policies and procedures reasonably designed to prevent persons employed by the public employees retirement system from misusing material, nonpublic information in violation of [federal and state] laws, rules, and regulations." *Id.* § 145.094(B). The chief investment officer must also monitor external transactions on behalf of the fund, *id.* § 145.094(C), and OPERS commits resources to monitoring the fund's external managers based upon the fund's overall performance.

Since 2007, OPERS's expenditures for legal and investigative actions have decreased significantly, but its net administrative expenses actually increased over the same time period. OPERS's allocation of resources demonstrates its belief that it best protects its fiduciaries' interests by investing greater amounts in consulting, investment, and financial services rather than in the investigation and litigation resources used during the recent period of market volatility. Institutional investors like OPERS find these administrative efforts to be more cost effective than constantly policing the market in an attempt to ferret out and prosecute fraud. The OPERS board manages roughly $60 billion in assets that are diversely invested in public and private equity, both domestic and foreign; hedge funds; real estate investment trusts; bonds; commercial paper; structured finance products; and

more. Monitoring the possibility of fraud by each company in which OPERS invests would be a monumental undertaking, to say the least.

Congress was well aware of this reality when it granted preference to institutional investors under the PSLRA. For Merck to suggest that such investors must undertake *actual* investigations of storm warnings is to ignore not only the manner in which such investors operate, but also the goals of the PSLRA. The Court should not craft a rule that undermines Congress's purposes by requiring pension funds to investigate every time negative information surfaces about one of the thousands of companies in which they are invested.

Nor is it feasible to require, as Merck suggests, that an actual investigation have been conducted, at the least, by plaintiff's *counsel* as a proxy. Pet. Br. at 45-46. Merck submits that such a requirement is reasonable given the "sophisticated plaintiffs' bar" that now exists in securities-fraud litigation. *Id*. But again Merck ignores the way large public pension funds approach such litigation. Large institutional investors like OPERS do not immediately retain counsel whenever suspicious signs of fraud arise. Rather, the initial investigation and drafting of the first complaints in a large securities class action occurs by plaintiff's counsel working with a smaller investor. Then, if such a claim has interest for a pension fund like OPERS, the PSLRA allows the fund to intervene by filing a motion for lead-plaintiff status based on the large losses suffered by the fund. See 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I); see, e.g., *In re Bank of Am.*, 2009 U.S. Dist. Lexis 56009, at *20-21.

The decision process for intervening in such cases is a careful and deliberate one. A number of large public pension funds have established a competitive process to choose outside counsel to prepare the fund's lead-plaintiff motions and, if successful, represent the fund in litigation. In Ohio, for instance, the Ohio Attorney General, working with five large, separately managed public pension funds with over $120 billion in assets under management, has established a panel of prominent securities-litigation firms to submit proposals to represent one or more of the funds when the Attorney General and the funds decide that such litigation is appropriate. The process takes into account many factors, including, among others, the quality of the written proposal and the law firm's record of success. To satisfy Merck's actual-investigation rule, the pension funds would have to short-circuit that competitive process and retain counsel at the first inkling of fraud. Merck's approach would therefore undermine the very investors to whom Congress has shown favor.

Unlike the impracticable actual-investigation standard, experience shows that the reasonable-investor test is eminently workable. See, e.g., *Wyser-Pratte Mgmt.*, 413 F.3d at 564-65; *Fujisawa*, 115 F.3d at 1335-36. Merck suggests that "it would force courts to engage in entirely hypothetical inquiries about what a reasonably diligent investigation would have entailed and how long it would have taken for such an investigation to bear fruit." Pet. Br. at 50. But the "reasonable man" standard has deep roots in the common law. E.g., *Stoffel v. New York, N.H. & H.R. Co.*, 205 F.2d 411, 412 (2d Cir. 1953) (L. Hand, J.) (where a "reasonable man with due regard for his

own safety" would not have acted as plaintiff, plaintiff was guilty of contributory negligence as a matter of law). All evidence shows that courts are well equipped to apply such a standard.

3. The Third Circuit's opinion is consistent with the reasonable-investor/reasonable-investigation test.

Under the standard of a reasonable investor conducting a reasonable investigation, the Third Circuit reached the right outcome. Regardless of when inquiry notice was triggered, Merck's insistence on the naproxen hypothesis and its detailed and effective reassurances would have prevented a reasonable investor from uncovering, upon reasonably diligent investigation, the specifics of Merck's fraud until the public disclosure of the 2003 Harvard Study. Pet. App. 47a.

Affirmance on the investigation prong is all the more warranted given the posture of this case. The allegations in the Complaint note—in great detail—that until November 2004, Merck did not disclose its internal documents indicating that it knew of Vioxx's adverse cardiovascular side effects early on. A determination of whether, in the exercise of due diligence, such documents could have been discovered earlier without the assistance of compulsory discovery is properly a question for the finder of fact, and cannot be determined on a Rule 12(b)(6) motion to dismiss. See *Fujisawa*, 115 F.3d at 1335 (noting that access to relevant information is an important factor in "confirming or dispelling" the suspicions raised by inquiry notice).

CONCLUSION

For the above reasons, the Court should affirm the Third Circuit's decision.

Respectfully submitted,

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