TOWARD A JUST MEASURE OF REPOSE: THE STATUTE OF LIMITATIONS FOR SECURITIES FRAUD

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ABSTRACT

Statutes of limitations, a long-standing bulwark of civil litigation, mitigate the risk that evidence of meritorious claims will become stale and relieve defendants who might be exposed to claims from unending uncertainty about whether claims will be brought. But these twin rationales are balanced against allowing plaintiffs sufficient time to discover and file meritorious claims. This balance is manifest in the judicial and congressional effort to fashion a statute of limitations for securities fraud claims. The Supreme Court in Merck & Co. v. Reynolds *recently attempted to strike that balance in its interpretation of the statute of limitations for securities fraud claims under section 10(b) and Rule 10b-5. But we show that the Court has failed.* Merck *presents a pleading trap for victims of securities fraud that will preclude the adjudication of meritorious claims.*

Moreover, the Supreme Court's Merck *decision exemplifies a much more serious problem with the entire limitations regime for securities fraud. We demonstrate that the discovery provision in that regime should be discarded for a singular statute of repose as the discovery provision unnecessarily precludes meritorious claims without providing any more support for the twin rationales beyond what is already provided by a statute of repose alone. The repose provision by itself reduces the use of stale evidence and litigation uncertainty and it does not unnecessarily preclude meritorious*

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claims. In this sense, our proposal bucks the trend of scholarship addressing the statute of limitations that advocates eliminating limitations periods entirely. We find that insights from behavioral economics and practical realities of market activity justify some measure of repose. Thus, we advocate abolishing the discovery provision in the statute of limitations but keeping the statute of repose.

TABLE OF CONTENTS

INTRODUCTION

Statutes of limitations have been part of the architecture of civil litigation for centuries.[1] These limitations are designed to mitigate the risk that evidence of meritorious claims will become stale and to relieve potential defendants from unending uncertainty about whether they will be brought into court.[2] The "stale evidence" rationale is rooted in the premise that resolving claims on their merits is more likely if the evidence, including testimony based on recall, is produced closer in time to the event that gives rise to the claim.[3] The "litigation uncertainty" rationale is based on two related propositions: (1) a party who is uncertain about whether it will be sued is more likely to be distracted by the threat of litigation, and thus less likely to devote resources to productive purposes; and (2) at some point in time, it is simply unjust to subject a party to the sword of Damocles—the lingering possibility that litigation could be brought at any moment.[4] These rationales are invariably balanced

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1. Wood v. Carpenter, 101 U.S. 135, 139 (1879). Nevertheless, the current climate of regulatory reform provides the opportunity for reevaluation. *See* Oliver Wendell Holmes, *The Path of the Law,* 10 HARV. L. REV. 457, 469 (1897) ("It is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV. It is still more revolting if the grounds upon which it was laid down have vanished long since, and the rule simply persists from blind imitation of the past.").

2. THE QUOTABLE JUDGE POSNER: SELECTIONS FROM TWENTY-FIVE YEARS OF JUDICIAL OPINIONS 158 (Robert F. Blomquist ed., 2010) (quoting Taylor v. Meirick, 712 F.2d 1112, 1119 (7th Cir. 1983)).

3. *See, e.g.*, John R. Sand & Gravel Co. v. United States, 552 U.S. 130, 133 (2008) ("Most statutes of limitations seek primarily to protect defendants against stale or unduly delayed claims."); Day v. McDonough, 547 U.S. 198, 205-06 (2006) ("The ... statute of limitation promotes judicial efficiency and conservation of judicial resources, [and] safeguards the accuracy of ... judgments by requiring resolution ... while the record is fresh.") (quoting Acosta v. Artuz, 221 F.3d 117, 123 (2d Cir. 2000)); Order of R.R. Telegraphers v. Ry. Express Agency, Inc., 321 U.S. 342, 348-49 (1944) ("Statutes of limitation ... promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared. The theory is that even if one has a just claim it is unjust not to put the adversary on notice to defend within the period of limitation and that the right to be free of stale claims in time comes to prevail over the right to prosecute them.").

4. *See, e.g.*, Young v. United States, 535 U.S. 43, 47 (2002) (stating that all limitations periods provide "repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities") (quoting Rotella v. Wood, 528 U.S. 549, 555 (2000)); Tulsa Prof'l Collection Servs., Inc. v. Pope, 485 U.S. 478, 486 (1988);

against allowing potential plaintiffs sufficient time to discover and file meritorious claims.

This delicate balance is manifest in the judicial and congressional effort to fashion a statute of limitations for securities fraud claims. The Supreme Court in *Merck & Co. v. Reynolds* recently attempted to strike that balance in its interpretation of the statute of limitations for securities fraud claims under section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.[5] The Court held in *Merck* that the two-year statute of limitations for plaintiff-investors begins, not when they actually discovered the fraud, but when they discovered or should have discovered the facts constituting securities fraud, which includes scienter—the "mental state embracing [an] intent to deceive, manipulate, or defraud."[6] *Merck* is the latest effort by the Court to fashion a limitations regime that serves both rationales. In this Article, we show that the Court has failed. Rather, *Merck* presents a trap for victims of securities fraud that will preclude the adjudication of meritorious claims. Moreover, *Merck* exemplifies a much more serious problem with the entire limitations regime for securities fraud.

Next, we argue that the discovery provision in the limitations regime should be discarded in favor of a singular statute of repose. The discovery provision unnecessarily precludes meritorious claims without providing any support for the twin rationales beyond what is already provided by the statute of repose alone. The repose provision by itself reduces both the use of stale evidence and litigation uncertainty, and it does not unnecessarily preclude meritorious claims. Our proposal bucks the trend of scholarship addressing the statute of limitations, which advocates eliminating limitations periods entirely. We find that insights from behavioral economics and practical realities of market activity justify some measure of

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Wood v. Carpenter, 101 U.S. at 139 ("They promote repose by giving security and stability to human affairs.").

5. 130 S. Ct. 1784, 1789-90 (2010); *see* Securities Exchange Act of 1934 § 10, 15 U.S.C. §§ 78a-78nn (2006); 17 C.F.R. § 240.10b-5 (2010); *see also* 28 U.S.C. § 1658(b) (providing that Section 10(b) and Rule 10b-5 private securities fraud actions "may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation").

6. *Merck*, 130 S. Ct. at 1789-90 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 n.12 (1976)).

repose. Thus, we advocate abolishing the discovery provision in the statute of limitations entirely but keeping the statute of repose.

Part I.A of this Article provides a brief overview of statutes of limitations and repose, as well as their purposes. Part I.B next provides the necessary background to understand the Supreme Court's *Merck* decision by discussing the initial statute of limitations for Rule 10b-5 actions that the Supreme Court adopted in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson* and its common law evolution, including the federal appellate courts' interpretations of what constitutes "discovery" and "facts constituting the violation."[7] Part I.C then discusses Congress's statute of limitations in the Sarbanes-Oxley Act of 2002 (SOX) and how the federal appellate courts have interpreted it.[8]

Part II examines *Merck*, including its factual and procedural background, its two rulings of note, and Justice Scalia's concurrence advocating for an "actual discovery" standard, a seemingly pro-plaintiff posture.[9] Part II.C also observes that *Merck* will likely play an increasingly important role in securities fraud litigation.

But, as Part III then argues, *Merck*'s discovery rule does more harm than good. First, *Merck*'s incorporation of scienter allows defendants to trigger discovery by invoking methods of imputing knowledge.[10] Second, the discovery standard may force plaintiffs to concede that essential facts are not evidence of scienter or to allege fraud by hindsight—setting plaintiffs up for ready dismissal.[11] And third, by incorporating scienter into the discovery inquiry, *Merck* has failed to achieve uniformity in the statute of limitations because the courts of appeals have different interpretations of what constitutes an adequate allegation of scienter.[12]

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7. 501 U.S. 350 (1991). *See infra* Part I.B (discussing the Supreme Court's *Lampf* decision and the lower federal appellate courts' treatment of the statute of limitations).

8. *See infra* Part I.C (describing SOX, its accompanying two-and-five-year structure, and how the federal appellate courts further divided over its meaning).

9. 130 S. Ct. 1784 (2010); *see infra* Part II.A-B.

10. *See infra* Part III.A.1.

11. *See infra* Part III.A.2 (exploring the "pleading trap" *Merck* sets up for plaintiff-investors).

12. *See infra* Part III.A.3 (demonstrating that the circuits take varying approaches in determining scienter).

Recognizing that *Merck* is marred with pitfalls and pleading traps, Part III next questions the usefulness of the discovery provision for the statute of limitations for section 10(b) and Rule 10b-5 actions and concludes it is unnecessary. The practical realities of securities fraud claims already encourage diligence and prompt filing.[13] Moreover, discovery of meritorious securities fraud claims is difficult and time-consuming.[14] By abolishing the discovery provision, meritorious claims proceed and the costs associated with litigating these colossal suits should also decrease.[15]

Yet Part IV argues that, contrary to the scholastic trend toward eschewing limitations periods entirely, some repose is still necessary.[16] Insights from behavioral economics, such as loss aversion, justify a statute of repose for section 10(b) and Rule 10b-5. Also, without repose, securities fraud would affect settled economic expectations of nonculpable market participants. Part IV then proposes a statute of repose for securities fraud. This limitation period must be a bright-line rule simple in application. And it must be long enough to promote merits resolution and to prevent an end run around the private right of action. Thus, Part IV concludes that Congress should retain only its five-year statute of repose that is triggered upon the happening of the fraud.

I. THE SUPREME COURT, CONGRESS, AND THE STATUTE OF LIMITATIONS FOR PRIVATE SECURITIES FRAUD

In the United States, companies are traditionally characterized by dispersed ownership, that is, "no single shareholder [or group] owns sufficient shares to ensure its ability to elect directors," and, as a result, ownership is separated from control.[17] Thus,

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13. *See infra* Part III.B.1.

14. *See infra* Part III.B.2 (showing that securities fraud is inherently secretive, complex, and difficult to detect).

15. *See infra* Part III.B.3 (observing that the statute of limitations, as a procedural cost with no corresponding benefit, imposes unnecessary, additional costs on litigants).

16. *See infra* Part IV.

17. JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 80, 82 (2006) [hereinafter COFFEE, GATEKEEPERS]; John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control,* 111 YALE L.J. 1, 25-39 (2001); *see also* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 129 (rev. ed., Harcourt, Brace & World, Inc. 1968)

shareholders in a dispersed ownership system depend on a company's public disclosures for information because these shareholders have little, if any, direct access to management and cannot easily monitor corporate affairs.[18] Because shareholders depend on corporate disclosures as their only source of information, it is all the more important that these disclosures are accurate. Congress concluded that one way to ensure the integrity of the nation's marketplace is to afford private rights of action to victims of securities fraud.[19] As the Supreme Court has long recognized, these private rights of action supplement enforcement efforts by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) to provide for holistic enforcement of federal securities laws.[20]

(1932); John H. Biggs, *Shareholder Democracy: The Roots of Activism and the Selection of Directors*, 39 LOY. U. CHI. L.J. 493, 498 (2008) ("The Public Company Accounting Oversight Board ("PCAOB") estimates that [55] percent of American families now own stock in public companies, mostly through their [Defined Contribution] plans and IRAs. Another large percentage own stocks through their state and municipal multi-employer plans where contributions, taxes, and benefits are all determined, in great part, by the investment results of the stocks held in public companies."). Some consider the separation of ownership and control the cause of the recent financial economic collapse; separating ownership from control turned companies into objects of speculation and transferred financial risk and, ultimately, responsibility, to shareholders. *E.g.*, MICHAEL LEWIS, THE BIG SHORT 263-64 (2010) ("The effect of turning a partnership into a corporation was to transfer the financial risk to the shareholders.... When the Wall Street investment bank screwed up badly enough, its risks became the problem of the United States government.").

18. COFFEE, GATEKEEPERS, *supra* note 17, at 82-83.

19. H.R. REP. NO. 105-803, at 2 (1998) (Conf. Rep.) (finding that securities regulation has a dual aim of protecting investors and promoting growth of financial markets); *see also* H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 (stating that the overriding purpose of the securities laws is to protect investors and maintain confidence in the market so national savings and investments may grow for the benefit of all).

20. *E.g.*, Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007) (recognizing that private actions are an "essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission"); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (finding that "the availability of private securities fraud actions" acts to deter fraud and thereby helps maintain "public confidence in the [securities] marketplace"); Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (reaffirming that the private right of action "constitutes an essential tool for enforcement of the 1934 Act's requirements"); Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986) (noting "the deterrent value of private rights of action" under the securities laws); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) ("Private enforcement ... provides a necessary supplement to [SEC] action.").

Several significant securities laws have shaped private securities fraud litigation. First, the Securities Act of 1933 (1933 Act) aimed to provide investors with sufficient, material information regarding securities that were offered for sale, and to prohibit deceit by the offerees.[21] Section 11 of the 1933 Act regulates the primary offering of securities by granting a private right of action to stock purchasers against those who make material misrepresentations or omissions in the registration statement of an initial public offering.[22] Section 12(a)(2) grants a private right of action against those who offer or sell stock through a prospectus or oral communication that contains a material omission or misstatement.[23] The difference between section 11 and section 12(a)(2) is that section 11 pertains to material misstatements and omissions made in a registration statement, while section 12(a)(2) pertains to material misstatements or omissions made in a prospectus.[24] In section 13 of the 1933 Act, Congress imposed a one-year statute of limitations triggered

21. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

22. Securities Act of 1933 § 11, 15 U.S.C. § 77k (2006). Under the 1933 Act, purchasers may sue "participants"—the issuer, signers of the registration statement, directors and officers, underwriters, and other professionals—by merely showing that the registration statement contained a material misrepresentation or omission. *E.g.*, *In re* Constar Int'l Inc. Sec. Litig., 585 F.3d 774, 782-83 (3d Cir. 2009); APA Excelsior III LP v. Premiere Techs., Inc., 476 F.3d 1261, 1271 (11th Cir. 2007); *In re* Daou Sys., Inc., 411 F.3d 1006, 1027 (9th Cir. 2005). Scienter is not required for a section 11 claim. Musick, Peeler & Garrett v. Employers Ins. of Wausau, 508 U.S. 286, 296 (1993). This heavy-handed form of liability is tempered by the defendant's affirmative defense of due diligence, *see* Securities Act of 1933 § 11(a)-(b), 15 U.S.C. § 77k(a)-(b), in which defendants other than the issuer may avoid liability by proving that, after a reasonable investigation, they had no grounds to believe that the parts of the registration statement attributed to them contained material misstatements or omissions. Securities Act of 1933 § 11, 15 U.S.C. § 77k(b)(3); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983); Escott v. Barchris Constr. Corp., 283 F. Supp. 643, 697-703 (S.D.N.Y. 1968).

23. Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77*l*(a)(2). A prospectus is "[a] printed document that describes a [corporation's business] and that is distributed to prospective buyers or investors." BLACK'S LAW DICTIONARY 1342 (9th ed. 2009). A plaintiff need only prove that the offeror or seller made a material misstatement or omission; an offeror or seller is someone who successfully solicits the purchase of securities motivated at least by a desire to serve his own financial interests or those of the securities owner. Pinter v. Dahl, 486 U.S. 622, 642-43 (1988).

24. *E.g.*, Miller v. Thane Int'l, Inc., 519 F.3d 879, 885 (9th Cir. 2008), *cert. denied,* 129 S. Ct. 161 (2008); Benzon v. Morgan Stanley Distribs., Inc., 420 F.3d 598, 608 (6th Cir. 2005); *In re* Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 277 (3d Cir. 2004); Oxford Asset Mgmt., Ltd. v. Jaharis, 297 F.3d 1182, 1189 (11th Cir. 2002); Gasner v. Bd. of Superintendents, 103 F.3d 351, 356 (4th Cir. 1996).

upon constructive discovery of the false statement and a three-year statute of repose that starts on the date of the fraud for section 11 and section 12 claims.[25] Section 13 triggers the statute of limitations either "within one year after the discovery" of the false statement "or after such discovery *should have been made* by the exercise of reasonable diligence."[26] The statute of limitations governing section 11 and section 12(a)(2) is triggered upon constructive discovery because determining when a plaintiff should have uncovered an untrue assertion in a registration statement or prospectus is arguably a simple task.[27]

Congress also passed the Securities Exchange Act of 1934 (1934 Act) to regulate the secondary trading of securities.[28] The primary aim of the 1934 Act was "to protect investors against [the] manipulation of stock prices."[29] The federal courts recognized that investors had an implied private right of action under section 10(b) of the 1934 Act, which prohibits fraudulent or deceptive conduct in connection with the purchase or sale of any security, and the SEC's accompanying Rule 10b-5.[30] Because this right of action was implied, it did not contain a statute of limitations,[31] but several other provisions of the 1934 Act did, including section 9(e), section 16(b), and section 18(a).[32] These sections had a one-year statute of limitations and a three-year statute of repose—the "one-and-three-year structure."[33] It was unclear, however, whether this statute of limitations applied to section 10(b) and Rule 10b-5 actions.[34]

25. Securities Act of 1933 § 13, 15 U.S.C. § 77m.

26. *Id.* (emphasis added).

27. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1801 (2010) (Scalia, J., concurring).

28. Securities Exchange Act of 1934, 15 U.S.C. § 78a.

29. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

30. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010). In 1946, for the first time, a court held that investors could bring a private action for violations of Rule 10b-5. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). According to the Supreme Court, the implied private right of action under Rule 10b-5 is now "simply beyond peradventure." Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

31. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 359 (1991).

32. *See* 15 U.S.C. §§ 78i(e), 78r(c), 78cc(b).

33. *Id.*

34. *See infra* Part I.B.

A. Statutes of Limitations, Repose, and Discovery-Accrual

Before discussing the statutes of limitations and repose for securities fraud specifically, a general understanding of these two procedural rules is necessary. "The statute of limitations is a complete bar to actions that do not meet its time limits. It is in no way dependent on the merits of the case."[35] The statute of limitations creates an affirmative defense when a plaintiff fails to sue within a specified time after the plaintiff discovers the cause of action, although it is often subject to tolling principles.[36] A statute of repose "extinguishes a plaintiff's cause of action after the passage of a fixed period of time, usually measured from one of the defendant's acts."[37] In essence though, both provide "repose,"[38] or a time limit after which an action cannot be brought in court.[39] Professor Tyler T. Ochoa and Judge Andrew J. Wistrich have written the seminal work that describes the purposes of statutes of limitations and repose. Simply stated, Professor Ochoa and Judge Wistrich found that these statues aim (1) to prevent the use of stale evidence, and (2) to provide defendants with the comfort of knowing that they are free from suit and to protect settled expectations.[40]

Statutes of limitations and statutes of repose, however, differ in both length and accrual. Statutes of limitations are often shorter and are usually triggered upon discovery of the claim (discovery-

35. VICTOR E. SCHWARTZ ET AL., PROSSER, WADE AND SCHWARTZ'S TORTS: CASES AND MATERIALS 617 (11th ed. 2005).

36. *See, e.g.*, Ma v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 597 F.3d 84, 88 n.4 (2d Cir. 2010); Tello v. Dean Witter Reynolds, Inc., 494 F.3d 956, 974 (11th Cir. 2007); Johnson v. Aljian, 490 F.3d 778, 782 n.13 (9th Cir. 2007).

37. *Ma*, 597 F.3d at 88 n.4; *see also Johnson*, 490 F.3d at 781 n.12.

38. Bridges v. United States, 346 U.S. 209, 230-31 (1953) (Reed, J., dissenting) ("Of course, statutes of limitation are statutes of repose.").

39. BLACK'S LAW DICTIONARY, *supra* note 23, at 1546.

40. Tyler T. Ochoa & Andrew J. Wistrich, *The Puzzling Purposes of Statutes of Limitation*, 28 PAC. L.J. 453, 458, 460 (1997). Professor Ochoa and Judge Wistrich catalogue the following purposes of statutes of limitations: (1) to promote repose, which provides peace of mind, avoids disrupting settled expectations, reduces uncertainty, and reduces protective measures and associated costs; (2) to minimize the deterioration of evidence, and thereby ensure accurate fact-finding, prevent fraud, reduce litigation costs, and protect the integrity of the judicial system; (3) to place defendants and plaintiffs on equal footing; (4) to promote cultural values of diligence; (5) to encourage the prompt enforcement of the substantive law; (6) to avoid the retrospective application of contemporary standards; and (7) to reduce the overall volume of litigation. *Id.* at 460-99.

accrual), whereas statutes of repose are often longer, capping the time for liability, and are triggered by the complained of event (event-accrual).[41] As the Article illustrates, the statute of limitations, with its discovery-based accrual, proves problematic in application.

B. The Supreme Court's Limitations Period

Section 10(b) of the 1934 Act was enacted without a statute of limitations or repose because the private right of action under section 10(b) and Rule 10b-5 was judicially created. So, "faced with the awkward task of discerning the limitations period that Congress intended ... to apply to a cause of action it really never knew existed,"[42] courts implied the applicable period using one of four alternatives: (1) the statute of limitations contained in section 13 of the 1933 Act;[43] (2) the forum state's statute of limitations for common law fraud; (3) the statute of limitations for securities fraud under the forum state's "blue-sky law";[44] or (4) the statute of limitations contained in section 9(e), section 16(b), or section 18(a) of the 1934 Act.[45]

For decades, courts borrowed the statute of limitations from the closest analogous state-law cause of action.[46] But "[d]eciding which

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41. *See, e.g.*, 15 U.S.C. § 1681p (2006) (imposing a limit of two years from discovery of the violation, plus a statute of repose at five years for violations of the Fair Credit Reporting Act); 29 U.S.C. § 1113 (imposing a limit of three years from discovery of an ERISA violation, plus a statute of repose at six years for breach of fiduciary duty); 31 U.S.C. § 3731 (imposing a limit of three years from discovery of the violation, plus a statute of repose at six years for violations of the False Claims Act); *see also* Wike v. Vertrue, Inc., 566 F.3d 590, 595 (6th Cir. 2009) (recognizing that statutes of limitations accrue on discovery and statutes of repose accrue on the happening of the complained of event); Balam-Chuc v. Mukasey, 547 F.3d 1044, 1049 (9th Cir. 2008) (same).

42. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 359 (1991).

43. The statute of limitations is expressly applicable to sections 11 and 12 of the 1933 Act. 15 U.S.C. § 77m.

44. A "blue-sky law" is a state statute that establishes "standards for offering and selling securities, the purpose being to protect citizens from investing in fraudulent schemes or unsuitable companies." BLACK'S LAW DICTIONARY, *supra* note 23, at 196.

45. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 12.16 (6th ed. 2009).

46. *See, e.g.*, Bath v. Bushkin, Gaims, Gaines & Jonas, 913 F.2d 817, 818-19 (10th Cir. 1990) (per curiam); Nesbit v. McNeil, 896 F.2d 380, 384 (9th Cir. 1990); O'Hara v. Kovens, 625 F.2d 15, 17 (4th Cir. 1980); Forrestal Vill., Inc. v. Graham, 551 F.2d 411, 413 (5th Cir. 1977).

features of state periods of limitations to adopt for which federal statutes waste[d] untold hours.... There [were] many potentially analogous state statutes, with variations for different kinds of securities offenses and different circumstances that might toll the period of limitations."[47] Recognizing the need to minimize the uncertainty and time-consuming litigation inherent in that approach, the Third Circuit in *In re Data Access Systems* was the first to advocate and adopt a uniform limitations period for section 10(b) and Rule 10b-5 claims.[48] In *Data Access*, the Third Circuit determined that using the limitations periods in other sections of the 1934 Act would lead to desired uniformity and certainty.[49] Specifically, the Third Circuit adopted the one-and-three-year structure that applied to sections 9(e), 16(b), and 18(a) of the 1934 Act.[50]

After *Data Access,* the stage was set for a uniform, national statute of limitations. "Both the bar and scholars ... pleaded, with a unanimity rare in the law, for help.... Only Congress or the Supreme Court [could] bring uniformity and predictability to this field."[51] And in 1991 the Supreme Court did just that, holding in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson* that the one-and-three-year structure under section 9(e) of the 1934 Act applied to securities fraud actions under section 10(b) and Rule 10b-5.[52] But the Court's answer was incomplete as it failed to resolve (1) whether discovery meant *actual* discovery or encompassed the idea of inquiry notice, and (2) what "facts" constituted the violation that must be discovered. Thus, the courts of appeals returned to

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47. Norris v. Wirtz, 818 F.2d 1329, 1332 (7th Cir. 1987); *see also* Jill E. Frisch, *As Time Goes By: New Questions About the Statute of Limitations for Rule 10b-5,* 61 FORDHAM L. REV. S101, S103-04 (1993).

48. 843 F.2d 1537, 1543 (3d Cir. 1988) (en banc); *see also* Ceres Partners v. Gel Assocs., 918 F.2d 349, 364 (2d Cir. 1990); Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1390-92 (7th Cir. 1990).

49. *Data Access*, 843 F.2d at 1549 ("The necessity for uniform federal remedies in security cases would seem to demand recourse to a uniform federal statute of limitations.").

50. *Id.*

51. *Norris*, 818 F.2d at 1332.

52. 501 U.S. 350, 361-62 (1991). The Supreme Court concluded that section 9(e) of the 1933 Act should apply to section 10(b) and Rule 10b-5 claims because there was a need for uniformity, securities fraud actions are multi-state in nature, and section 9(e) shares the same purpose—protecting investors against manipulation of stock prices—and similar elements with section 10(b) and Rule 10b-5. *Id.* at 360-61.

old habits with the statute of limitations and divided—on both questions—again.

1. "Discovery"

After *Lampf,* scholars were in agreement: the Supreme Court's endorsement of section 9(e) meant that the statute of limitations was triggered upon *actual* discovery, not constructive discovery.[53] The Third and Ninth Circuits arguably agreed,[54] but the majority of circuits did not, concluding that "inquiry notice"—a version of constructive discovery—was the appropriate standard.[55] Inquiry notice is the "point at which [plaintiffs] possess[ ] a quantum of information sufficiently suggestive of wrongdoing," that they should investigate "to confirm the existence of [their] claim."[56] The courts concluding that the statute of limitations was triggered upon inquiry notice were concerned that if the standard was actual discovery, investors would wait to see whether a poorly performed

53. *E.g.*, Lyman Johnson, *Securities Fraud and the Mirage of Repose,* 1992 WIS. L. REV. 607, 620, 625; Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court,* 51 BUS. LAW. 309, 313, 333-34 (1996); Roy M. Van Cleave, *The Federal Securities Acts' One-Year Inquiry Notice Statute of Limitations: Are the Scales Tipped Against Fraud Claimants?*, 22 J. CORP. L. 79, 80-81 (1996); Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action,* 40 ARIZ. L. REV. 1003, 1009 (1998).

54. *See* Gruber v. Price Waterhouse, 911 F.2d 960, 964 n.4 (3d Cir. 1990) (stating that the Third Circuit's *Data Access* decision does not provide for inquiry notice); *see also In re* NAHC, Inc. Sec. Litig., 306 F.3d 1314, 1318 (3d Cir. 2002) (recognizing that the Third Circuit had not yet precisely decided the statute of limitations issue); Berry v. Valence Tech., Inc., 175 F.3d 699, 704 (9th Cir. 1999) (expressing doubts that the inquiry-notice standard survived *Lampf*).

55. *E.g.*, Fin. Sec. Assurance, Inc. v. Stephens, Inc., 450 F.3d 1257, 1267-68 (11th Cir. 2006); Shah v. Meeker, 435 F.3d 244, 249 (2d Cir. 2006); Glaser v. Enzo Biochem, Inc., 126 F. App'x 593, 597 (4th Cir. 2005); New Eng. Health Care Employees Pension Fund v. Ernst & Young, L.L.P., 336 F.3d 495, 500 (6th Cir. 2003); LC Capital Partners, LP v. Frontier Ins. Group, Inc., 318 F.3d 148, 154 (2d Cir. 2003); *In re NAHC, Inc. Sec. Litig.*, 306 F.3d at 1325; Young v. Lepone, 305 F.3d 1, 8 (1st Cir. 2002); Theoharous v. Fong, 256 F.3d 1219, 1228 (11th Cir. 2001); Ritchey v. Horner, 244 F.3d 635, 638-39 (8th Cir. 2001); Sterlin v. Biomune Sys., 154 F.3d 1191, 1199-1200 (10th Cir. 1998); Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 670 (7th Cir. 1998); Marks v. CDW Computer Ctrs., Inc., 122 F.3d 363, 367 (7th Cir. 1997); Dodds v. Cigna Sec., Inc., 12 F.3d 346, 350 (2d Cir. 1993); Topalian v. Ehrman, 954 F.2d 1125, 1134-35 (5th Cir. 1992).

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

stock recovered, then reap investment profits if it did, and sue for damages if it did not.[57] Whether a plaintiff was on inquiry notice involved a two-step analysis:

> (1) First, when did the plaintiff receive sufficient information of possible wrongdoing such that a reasonable investor would undertake an investigation to determine if a legal claim exists ("inquiry notice"); [and]
> (2) [Second,] when thereafter, in the exercise of reasonable diligence should the plaintiff have discovered the facts constituting the violation.[58]

The idea of inquiry notice is less than clear, and the courts of appeals disagreed over many aspects of it. The courts could not agree on the doctrinal reasons for rejecting an actual discovery standard.[59] And the application was even more divided: some circuits held that the statute of limitations began when the plaintiff was on inquiry notice—that is, when the facts suggested possible wrongdoing.[60] In contrast, other circuits stated that the statute of limitations began after the plaintiff, exercising reasonable diligence,

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57. *E.g.*, *New Eng. Health Care Employees Pension Fund*, 336 F.3d at 499; *Sterlin*, 154 F.3d at 1202; Tregenza v. Great Am. Commc'ns Co., 12 F.3d 717, 722 (7th Cir. 1993); Brumbaugh v. Princeton Partners, 985 F.2d 157, 163 (4th Cir. 1993).

58. Sarah S. Gold & Richard L. Spinogatti, *Revisiting the Limitations Period for Securities Fraud*, 241 N.Y.L.J. 3 (June 11, 2009), *available at* http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202431372080.

59. *See Ritchey*, 244 F.3d at 638 (finding inquiry-notice standard in section 13 of the 1933 Act); Great Rivers Coop. v. Farmland Indus., Inc., 120 F.3d 893, 896 (8th Cir. 1997) (same); *Tregenza*, 12 F.3d at 722 (finding inquiry-notice standard through "judicial creativity"); Menowitz v. Brown, 911 F.2d 36, 41 (2d Cir. 1993) (per curiam) (finding inquiry-notice standard within the meaning of the word "discovery" in section 9(e) of the 1934 Act); Howard v. Haddad, 962 F.2d 328, 330 (4th Cir. 1992) (accepting inquiry-notice standard without explanation); Anixter v. Home-Stake Prod. Co., 939 F.2d 1420, 1441 (10th Cir. 1991) (finding inquiry-notice standard impliedly adopted in *Lampf* even though not in section 9(e)).

60. *E.g.*, GO Computer, Inc. v. Microsoft Corp., 508 F.3d 170, 177 (4th Cir. 2007); Franze v. Equitable Assurance, 296 F.3d 1250, 1254-55 (11th Cir. 2002); *Theoharous*, 256 F.3d at 1228; *Brumbaugh*, 985 F.2d at 162-63. The Fifth and Eighth Circuits likewise start the statute of limitations clock at the first sign of "storm warnings," if a reasonably diligent inquiry could have uncovered the facts supporting a fraud claim within the limitations period. *E.g.*, *Great Rivers Coop.*, 120 F.3d at 896, 898-99 (starting the limitations clock on the "storm warnings" date); Bodenhamer v. Shearson Lehman Hutton, Inc., No. 92-2392, 1993 WL 277033, at *2 (5th Cir. July 14, 1993) (nonprecedential decision); Jensen v. Snellings, 841 F.2d 600, 606-07 (5th Cir. 1988).

could have discovered the facts constituting the violation.[61] And courts that adopted this latter approach were likewise divided over whether "reasonable diligence" was measured objectively, subjectively, or both.[62] In some circuits, inquiry notice involved burden-shifting: once the defendant established that the plaintiffs were on inquiry notice, the plaintiffs had to show that they exercised reasonable due diligence but were unable to discover their injuries.[63] The Second Circuit adopted an approach all its own: if the plaintiff was on inquiry notice and failed to conduct an investigation, the statute of limitations began on the date the plaintiff was placed on inquiry notice;[64] but if the plaintiff investigated, the statute of limitations began when a reasonably diligent plaintiff would have discovered the facts constituting the violation.[65]

2. *"The Facts Constituting the Violation"*

Yet the debate over how to interpret discovery overshadowed a more fundamental question concerning the statute: what does the plaintiff need to discover? To state a Rule 10b-5 claim, a plaintiff must allege and prove six elements: (1) that the defendant made a material misrepresentation or omission; (2) that the defendant acted with a wrongful state of mind (scienter); (3) that the material misrepresentation or omission was made in connection with the purchase or sale of a security; (4) that the plaintiff relied on the material misrepresentation; (5) that the plaintiff suffered an economic loss as a result; and (6) that the material misrepresenta-

61. *E.g.*, *New Eng. Health Care Employees Pension Fund*, 336 F.3d at 501; Young v. Lepone, 305 F.3d 1, 8-10 (1st Cir. 2002); *Sterlin*, 154 F.3d at 1200-01; Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1335 (7th Cir. 1997).

62. *Compare Young*, 305 F.3d at 9 (stating that the plaintiff bears the burden of "showing that she fulfilled her corresponding duty of making a reasonably diligent inquiry into the possibility of fraudulent activity"), *with* Wyser-Pratte Mgmt. Co. v. Telxon Corp., 413 F.3d 553, 563 n.9 (6th Cir. 2005) (employing a strictly objective approach when examining what information would be available to an investor who conducted a reasonably diligent investigation); *and Sterlin,* 154 F.3d at 1202 n.20 (using strictly objective approach), *with Fujisawa Pharm. Co.*, 115 F.3d at 1335 (using both objective and subjective components in assessing what information an investor in the plaintiff's position could have uncovered had it investigated possible fraud).

63. *In re* Merck & Co. Sec., Derivative & ERISA Litig., 543 F.3d 150, 161 (3d Cir. 2008).

64. Shah v. Meeker, 435 F.3d 244, 251 (2d Cir. 2006).

65. LC Capital Partners, LP v. Frontier Ins. Group, Inc., 318 F.3d 148, 154 (2d Cir. 2003).

tion actually caused the loss.[66] The majority of courts concluded that plaintiffs had to have only sufficient "storm warnings"[67]—knowledge of suspicious facts—to trigger a duty to investigate, and that once a reasonably diligent investigation would have discovered these suspicious facts, the statute of limitations began.[68] Most circuits were less than clear, though, regarding whether storm warnings or suspicious facts included scienter.[69]

C. Congress and the Sarbanes-Oxley Act

In 2001, the landscape of corporate regulation changed when massive corporate scandals rocked investor confidence in the capital markets. When corporate giants Enron, WorldCom, and Adelphia crumbled amid allegations of years of crooked accounting, Congress responded with the Sarbanes-Oxley Act of 2002.[70] SOX was significant on many fronts, most notably creating stringent reporting requirements aimed at otherwise lax corporate oversight.[71] SOX

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66. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010); *see* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341-42 (2005). Section 11 claims, in contrast, do not require proof of reliance, causation, or scienter, but only materiality and damages. *E.g.*, Alpern v. UtiliCorp United, Inc., 84 F.3d 1525, 1541 (8th Cir. 1996). Loss causation is not an element of a section 11 claim, but an affirmative defense to it. *See* 15 U.S.C. § 77*l*(b) (2006); Ind. State Dist. Council of Laborers v. Omnicare, Inc., 583 F.3d 935, 947 (6th Cir. 2009), *cert. dismissed,* 178 L. Ed. 2d 411 (2010).

67. For a full discussion of "storm warnings," see J. Robert Brown, Jr., The Supreme Court and the Mission To Restrict Investor Protection: *Merck v. Reynolds* (Part 6: The Misguided Concept of Inquiry Notice) (June 22, 2009), http://www.theracetothebottom.org/securities-issues/the-supreme-court-and-the-mission-to-restrict-investor-prote-7.html.

68. New Eng. Health Care Employees Pension Fund v. Ernst & Young, L.L.P., 336 F.3d 495, 501 (6th Cir. 2003); Young v. Lepone, 305 F.3d 1, 9-10 (1st Cir. 2002).

69. For example, the Seventh Circuit had suggested that the plaintiff had to have known (or should have known) facts that would establish scienter. Law v. Medco Research, Inc., 113 F.3d 781, 786 (7th Cir. 1997) ("In a fraud case, [the plaintiff] needs to know ... that the defendant has made a representation that was *knowingly* false. When the plaintiff knows or should know this, the statute of limitations begins to run."); *see also* Sudo Props., Inc. v. Terrebonne Parish Consol. Gov't, 503 F.3d 371, 375, 377-78 (5th Cir. 2007) (stating inquiry notice was not triggered by plaintiff's knowledge that defendant's predictions were "grossly incorrect," until plaintiff "learned for the first time that [defendant] had intentionally misled him").

70. *See generally* ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER (Nancy B. Rapoport et al., eds., 2d ed. 2009).

71. SOX had several effects on corporate governance. The law (1) required principal executive officers to certify that certain reports contained no false or misleading information, Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241(a); (2) provided criminal penalties if the

also expanded the statute of limitations applicable to most private remedies under the securities laws.[72] For section 10(b) and Rule 10b-5 claims, SOX provided a two-year statute of limitations and a five-year statute of repose.[73] The language adopted by Congress was similar to the language used in section 9(e) of the 1934 Act.[74]

Congress thus lengthened the one-and-three-year structure adopted in *Lampf*. In its report on SOX, the Senate Judiciary Committee expressed concern that the one-and-three-year structure "unfairly limit[ed] recovery for defrauded investors in some cases,"[75] noting that some states were forced to forgo their claims against Enron, for example, because of the statute of limitations.[76] The Committee was also concerned that the complexity and nature of securities fraud made these claims difficult to detect.[77] Additionally, the Committee observed that plaintiffs faced significant procedural

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CEO knowingly certified false information, *id.* § 906, 15 U.S.C. § 1350(c); and (3) mandated that each annual report filed by a company contain a report on internal controls established to guard against fraud, *id.* § 404, 15 U.S.C. § 7262(a)-(b).

SOX has been criticized as "quack corporate governance," *see generally* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,* 114 YALE L.J. 1521 (2005), and as nonresponsive because, ironically, had SOX been in effect, Enron would have met all of its requirements, JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 79-85 (2008). But others have been quick to defend the law. *See generally* J. Robert Brown, Jr., *Criticizing the Critics: Sarbanes-Oxley and Quack Corporate Governance,* 90 MARQ. L. REV. 309 (2006); Charles W. Murdock, *Sarbanes-Oxley Five Years Later: Hero or Villain,* 39 LOY. U. CHI. L.J. 525, 526 (2008) (concluding "the policy behind Sarbanes-Oxley is essential for the proper functioning of efficient capital markets").

72. 28 U.S.C. § 1658(b); *see also* HAZEN, *supra* note 45.

73. 28 U.S.C. § 1658(b) ("[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(47)), may be brought not later than the earlier of ... (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation.").

74. *Compare id.*, *with* 15 U.S.C. § 78i(e).

75. S. REP. NO. 107-146, at 8 (2002).

76. *Id.* ("As Washington State Attorney General Gregoire testified at the Committee hearing, in the Enron state pension fund litigation, the current short statute of limitations has forced some states to forgo claims against Enron based on alleged securities fraud in 1997 and 1998. In Washington state alone, the short statute of limitations may cost hard-working state employees, firefighters and police officers nearly $50 million in lost Enron investments, which they will never recover.").

77. *Id.* at 9 ("[T]he best cons are designed so that even after victims are cheated, they will not know who cheated them, or how."); *see also* Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 377 (1991) (Kennedy, J., dissenting) ("Ponzi schemes, for example, can maintain the illusion of a profit-making enterprise for years, and sophisticated investors may not be able to discover the fraud until long after its perpetration.").

obstacles under the Private Securities Litigation Reform Act of 1995 (PSLRA), including its lead-plaintiff selection process,[78] its stay of discovery pending a motion to dismiss[79]—"consideration of which can take over a year in itself"[80]—and its heightened pleading standards.[81] The Committee worried that by the time plaintiff-investors had learned enough facts to file a complaint capable of surviving a motion to dismiss and to begin discovery, the claim was likely to be time barred.[82] To allow plaintiffs time to adequately investigate their claims and to file meritorious suits, the Committee proposed, and Congress accepted, lengthening the statute of limitations.[83]

But Congress's expanded limitations period left the phrase "discovery of the facts constituting the violation" undefined,[84] and the courts of appeals still had to determine whether discovery meant *actual* discovery or something else. After SOX, two circuits changed their approaches. The Ninth Circuit in *Betz v. Trainer Wortham & Co.* and the Third Circuit in *In re Merck & Co.* held that plaintiff-investors must have actual knowledge that the defendant made misrepresentations with scienter before incurring any duty to investigate.[85] These cases thus presented yet *another* approach to the statute of limitations. The defendants in *Merck* asked the Supreme Court to weigh in,[86] and the Court granted a writ of certiorari.[87]

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78. 15 U.S.C. § 78u-4(a)(2)-(3), (7).

79. *Id.* § 78u-4(b)(3).

80. S. REP. NO. 107-146, at 9.

81. 15 U.S.C. § 78u-4(b)(1)-(2).

82. S. REP. NO. 107-146, at 9.

83. *Id.* at 9-10. The Senate Judiciary Committee also observed that a short statute of limitations invites defendants to take sophisticated steps to conceal their deceit—a point proved right by Enron. *Id.* ("[I]t only takes a few seconds to warm up the shredder.").

84. 28 U.S.C. § 1658(b).

85. Betz v. Trainer Wortham & Co., 519 F.3d 863, 873 (9th Cir. 2008), *vacated*, 130 S. Ct. 2400 (2010); *In re* Merck & Co. Sec., Derivative & ERISA Litig., 543 F.3d 150, 172 (3d Cir. 2008). Three judges on the Ninth Circuit dissented from the circuit's refusal to rehear the case en banc, arguing that the approach adopted in *Betz* was in conflict with all ten other circuits. *Betz*, 519 F.3d at 865 (Kozinski, C.J., dissenting from the denial of the petition to rehear the case en banc).

86. Petition for Writ of Certiorari at 35-36, Merck & Co. v. Reynolds, 130 S. Ct. 1784 (2010) (No. 08-905), 2009 WL 133458.

87. Merck & Co. v. Reynolds, 129 S. Ct. 2432 (2009). The Supreme Court, after *Merck,* granted the writ of certiorari in *Betz* and immediately remanded to the Ninth Circuit for

II. *MERCK & CO. V. REYNOLDS* AND THE IMPORTANCE OF THE STATUTE OF LIMITATIONS

Despite the Supreme Court's initial attempt in *Lampf* to define the statute of limitations and Congress's remedial legislation in SOX, the standard remained in flux.[88] In *Merck*, the Court again entered the fray and clarified that a section 10(b) and Rule 10b-5 action accrues "(1) when the plaintiff did in fact discover, or (2) when a reasonably diligent plaintiff would have discovered, the facts constituting the violation—whichever comes first,"[89] and that "[f]acts constituting the violation" include scienter.[90] This Article recounts the case in some detail because the decision serves as background for later discussion.

A. Vioxx, Heart Attacks, and Stock Fraud

In May 1999, the Food and Drug Administration (FDA) approved Vioxx, a potential "blockbuster" painkiller developed by Merck that was used to treat arthritis and other acute pain.[91] Merck touted Vioxx in press releases, public statements, and SEC filings as possessing all the beneficial effects of traditional pain relievers, but without the harmful gastrointestinal side effects associated with those drugs.[92] Before the FDA approved Vioxx though, some Merck officials were concerned that the drug could cause heart attacks, or "cardiovascular events."[93] Accordingly, Merck began a study comparing Vioxx with the active ingredient in other pain relievers—naproxen—and discovered that Vioxx users had a higher incidence

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further consideration in light of *Merck*. Trainer Wortham & Co. v. Betz, 130 S. Ct. 2400 (2010).

88. *See supra* Part I.B (discussing the various approaches the federal courts of appeals took to determine when the statute of limitations was triggered for securities fraud claims).

89. *Merck*, 130 S. Ct. at 1789-90 (internal quotation marks omitted).

90. *Id.* at 1790 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976)).

91. *In re* Merck & Co. Sec., Derivative & ERISA Litig., 543 F.3d 150, 153 (3d Cir. 2008). Merck is the world's second-biggest drug manufacturer by sales, with roughly $40 billion in annual revenue since November 2009. Jesse J. Holland, *Court Says Vioxx Lawsuit Can Proceed*, ABC NEWS, Apr. 27, 2010, http://abcnews.go.com/Business/wireStory?id=10486758.

92. *In re Merck & Co.*, 543 F.3d at 153-54.

93. *Id.* at 154.

of heart attacks than naproxen users.[94] Merck disclosed the study's findings in a press release in March 2000.[95] The company, however, tried to soften this blow and advanced the "naproxen hypothesis"—that the lower incidence of heart attacks for patients taking naproxen was the result of a beneficial effect of naproxen, rather than any harmful effect of Vioxx.[96]

In 2001, the FDA conducted a hearing to determine if the results of Merck's study must be incorporated into Vioxx's labeling.[97] That same year, a group of plaintiffs brought a products-liability lawsuit against Merck and another pharmaceutical company, alleging that Vioxx and another pain reliever were marketed as effective pain relievers, despite the fact that the companies' own research demonstrated that users of these drugs were more likely to suffer heart attacks.[98] At about this time, the *Journal of the American Medical Association* picked up the results of Merck's study and asserted that Vioxx posed an increased risk of heart attack, garnering considerable media attention.[99] Attracting additional media attention, the FDA posted a warning letter that it had issued to Merck regarding Vioxx.[100] The letter stated that Merck's promotional materials were "false, lacking in fair balance, or otherwise misleading."[101] Then, in

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94. *Id.* The study found that about four out of one thousand participants who took Vioxx suffered heart attacks compared to only one out of one thousand who took naproxen. *Merck*, 130 S. Ct. at 1790. A later study linked Vioxx to more than 27,000 heart attacks nationwide from the time it came on the market in 1999 through 2003. Rita Rubin, *How Did Vioxx Debacle Happen?,* USA TODAY, Oct. 12, 2004, http://www.usatoday.com/news/health/2004-10-12-vioxx-cover_x.htm. A study by the *New England Journal of Medicine* on Vioxx has also been criticized: the *Journal* "disclosed its concern about studies it had published dealing with ... Vioxx," because the "studies in question reported only selective data on heart attacks and strokes" and did not mention the cardiovascular or overall dangers of Vioxx. Charles W. Murdock, *Why Not Tell the Truth?: Deceptive Practices and the Economic Meltdown*, 41 LOY. U. CHI. L.J. 801, 805 (2010).

95. *In re Merck & Co.*, 543 F.3d at 154.

96. *Merck*, 130 S. Ct. at 1791. Merck acknowledged that its "naproxen hypothesis" had not been observed in any clinical studies. *Id.*

97. *In re Merck & Co.*, 543 F.3d at 155.

98. *Id.* at 156. An additional lawsuit was brought in September 2001 alleging consumer fraud on behalf of Vioxx users, and later a second product liability lawsuit was also brought. *Id.* at 158.

99. *Id.* at 156.

100. *Id.* at 156-57.

101. *Id.* at 156. The FDA was largely criticized for its handling of the Vioxx situation. *See, e.g.*, Rubin, *supra* note 94. After the FDA warning letter was released, more products-liability lawsuits were filed. *Merck*, 130 S. Ct. at 1791.

October 2001, the *New York Times* reported that Vioxx users may have an increased risk of heart attack.[102]

A few months later, in April 2002, the FDA required Merck to disclose the risk of heart attack on Vioxx labels.[103] A fall in Vioxx sales ensued; Merck's stock dropped 6.5 percent when *Reuters* released a story on Merck's trouble.[104] The *Wall Street Journal* then published an article that discussed an additional third-party study that concluded Vioxx was linked to a 39 percent increase in the risk of heart attack when compared with a competing pain reliever.[105]

It was not until November 2003 that a group of investor-plaintiffs filed a section 10(b) and Rule 10b-5 action against Merck alleging that the company, its officers, and its directors knowingly misrepresented the heart attack risk associated with Vioxx.[106] Merck later withdrew Vioxx from the market, and Merck's stock dropped an additional 27 percent.[107] In November 2004, the *Wall Street Journal* reported that internal Merck e-mails showed that Merck fought for years "to keep safety concerns over [Vioxx] from destroying the drug's commercial prospects."[108]

The district court dismissed the complaint, concluding that the plaintiff-investors should have been alerted to the possibility of Merck's misrepresentation before November 2001 because (1) Merck's March 2000 study showed adverse cardiovascular results for Vioxx; (2) the FDA's warning letter in September 2001 stated Merck's marketing campaign was false; and (3) users filed products-liability actions in September and October 2001 that alleged Merck intentionally downplayed risks of Vioxx.[109] According

102. *In re Merck & Co.*, 543 F.3d at 158.

103. *Id.* at 159.

104. *Id.*

105. *Id.* Researchers found that those given Vioxx for thirty to ninety days were 37 percent more likely to have suffered a heart attack than those given either a different painkiller or no painkiller at all. *Merck*, 130 S. Ct. at 1792.

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

107. *In re Merck & Co.*, 543 F.3d at 159; *see also* Press Release, Merck, Merck Announces Voluntary Worldwide Withdrawal of VIOXX (Sept. 30, 2004), *available at* http://www.merck.com/newsroom/vioxx/pdf/vioxx_press_release_final.pdf. An estimated two million people were taking Vioxx when it was pulled from the market. Rubin, *supra* note 94. Shareholders lost a combined $28 billion when the price of Merck stock dropped after Vioxx was pulled from the market. Holland, *supra* note 91.

108. *In re Merck & Co.*, 543 F.3d at 159-60.

109. *In re* Merck & Co. Sec., Derivative & ERISA Litig., 483 F. Supp. 2d 407, 423-24

to the district court, investors had abundant public information that would cause investor concerns and would put investors on inquiry notice before November 2001.[110] The Third Circuit, however, reversed the district court's holding because the three events before November 2001 did not suggest that Merck acted with scienter.[111]

B. The Supreme Court

The Supreme Court agreed with the Third Circuit that before November 2001, the plaintiffs did not, and could not, discover the facts constituting the violation.[112] The Court reasoned that the FDA warning letter showed little about whether Merck put forth the naproxen hypothesis with fraudulent intent, and that the products-liability lawsuits did not suggest that Merck knew the naproxen hypothesis was false.[113] In so doing, the Court made two notable rulings: it defined both "discovery" and "the facts constituting the violation," effectively ending the circuit splits regarding section 10(b) and Rule 10b-5 claims.

1. "Discovery"

First, the Court clarified that the statute of limitations for section 10(b) and Rule 10b-5 begins when the plaintiff *actually* discovered, or *reasonably should have* discovered, the facts constituting the violation—whichever comes first.[114] The Court reasoned that SOX implicitly incorporated constructive discovery because "discovery" was traditionally a term of art that encompassed both actual and constructive discovery,[115] and, according to the majority, every court

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(D.N.J. 2007).

110. *Id.* at 424.

111. *In re Merck & Co.*, 543 F.3d at 172. Judge Roth dissented and concluded that there were sufficient storm warnings more than two years before the filing of the complaint that put the plaintiffs on inquiry notice of fraud. *Id.* at 173 (Roth, J., dissenting).

112. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1798-99 (2010).

113. *Id.* at 1799.

114. *Id.* at 1793, 1796. Justice Stevens concurred, but opined that in this case there was no difference between the time when the plaintiffs discovered or should have discovered the facts to support their claim, and as such, the Court should have waited until a case came before it in which the difference between the actual discovery rule and the constructive discovery rule would affect the outcome. *Id.* at 1799 (Stevens, J., concurring in part).

115. *Id.* at 1793-95.

of appeals held this before SOX.[116] The Court then put the concept of inquiry notice to rest because inquiry notice—the point at which facts would lead a reasonably diligent plaintiff to *investigate* a possible fraud—was not necessarily the time at which a plaintiff would have *discovered* the fraud.[117] And this, the Court continued, could not be reconciled with the statute's text that states a plaintiff's claim accrues after discovery.[118]

2. "The Facts Constituting the Violation"

The Supreme Court also clarified that the "facts constituting the violation" include scienter, or the defendant's mental state.[119] This is so, reasoned the Court, because scienter is an essential element to Rule 10b-5 claims, a fact emphasized when Congress enacted heightened pleading requirements for scienter in the PSLRA.[120] The Court expressed concern that "[s]o 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 'discovered' the fraud."[121]

The Court declined to address whether reliance and loss causation were also facts "constitut[ing] the violation."[122] But the Court left open the possibility that plaintiffs may be on notice of fraud solely by the materiality of a representation when it observed that "[i]t is unlikely ... that someone would falsely say 'I am not married' without being aware of the fact that his statement is false," thereby suggesting scienter.[123] The Court noted, however, that an incorrect prediction about a firm's future earnings by itself was insufficient to suggest scienter.[124]

116. *Id.* at 1794-95.

117. *Id.* at 1797.

118. *Id.* For this same reason, the Court rejected Merck's fall-back argument "that even if the limitations period does generally begin at 'discovery,' it should nonetheless run from the point of 'inquiry'" notice if the plaintiff fails to undertake a diligent investigation—it could not be reconciled with the text of the statute. *Id.* at 1797-98.

119. *Id.* at 1796.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.* at 1796-97.

124. *Id.* at 1797 ("An incorrect prediction about a firm's future earnings, by itself, does not automatically tell us whether the speaker deliberately lied or just made an innocent (and

3. Justice Scalia's Concurrence

Justice Scalia has been forthright with his distaste for implied private rights of action in general[125] and is often regarded as a pro-business judge.[126] But in *Merck*, Justice Scalia, joined by Justice Thomas, advocated for an *actual* discovery standard, a more plaintiff-friendly approach.[127] He disagreed with the majority that

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therefore nonactionable) error.").

125. *See, e.g.*, Alexander v. Sandoval, 532 U.S. 275, 291 (2001) (declining to recognize implied right of action); Franklin v. Gwinnett County Pub. Sch., 503 U.S. 60, 77-78 (1992) (Scalia, J., concurring) (suggesting that the Court should abandon implied rights of action entirely); Thompson v. Thompson, 484 U.S. 174, 191-92 (1988) (Scalia, J., concurring) (arguing for a "categorical position that federal private rights of action will not be implied").

126. *See, e.g.*, Erwin Chemerinsky, *The Roberts Court at Age Three,* 54 WAYNE L. REV. 947, 972 (2008) ("Preemption issues create an opportunity for an unusual coalition between more liberal Justices, like Stephen Breyer, who favor more expansive national power, and conservative Justices, like Antonin Scalia and John Roberts, who are strongly pro-business."); Minutes from a Convention of The Federalist Society, *The Roberts Court and Federalism,* 4 N.Y.U. J.L. & LIBERTY 330, 343 (2009) (quoting Professor Jeffrey Rosen as stating "Justice Scalia has always tended to be more of a pro-business conservative than a libertarian, states' rights conservative, beginning with his days as the editor of *Regulation* magazine, which many called *Deregulation*, and tracing back to a particular date in 1984 when he debated Richard Epstein at the Cato Institute"); Pamela Jones Harbour, *The Supreme Court's Antitrust Future: New Directions or Revisiting Old Cases?*, ANTITRUST SOURCE, Dec. 2007, http://www.abanet.org/antitrust/at-source/07/12/Dec07-Harbour12-17.pdf ("The Court is now undeniably 'conservative' in a way that would be comfortable to the Reagan Administration. Five Republican appointees—Chief Justice John Roberts, joined by Associate Justices Anthony Kennedy, Antonin Scalia, Clarence Thomas, and Samuel Alito—anchor a solidly conservative and pro-business majority for this Court.").

127. Justice Scalia has been on the more plaintiff-friendly side of the statute of limitations debate for securities fraud before. In *Lampf*, Justice Scalia argued in concurrence that "absent a congressionally created limitations period state periods govern, or, if they are inconsistent with the purposes of the federal Act, *no limitations period exists.*" Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 364 (1991) (Scalia, J., concurring) (emphasis added). But he tempered this statement and instead thought it best to adopt the statute of limitations set forth in the 1934 Act. Justice Scalia stated,

> [T]he unintended and possibly irrational results [of holding that there is no statute of limitations] will certainly deter judicial invention of causes of action. That is not an unworthy goal, but to pursue it in that fashion would be highly unjust to those who must litigate past inventions. An alternative approach would be to say that since we "implied" the cause of action we ought to "imply" an appropriate statute of limitations as well. That is just enough, but too lawless to be imagined.... [T]he most responsible approach, where the enactment that has been the occasion for our creation of a cause of action contains a limitations period for an analogous cause of action, is to use that. We are imagining here. And I agree with the Court that we can imagine no clearer indication of how Congress would have balanced the policy considerations

the statute of limitations starts upon either actual or constructive discovery, arguing that the statute of limitations begins only if the plaintiffs *actually* discovered the fraud.[128] He pointed to the statute of limitations for section 11 and section 12 claims that states these claims must be "brought within one year after the discovery of the untrue statement or the omission, *or after such discovery should have been made by the exercise of reasonable diligence*."[129] In the context of section 11 and section 12 claims, Justice Scalia pointed out, "discovery" cannot mean constructive discovery because it would render the second phrase superfluous.[130] Justice Scalia also found good reason for the *actual* discovery rule because scienter, as an element to Rule 10b-5 actions, is more difficult to discover than the elements of section 11 or section 12 claims, which involve only whether an untrue statement was made in a prospectus or registration statement.[131]

In addition, Justice Scalia took issue with the majority's claim that the federal appellate courts all agreed that the statute of limitations for section 10(b) claims meant "constructive discovery." First, Justice Scalia noted that it was unrealistic to assume that both houses of Congress knew of and agreed with the federal appellate courts; and even if they had, their "collective intent" could not trump the plain text of the statute they enacted.[132] Second,

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> implicit in any limitations provision than the balance struck by the same Congress in limiting similar and related protections.

Id. at 365-66 (internal quotations omitted).

128. *Merck*, 130 S. Ct. at 1801-02 (Scalia, J., concurring). Faculty at law and business schools argued that regardless of actual or constructive discovery, "[t]he substance of the underlying claim presumes that members of the class are aware of the facts known to the market." Therefore, "[t]o the extent the market is aware of the fraud," the limitations period would begin. Brief of Amici Curiae Faculty at Law and Business Schools in Support of Respondents at 34, *Merck*, 130 S. Ct. 1784 (No. 08-905), 2009 WL 3477293.

129. 15 U.S.C. § 77m (2006) (emphasis added). Justice Scalia observed that "[t]o interpret § 1658(b)(1) as imposing a constructive-discovery standard, one must therefore assume, contrary to common sense, that the same word means two very different things in the same statutory context of limitations periods for securities-fraud actions under the 1933 and 1934 Acts." *Merck*, 130 S. Ct. at 1800.

130. *Merck*, 130 S. Ct. at 1800-01.

131. *Id.*

132. *Id.* at 1802. This is a point Justice Scalia has made before. *See, e.g.*, Zedner v. United States, 547 U.S. 489, 509-10 (2006) (Scalia, J., concurring) ("[T]he only language that constitutes 'a Law' within the meaning of the Bicameralism and Presentment Clause of Article I, § 7, and hence the only language adopted in a fashion that entitles it to our attention, is the text of the enacted statute."); United States v. Thompson/Center Arms Co.,

Justice Scalia stated that the appellate courts were in fact divided over their interpretation of "discovery" under the statute of limitations.[133]

C. The Reach of Merck *and Subprime Litigation*

The reach of *Merck* thus far is unclear. To the extent that the time from the end of the alleged class period until the plaintiffs file their complaint is a proxy for the likelihood that a statute of limitations defense will arise, filing statistics suggest that historically, the statute of limitations has not been much of an issue. That is consistent with the idea that *Merck* will affect only a few outlier securities class actions that are filed late. According to Cornerstone Research, between 1997 and 2008, the median time between the plaintiff's complaint and the end of the class period was twenty-eight days.[134] NERA Economic Consulting also reported that "[t]he majority of complaints in securities class actions are filed within the three-month period after the end of the alleged class period."[135]

Although these statistics suggest that *Merck* may have limited application, more recent filing statistics suggest that the period between the filing of the plaintiffs' first complaint and the end of the class period has been lengthening. For example, Cornerstone Research found that although the median filing lag between 1997 and 2008 was twenty-eight days, for 2009 the median filing lag was sixty-four days; and in the last half of 2009, the median filing lag was one hundred days.[136] NERA reported a longer delay in general, but also found an upward trend as of late: for the past three years, an average of 161 days passed from the end of the class period to

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504 U.S. 505, 521 (1992) (Scalia, J., concurring) ("[Legislative history is] that last hope of lost interpretive causes, that St. Jude of the hagiology of statutory construction."). For a full discussion of the Supreme Court's use of legislative history, see David S. Law & David Zaring, *Law Versus Ideology: The Supreme Court and the Use of Legislative History,* 51 WM. & MARY L. REV. 1653 (2010).

133. *Merck*, 130 S. Ct. at 1802-03 (Scalia J., concurring); *see also supra* Part I.B (discussing the varied approaches the courts of appeals adopted).

134. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2009: A YEAR IN REVIEW 6 (2009).

135. STEPHANIE PLANCICH & SVETLANA STARYKH, NERA, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2009 YEAR-END UPDATE 8 (2009), *available at* http://www.nera.com/extImage/Recent_Trends_Report_01.10.pdf.

136. CORNERSTONE RESEARCH, *supra* note 134, at 6.

the time the plaintiff filed their complaint.[137] But in the last half of 2009, the average time increased to 279 days with only 69 percent of cases filed within one year.[138] These statistics suggest that the statute of limitations may be more of an issue now than before. Indeed, the percentage of filings with a one-year lag or more has increased steadily from 5 percent in 2005 to 18 percent in 2009,[139] and the percentage of filings with a lag of less than six months has fallen from 86 percent in 2005 to 71 percent in 2009.[140]

One area in which the statute of limitations may prove particularly significant is the ongoing litigation surrounding the subprime meltdown and the credit crisis.[141] According to Kevin LaCroix, author of the highly respected legal blog the D&O Diary, "[a]s we move forward in time and the crisis-related events recede further into the past, additional filings increasingly may raise questions of timeliness. Statute of limitations questions are already arising in some of these cases ... and they are increasingly likely to arise in future cases."[142] LaCroix also observes that many securities fraud cases had been put on the back burner by plaintiff-investors because of the urgency of the credit crisis, and that now, these claims are resurfacing.[143] These too will likely raise statute of limitations issues. In sum, filing statistics and the credit crisis

137. PLANCICH & STARYKH, *supra* note 135, at 8-9.

138. *Id.* at 9. NERA hypothesized that this increased lag is temporary: plaintiffs were focused on the large credit crisis litigation over the past two years and only now are returning to other noncredit crisis cases with older class periods. *Id.* at 9. This hypothesis, though, remains to be tested.

139. CORNERSTONE RESEARCH, *supra* note 134, at 7.

140. *Id.*

141. Kevin LaCroix, The Sands of Time: An Interesting New Subprime Securities Suit, The D&O Diary (May 26, 2010), http://www.dandodiary.com/2010/05/articles/subprime-litigation/the-sands-of-time-an-interesting-new-subprime-securities-suit/; Kevin LaCroix, Who's Getting Hit With Securities Suits These Days, The D&O Diary (May 17, 2010), http://www.dandodiary.com/2010/05/articles/securities-litigation/whos-getting-hit-with-securities-suits-these-days/; Kevin LaCroix, U.S. Supreme Court Allows Merck Vioxx Securities Suit to Proceed, The D&O Diary (Apr. 27, 2010), http://www.dandodiary.com/2010/04/articles/securities-litigation/us-supreme-court-allows-merck-vioxx-securities-suit-to-proceed/; *see also* Pub. Employees Ret. Sys. of Miss. v. Merrill Lynch & Co., 714 F. Supp. 2d 475, 479-81 (2010).

142. LaCroix, U.S. Supreme Court Allows Merck Vioxx Securities Suit to Proceed, *supra* note 141; *see, e.g.*, *Pub. Employees Ret. Sys. of Miss.*, 714 F. Supp. 2d at 479-81.

143. *E.g.*, LaCroix, The Sands of Time: An Interesting New Subprime Securities Suit, *supra* note 141; LaCroix, Who's Getting Hit With Securities Suits These Days, *supra* note 141.

litigation suggest that *Merck*'s impact will not be limited to a few cases.

III. THE DANGERS OF *MERCK* AND ABOLISHING DISCOVERY-ACCRUAL

Merck was quickly heralded as a victory for plaintiffs,[144] mainly because the outcome could have been worse: the Court could have concluded that the statute of limitations is triggered when a plaintiff-investor is on inquiry notice[145]—a vague and malleable concept that starts the clock when a plaintiff is alerted to the possibility that fraud might be afoot. Still, Part III explores the pitfalls of *Merck*. This Part shows that *Merck* precludes the prosecution of meritorious securities fraud claims because it sets up a pleading trap for plaintiffs that may force devastating concessions or expose attorneys to Rule 11 sanctions. Part III also examines whether the discovery provision interpreted in *Merck* is necessary at all and concludes that it is not. As this Part demonstrates, the discovery provision fails to spur prompt filing, rests on the unfounded assumption that plaintiffs have discovered their claim but intentionally delayed filing, and imposes a procedural cost with no corresponding benefit.

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144. *E.g.*, Brent Kendall, *Suit Against Merck Allowed to Proceed*, WALL ST. J., Apr. 28, 2010, http://online.wsj.com/article/SB10001424052748703832204575210000606165846.html ("David C. Frederick, who argued the case for the plaintiffs, said the ruling 'is a wonderful decision and we look forward to litigating the merits in the district court.' ... Tuesday's ruling against Merck may knock out the timeliness argument as a line of defense for companies fending off investor lawsuits."); LaCroix, U.S. Supreme Court Allows Merck Vioxx Securities Suit to Proceed, *supra* note 141 ("[T]he Court's opinion definitely is helpful to the plaintiffs. In recent years, the Court has developed a reputation as hostile to private securities lawsuits. Without a doubt, the Court has issued a series of decisions (Tellabs, Stoneridge, Twombley/Iqbal, Dura, etc.) that have proved helpful to defendants. But the Court's opinion in the Merck case is not only helpful to the plaintiffs in that case but it likely will prove useful to plaintiffs in other cases as well."); Tony Mauro, *Merck Shareholder Suit Timely, Justices Rule*, LEGAL INTELLIGENCER, Apr. 28, 2010, *available at* 2010 WLNR 8734527 (stating that *Merck* is beneficial for plaintiffs); Kevin C. Newsom & J. Thomas Richie, *Amicus Update: Supreme Court Decision Spells Increased Difficulty for Defendants in Securities Law Claims*, DRI: THE VOICE OF THE DEFENSE BAR, Apr. 29, 2010, http://www.dri.org/open/Article.aspx?ID=311 ("[D]efendants will have a more difficult time than in the past showing that securities law claims are time-barred, which will augment risks in litigation and increase discovery costs.").

145. Brief for the Petitioners, *supra* note 56, at 16-33 (arguing that the statute of limitations begins when the plaintiff was alerted to the possibility of fraud).

A. The Problematic Incorporation of Scienter

The Supreme Court's securities fraud jurisprudence since *Blue Chip Stamps v. Manor Drug Stores*[146] has been consistent in one regard: it has rejected the expansion of remedies afforded to investors for securities fraud and limited the exposure of defendants to securities fraud liability.[147] What then explains *Merck*? Does the case represent a paradigm shift in favor of plaintiff-investors, possibly the result of the recent financial disaster? It is possible that this scandal, which led to a loss of confidence in the market, translated into a difference in judicial attitude.[148] Although that is possible, *Merck* is not a paradigm shift at all. The decision does little to help investors; rather, it allows defendants to use scienter offensively and puts plaintiffs in a perilous pleading position.

Part III.A first shows that by incorporating scienter, *Merck* has given defendants a tool to trigger the statute of limitations—they can invoke the collective scienter and core operations theories to argue that the plaintiffs constructively discovered their fraud earlier.[149] This Section also cautions plaintiffs of *Merck*'s pleading trap. Plaintiffs must craft alleged misrepresentations as actionable in order to survive a Rule 12(b)(6) motion to dismiss, but must also

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146. 421 U.S. 723 (1975) (limiting private damages action under Rule 10b-5 to actual purchasers or sellers of securities).

147. Michael J. Kaufman, *Mending the Weathered Jurisdictional Fences in the Supreme Court's Securities Fraud Decisions,* 49 SMU L. REV. 159, 188-89 (1996). The Supreme Court's most recent trilogy may easily be added to the chart showing this trend. *See* Stoneridge Invs. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 159-64 (2008) (rejecting scheme liability); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322-23 (2007) (heightening the pleading standard by requiring district courts to weigh both culpable and nonculpable inferences of scienter at the motion to dismiss stage); Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342-44 (2005) (stating that a securities fraud plaintiff cannot plead loss causation simply by alleging in the complaint, and later establishing, that the price of the security on the date of purchase was inflated because of the misrepresentation).

148. Some commentators have argued that *Merck* and the recent cases decided since *Dura* are consistent in that they all represent the Court's approach to "judicial conservatism, grounded in statutory language." Jordan Eth et al., *Justices Focus on Language in Cases Like 'Merck,'* RECORDER, Apr. 30, 2010, *available at* 2010 WLNR 8952438. But *Merck* adopted a constructive discovery standard—the statute contains no language suggesting that the standard should be constructive as opposed to actual discovery. Justice Scalia's concurrence argued just that point. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1800-01 (2010) (Scalia, J., concurring).

149. *See infra* Part III.A.1.

tread carefully to avoid triggering the statute of limitations.[150] Conceding that earlier misrepresentations were not made with scienter—or were not evidence of it—may force plaintiffs to rely on fewer indicia of the corporate defendant's culpable mental state, or force plaintiffs into pleading fraud by hindsight. Another danger is that if plaintiffs file before the event they claim provided them with sufficient evidence of scienter, they may set themselves up for Rule 11 sanctions. Last, Part III.A shows that *Merck* failed to establish a uniform statute of limitations when it incorporated scienter—the federal courts have no common requirements for alleging and proving a company's mental state for securities fraud.[151]

1. Scienter on the Offensive: Collective Scienter and Core Operations

The statute of limitations will be significant in future securities fraud actions.[152] But this may be to plaintiffs' detriment. *Merck* held that the statute of limitations does not begin until the plaintiff has, or should have, discovered the facts constituting the violation, which include scienter.[153] This appears to be a victory for plaintiffs—the statute does not begin on the *possibility* of fraud, but rather upon the discovery of actual fraud. But "[a]ll that glisters is not gold,"[154] and the Court's seemingly pro-plaintiff standard provides a formidable weapon for defendants: scienter can be used offensively, and methods of imputing scienter, such as the collective scienter theory and the core operations inference, can be used to trigger constructive discovery.

Scienter is usually pleaded with circumstantial evidence.[155] At the Rule 12(b)(6) stage, without the benefit of discovery,[156] it is hard

150. *See infra* Part III.A.2.

151. *See infra* Part III.A.3.

152. *See supra* Part II.C (describing how filing statistics and anecdotal evidence suggest that the statute of limitations may become increasingly important for future securities claims).

153. *Merck*, 130 S. Ct. at 1789-90 (majority opinion).

154. WILLIAM SHAKESPEARE, THE MERCHANT OF VENICE act 2, sc. 7, L. 65 (David Bevington & David Scott Kastan eds., Bantam Classic 2005).

155. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983).

156. *See* 15 U.S.C. § 78u-4(b)(3)(B) (2006) (automatically staying discovery pending the resolution of a defendant's motion to dismiss).

to imagine another way that plaintiffs might plead the defendant-company's mental state with the sufficient particularity that the PSLRA demands.[157] Plaintiffs often rely on methods for courts to infer scienter or impute knowledge. Two popular methods include the "collective scienter" theory and the "core operations inference." Under the collective scienter theory, or "group pleading doctrine," a court will impute scienter to officers and directors if they had day-to-day control or involvement in regular company operations and misstatements appeared in group-published documents, including annual reports and press releases.[158] This means a plaintiff can show a defendant-company acted with scienter without specifically naming the persons who concocted and disseminated the fraud.[159] Although most courts have rejected this method of imputing knowledge—finding it inconsistent with the PSLRA's requirement that plaintiffs allege facts with particularity[160]—it is accepted in some circuits.[161]

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157. *See id.* at § 78u-4(b)(1)-(2) (requiring the plaintiff to plead with particularity facts demonstrating a strong inference of scienter). The federal appellate courts have likewise curbed plaintiffs' use of confidential informants in securities fraud, which was a critical tool plaintiffs used to investigate potential stock fraud and meet the PSLRA's heightened pleading requirements. *See* Michael J. Kaufman & John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Fraud Litigation*, 19 CORNELL J.L. & PUB. POL'Y 637, 646-61 (2010) [hereinafter Kaufman & Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants*]; Michael J. Kaufman & John M. Wunderlich, *Congress, the Supreme Court, and the Proper Role of Confidential Informants in Securities Fraud Litigation*, 36 SEC. REG. L.J. 345, 351-57 (2008) [hereinafter Kaufman & Wunderlich, *Congress, the Supreme Court, and the Proper Role of Confidential Informants*]; Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path from* Central Bank *to* Stoneridge Investment Partners*,* 6 BERKELEY BUS. L.J. 131, 186 (2009).

158. Winer Family Trust v. Queen, 503 F.3d 319, 335 (3d Cir. 2007).

159. Makor Issues & Rights, Ltd. v. Tellabs, Inc. (*Tellabs II*), 513 F.3d 702, 710 (7th Cir. 2008).

160. *See, e.g.*, Mizzaro v. Home Depot, Inc., 544 F.3d 1230, 1254 (11th Cir. 2008); Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 533 (5th Cir. 2008); Pugh v. Tribune Co., 521 F.3d 686, 693 (7th Cir. 2008); *Winer Family Trust*, 503 F.3d at 335; Makor Issues & Rights, Ltd. v. Tellabs, Inc. (*Tellabs I*), 437 F.3d 588, 602-03 (7th Cir. 2006), *vacated*, 551 U.S. 308 (2007); Southland Sec. Corp. v. INSpire Ins. Solutions, Inc., 365 F.3d 353, 366 (5th Cir. 2004); *In re* Apple Computer, Inc. Sec. Litig., 243 F. Supp. 2d 1012, 1023 (N.D. Cal. 2002).

161. *See, e.g.*, Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc., 531 F.3d 190, 195 (2d Cir. 2008) (indicating a willingness to allow a plaintiff "to raise the required inference [of scienter] with regard to a corporate defendant without doing so with regard to a specific individual defendant"); City of Monroe Employees Ret. Sys. v. Bridgestone Corp.,

Similarly, the core operations inference suggests the defendant acted with scienter if the misrepresentation concerns a "core operation" of the defendant's business.[162] Officers can be assumed to know the "facts critical to a business's core operations or to an important transaction that would affect a company's performance."[163] By way of example,

> [s]uppose General Motors announced that it had sold one million SUVs in 2006, and the actual number was zero. There would be a strong inference of corporate scienter, since so dramatic an announcement would have been approved by corporate officials sufficiently knowledgeable about the company to know that the announcement was false.[164]

Both the collective scienter and the core operations theories lead to the inference that the defendant must have known the facts surrounding the misstatement because it would be absurd to suggest otherwise—or at the very least, it would suggest the defendants were negligent in their ignorance.[165]

In *Merck,* the Court left open the possibility that defendants could use these methods to their advantage. The Court's marriage hypothetical implies that it would be absurd to suggest that there are certain statements made without knowledge of their falsity.[166]

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399 F.3d 651, 688 (6th Cir. 2005) ("[K]nowledge of a corporate officer or agent acting within the scope of his authority is attributable to the corporation."); Schwartz v. Celestial Seasonings, Inc., 124 F.3d 1246, 1254 (10th Cir. 1997) (stating that plaintiff-investors need not "match" specific misstatements to specific officers or directors).

162. *See* HAZEN, *supra* note 45, § 12.8[4][D]. According to the Ninth Circuit, allegations regarding a company's core operations may be relevant to scienter in three circumstances: (1) where the defendant has actual knowledge of the information; (2) where it would be absurd to conclude that the defendants did not know the information; and (3) where the allegations taken together raise a cogent and compelling standard of scienter. S. Ferry LP No. 2 v. Killinger, 542 F.3d 776, 785-86 (9th Cir. 2008).

163. Jones v. Corus Bankshares, Inc., 701 F. Supp. 2d 1014, 1028 (N.D. Ill. 2010) (internal quotation marks omitted); *see also In re* Sears, Roebuck & Co. Sec. Litig., 291 F. Supp. 2d 722, 727 (N.D. Ill. 2003).

164. *Tellabs II*, 513 F.3d at 710.

165. *See* Pittleman v. Impac Mortg. Holdings, Inc., No. SACV 07-0970 AG (MLGx), 2009 WL 648983, at *3 (C.D. Cal. Mar. 9, 2009); *see also* Zucco Partners, L.L.C. v. Digimarc Corp., 552 F.3d 981, 1000 (9th Cir. 2009) (recognizing that the core operations inference would apply if a "fact is of such prominence that it would be 'absurd' to suggest that management was without knowledge" of it).

166. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1796-97 (2010) ("We recognize that certain

And if plaintiffs can invoke these methods to impute scienter to defendants, nothing prevents defendants from doing so as well.[167] Thus, defendants may point to earlier misrepresentations and argue that these statements concerned a "core operation" of the company's business and that scienter could have been inferred therefrom. For example, if GM announces in 2006 that the number of cars it sold was one million when the actual number was zero, under the "core operations" inference this constitutes scienter that a reasonable investor would be aware of—even though the plaintiffs may not actually have discovered that this statement was fraudulent until 2010.

2. The Pleading Game Plaintiffs Cannot Win

There is another reason to be suspect of *Merck*: it creates a pleading trap for plaintiffs that forces them to concede essential facts and sets their claims up for resolution on a motion to dismiss. The Court's decision does not address this pleading issue. Omitting scienter from the statute of limitations inquiry may have been beneficial to plaintiffs as they could hide behind the vagueness of the inquiry-notice standard. But now, parties will argue over the precise point at which a reasonably diligent plaintiff would have pieced together enough information sufficient to show scienter.

First, although the defendant bears the burden of proving the statute of limitations issue as an affirmative defense,[168] scienter is an element of the plaintiff's case-in-chief, which the plaintiff must

statements are such that, to show them false is normally to show scienter as well. It is unlikely, for example, that someone would falsely say 'I am not married' without being aware of the fact that his statement is false.").

167. Indeed, Justice Kennedy was skeptical of just the inverse and stated at oral argument that "the companies can't have it both ways. They can't endorse the *Twombly* case and then say just an inquiry notice of a general — of a general nature suffices. You have to have specific evidence of scienter. And there's nothing here to indicate that the plaintiffs had that." Transcript of Oral Argument at 12, *Merck*, 130 S. Ct. 1784 (No. 08-905), *available at* http://www.supremecourt.gov/oral_arguments/argument_transcripts/08-905.pdf.

168. *See, e.g.*, Young v. Lepone, 305 F.3d 1, 8-9 (1st Cir. 2002) (stating that the statute of limitations is an affirmative defense and the defendant bears the burden of proof). At the Rule 12(b)(6) stage, defendants may argue that the statute of limitations had run only on the narrative in the complaint. *See* Law v. Medco Research, Inc., 113 F.3d 781, 783 (7th Cir. 1997). But later on a motion for summary judgment, the defendant may prove its assertion that the statute of limitations had begun with evidence of its own. *Id.*

allege and prove.[169] Therefore, the plaintiff cannot fend off a statute of limitations defense by arguing that *no* evidence of scienter ever arose. The plaintiff must indicate some point in time at which the plaintiff discovered evidence of scienter.[170]

Moreover, defendants control points of contention regarding scienter as they raise the statute of limitations issue. A defendant may point to an earlier misrepresentation about the company's flagship product and argue that under the "core operations" inference, the plaintiff should have inferred scienter, thereby triggering the statute of limitations.[171] To keep the limitations period from running, plaintiffs must concede—assuming they can—that the misrepresentation did not suggest that the defendant acted with scienter and thus was not actionable securities fraud. And so the plaintiffs' very allegations will be used against them.[172]

Even still, plaintiffs must point to *some* evidence that the defendant acted with scienter or they will not have filed their claim in good faith. Forcing plaintiffs to point to an "aha! moment" or the "smoking gun" of fraud will likely set the claim up for ready dismissal at the Rule 12(b)(6) stage for two reasons. First, solitary

169. 15 U.S.C. § 78u-4(b) (2006); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976).

170. *See* Mia Mazza, *The Tactics of Asserting the Statute of Limitations Defense After* Merck v. Reynolds, 6 SEC. LITIG. REP. 1 (2010) ("Whereas *Tellabs* requires courts to take a holistic approach to scienter at the initial pleading stage, *Merck* will require courts to analyze scienter in a more surgical manner.... [U]nder *Merck,* courts may be asked to take the 'collective' body of facts and start slicing them away one by one ... to determine whether it was the very first fact that, upon emerging into the eye of the reasonably diligent public 'indicated' scienter.").

171. *See supra* Part III.A.1 (describing how defendants may invoke the collective scienter theory and the "core operations" inference offensively against plaintiffs).

172. Van Cleave, *supra* note 53, at 88 ("This story very likely starts with the standard assertions that, prior to the fraudulent transaction, the defendants intentionally and knowingly made the untrue statements or failed to state the required material facts. If the complaint is not filed within [two years] of any of these startling allegations, the plaintiff's detailed account of the fraud enables the defendant to plead expiration of the [two-year] statute of limitations. The blatancy of the plaintiff's allegations may be used against him as the very facts which alerted him to the fraud."); *cf.* Mazza, *supra* note 170, at 1 (noting that the converse is true for defendants but neglecting that plaintiffs bear the ultimate burden of proof, stating "[a]lthough parties are permitted to make 'alternative' or 'inconsistent' arguments under Rule 8(d)(3), there is nevertheless a real tension between arguing (i) that plaintiffs fall short of meeting the Reform Act's stringent standard for pleading scienter, and (ii) that 'facts indicating scienter available to the reasonably diligent public more than two years before the complaint was filed" and noting that "combining both arguments in one motion may serve to undermine one or both of these points").

events as evidence of the defendant's mental state often prove unsuccessful. To illustrate, one of the more common ways plaintiffs attempt to allege scienter is to allege that the defendants had "motive and opportunity"—for example, that the defendants made misrepresentations to sell their own shares at a profit and that this trading pattern was suspicious or unusually out of line with prior trading practices.[173] But the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* stated that courts must consider all the facts taken collectively—not whether any individual allegation, scrutinized in isolation, evidences scienter.[174] Thus, courts such as the Third Circuit, which had previously allowed a plaintiff to plead scienter by alleging that the defendant had "motive and opportunity" to commit stock fraud, have since rejected this approach.[175] Rather, scienter is a conclusion dependent on a variety of factors, including (1) the materiality and scale of the fraud; (2) whether the allegations involve violations of generally accepted accounting principles[176] or the company's own accounting policies; (3) whether

173. *See, e.g.*, ECA, Local 134 IBEW Joint Pension Trust of Chi. v. JP Morgan Chase Co., 553 F.3d 187, 198-99 (2d Cir. 2009); Cornelia I. Crowell GST Trust v. Possis Med., Inc., 519 F.3d 778, 783 (8th Cir. 2008); *In re* Suprema Specialties, Inc. Sec. Litig., 438 F.3d 256, 277 (3d Cir. 2006); *In re* PEC Solutions, Inc. Sec. Litig., 418 F.3d 379, 390 (4th Cir. 2005); Novak v. Kasaks, 216 F.3d 300, 307-08 (2d Cir. 2000). The renowned plaintiffs' lawyer William S. Lerach, responsible for several major securities fraud victories over corporate giants such as WorldCom and Enron, considers insider selling to be "footprints in the snow" of the culpable. PATRICK DILLON & CARL M. CANNON, CIRCLE OF GREED: THE SPECTACULAR RISE AND FALL OF THE LAWYER WHO BROUGHT CORPORATE AMERICA TO ITS KNEES 3 (2010).

174. *Tellabs*, 551 U.S. at 323-24 ("The inference that the defendant acted with scienter need not be irrefutable, *i.e.*, of the smoking-gun genre, or even the most plausible of competing inferences.") (internal quotation marks omitted); *see also* Zucco Partners, L.L.C. v. Digimarc Corp., 552 F.3d 981, 991 (9th Cir. 2009) ("[W]e recognize that *Tellabs* calls into question a methodology that relies exclusively on a segmented analysis of scienter.").

175. Inst. Invs. Group v. Avaya, Inc., 564 F.3d 242, 276 (3d Cir. 2009) ("While it is true that motive can be a relevant consideration, and personal financial gain may weigh heavily in favor of a scienter inference, we agree with the Seventh Circuit that the absence of a motive allegation is not fatal. As earlier stated, allegations must be considered collectively; the significance that can be ascribed to an allegation of motive, or lack thereof, depends on the entirety of the complaint. If the significance of the presence, or absence, of motive allegations can be ascertained only by reference to the complete complaint, then a general rule that motive allegations are sufficient—or necessary—is unsound.") (internal citation and quotation marks omitted).

176. "Promulgated by the accounting profession's Financial Accounting Standards Board, 'generally accepted accounting principles' are the conventions, rules, and procedures that define accepted accounting practices." United States v. Arthur Young & Co., 465 U.S. 805, 811 n.7 (1984).

the SEC or some other party brought an action alleging the same fraudulent conduct; and (4) whether the defendant had ready access to information that would show that the public statements were not accurate.[177] If plaintiffs cabin their scienter allegations, they will lack the ability to paint the compelling mosaic necessary to show the defendant's fraudulent intent.

Second, securities fraud plaintiffs must allege why each misstatement would have been false or misleading at the time the plaintiffs allege that the misstatement was made.[178] Merely alleging that defendants made misstatements and then showing in hindsight that they were false does not satisfy the PSLRA's particularity requirement.[179] This concept is commonly referred to as the general prohibition against pleading "fraud by hindsight."[180] Plaintiffs must have "specific allegations showing that the [d]efendants either knew of or recklessly disregarded the falsity of their own statements *at the time the statements were made*."[181] Without these specific allegations, the fact that the defendants' statements later turned out to be false is irrelevant, and courts will refuse to find scienter because it would be the equivalent of finding fraud by hindsight.[182]

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177. Schleicher v. Wendt, 529 F. Supp. 2d 959, 971-72 (S.D. Ind. 2007) (collecting cases); *see also* Helwig v. Vencor, Inc., 251 F.3d 540, 552 (6th Cir. 2001) (naming nine factors as suggestive of scienter: (1) insider trading at a suspicious time or in an unusual amount; (2) divergence between internal reports and external statements on the same subject; (3) closeness in time of an allegedly fraudulent statement or omission and the later disclosure of inconsistent information; (4) evidence of bribery; (5) ancillary lawsuits charging fraud and the company's quick settlement of that suit; (6) disregard of the most current factual information; (7) disclosure of accounting information in a way that its negative implications could only be understood by one with a high degree of sophistication; (8) personal interest of certain directors in not informing disinterested directors of an impending sale of stock; and (9) self-interested motivation of defendants in saving their salaries or jobs).

178. Elam v. Neidorff, 544 F.3d 921, 927 (8th Cir. 2008); *In re* Cerner Corp. Sec. Litig., 425 F.3d 1079, 1083 (8th Cir. 2005); DiLeo v. Ernst & Young, 901 F.2d 624, 627-28 (7th Cir. 1990).

179. *Elam*, 544 F.3d at 927; *In re Cerner Corp.*, 425 F.3d at 1083.

180. *See* Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need To Know,* 62 BUS. LAW. 1281, 1321 (2007). The fraud-by-hindsight doctrine has been criticized as a thinly veiled attempt by courts to screen securities cases early, rather than an effort to control the hindsight bias in securities litigation. Mitu Gulati et al., *Fraud by Hindsight,* 98 NW. U. L. REV. 773, 776-77 (2004).

181. Konkol v. Diebold, Inc., 590 F.3d 390, 403 (6th Cir. 2009) (emphasis added); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 320 (2007) (stating that requiring plaintiffs to plead a strong inference of scienter prevents pleading fraud by hindsight).

182. *See, e.g.*, *Konkol*, 590 F.3d at 403; Pugh v. Tribune Co., 521 F.3d 686, 694-95 (7th Cir. 2008); Winer Family Trust v. Queen, 503 F.3d 319, 331-32 (3d Cir. 2007); *see also*

Forcing plaintiffs to admit that earlier misrepresentations were not made with the requisite scienter may cause plaintiffs to fall dangerously close to alleging fraud by hindsight.[183]

When a defendant raises the statute of limitations defense, it is a lose-lose situation for plaintiffs: either defeat the statute of limitations defense by conceding that previous events did not establish the defendant's culpable state of mind and thus expose the case to ready dismissal; *or* lose on the statute of limitations defense and be forever barred from suit.[184] Further, if the plaintiffs file their complaint before the date of the event that they claim provided sufficient evidence of scienter, they risk Rule 11 sanctions. When Congress enacted the PSLRA, it also enacted a heightened Rule 11 provision that required courts to issue findings that the attorneys and parties complied with Rule 11's requirement that the allegations contained existing evidentiary support.[185] If plaintiffs defend against the statute of limitations and argue that certain facts did

Higginbotham v. Baxter Int'l, Inc., 495 F.3d 753, 758 (7th Cir. 2007) ("[T]here is a big difference between knowing about the reports from [a subsidiary] and knowing that the reports are false. The complaint documents the former but not the latter.").

183. *See* Inst. Invs. Group v. Avaya, Inc., 564 F.3d 242, 269 (3d Cir. 2009) (concluding that the plaintiffs did not allege fraud by hindsight because, in judging the totality of circumstances and allegations, the court concluded there was a strong inference of scienter).

184. In *Merck* this problem was apparent at oral argument. The plaintiffs maintained that the statements made by Merck concerning the naproxen hypothesis did not show scienter because the defendants never disclosed that the hypothesis was not tested, and thus they could not have discovered facts constituting scienter before the statute of limitations had run. Transcript of Oral Argument, *supra* note 167, at 36 (statement of David C. Frederick, Esq.). Justice Kennedy observed at argument, "[even if the Court adopts] your theory of the case, there is some problem with the allegation that there was fraud ... because Merck did not disclose that the hypothesis was only hypothetical, and the FDA August letter made that clear." *Id.* at 42.

185. 15 U.S.C. § 78u-4(c)(1)-(2) (2006). Congress enacted this provision as part of its objective in the PSLRA to reduce "frivolous" suits. S. REP. NO. 104-98, at 7, 14 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 686, 693. Recent decisions from the federal appellate courts suggest federal district courts should apply this provision with a renewed vigor. *See, e.g.*, Ledford v. Peeples, 605 F.3d 871, 928 (11th Cir. 2010) (reversing district court's decision that failed to impose Rule 11 sanctions on plaintiff's counsel); ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 579 F.3d 143, 155 (2d Cir. 2009) (encouraging parties to move for Rule 11 sanctions and suggesting that failure to do so would result in lesser award of fees); Citibank Global Mkts., Inc. v. Rodriguez Santana, 573 F.3d 17, 31-32 (1st Cir. 2009) (suggesting that Rule 11 findings are required even if a "claim was made under the securities laws but where all claims were dismissed on state law grounds"); *see also* Cohen v. USEC, Inc., 70 F. App'x 679, 689 (4th Cir. 2003) (remanding the case to the district court to make required Rule 11 findings); Gurary v. Nu-Tech Bio-Med, Inc., 303 F.3d 212, 222-26 (2d Cir. 2002) (same).

not give rise to actionable securities fraud even though they had filed suit at the time those events occurred, sanctions would be appropriate. Consider the exchange that took place at oral argument in *Merck* between plaintiffs' counsel and the Justices. Counsel suggested that the plaintiffs first found sufficient evidence of scienter in 2004 when the *Wall Street Journal* published internal e-mails from Merck executives stating that they wanted to keep the side effects of Vioxx secret to enhance the drug's profitability.[186] But the plaintiffs filed their complaint in 2003, before this article was published.[187] Justice Sotomayor then questioned, "[s]o you are admitting that you filed an improper complaint, that you didn't have a ... good faith basis for the complaint you filed?"[188]

As shown, *Merck* contains several pleading pitfalls for plaintiff-investors. Artful pleading will become paramount in cases involving the statute of limitations. Plaintiffs must be careful to retain the allegations that are necessary to make a "cogent and ... compelling" case that the defendant-company acted with scienter,[189] avoid fraud by hindsight and sanctions, and defeat the statute of limitations.

3. Failing To Achieve Uniformity in the Statute of Limitations

Another detriment of *Merck* is that it fails to achieve the much sought-after uniformity in the statute of limitations for securities fraud. In *Lampf,* the Supreme Court adopted a uniform statute of limitations, concluding that "the federal interests in predictability and judicial economy counsel[ed]" in favor of a uniform rule in the

186. Transcript of Oral Argument, *supra* note 167, at 33.

187. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1790 (2010).

188. Transcript of Oral Argument, *supra* note 167, at 33; *see also* DeBruyne v. Equitable Life Assurance Soc'y, 920 F.2d 457, 466 n.19 (7th Cir. 1990) ("Plaintiffs have also suggested that they have complied with the statute of limitations because at least a portion of their knowledge regarding the alleged misrepresentations did not arise until after they filed the complaint and hired their expert .... It is an intellectually bankrupt argument, however, or a violation of rule 11, for a plaintiff to file a complaint alleging misrepresentation and, in the same breath, to assert that he or she did not discover the misrepresentation until after the filing of the complaint.").

189. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007) ("An inference of fraudulent intent may be plausible, yet less cogent than other, nonculpable explanations for the defendant's conduct. To qualify as 'strong' within the intendment of § 21D(b)(2), we hold, an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.").

context of claims under section 10(b) and Rule 10b-5.[190] *Merck* ended the divide over what "discovery" means and what "facts constitut[e] the violation,"[191] but substituted one circuit split for another by incorporating scienter.[192] The Supreme Court has consistently dodged the question of what scienter means,[193] and the federal appellate courts have been far from uniform in their approach.[194] Now, plaintiffs seeking to avoid the statute of limitations defense may seek out those circuits with stringent scienter standards so they may successfully argue that they did not have notice of that claim.

In sum, *Merck* is plaintiff friendly insofar as it could have been worse for plaintiff-investors. *Merck* still presents substantial obstacles for plaintiffs in overcoming the statute of limitations defense. But what then is the answer? What could the Court have done? Part III.B argues that the remedy lies in abolishing the statute of limitations.

B. The Illusory Benefits to a Discovery Provision

The statute of limitations and its statute of repose involve a delicate balance: "too much emphasis on the statute of limitations can precipitate premature and groundless suits, as plaintiffs rush to beat the deadline without being able to obtain good evidence of fraud; and the ... statute of repose gives defendants a definite limit

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190. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 357 (1991).

191. *Merck*, 130 S. Ct. at 1789-90.

192. *Id.* at 1796.

193. *Tellabs*, 551 U.S. at 319 n.3; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976).

194. *See* Edward J. Goodman Life Income Trust v. Jabil Circuit, Inc., 594 F.3d 783, 790-91 (11th Cir. 2010) (holding that scienter requires deliberate recklessness or actual knowledge, and motive and opportunity alone are never sufficient); *In re* Software Toolworks Inc., 50 F.3d 615, 626 (9th Cir. 1994) (same); *see also* Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc., 576 F.3d 172, 181, 199 (4th Cir. 2009) (asserting that motive and opportunity are useful factors, but not themselves necessary or sufficient); Frank v. Dana Corp., 547 F.3d 564, 570 (6th Cir. 2008) (same); Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc., 537 F.3d 527, 533 (5th Cir. 2008) (same); ACA Fin. Guar. Corp. v. Advest, Inc., 512 F.3d 46, 58 (1st Cir. 2008) (same); Makor Issues & Rights, Ltd. v. Tellabs, Inc. (*Tellabs I*), 437 F.3d 588, 601 (7th Cir. 2006) (same); Adams v. Kinder-Morgan, Inc., 340 F.3d 1083, 1105 (10th Cir. 2003) (same); Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000) (motive and opportunity alone are sufficient to establish scienter); *In re* Advanta Corp. Sec. Litig., 180 F.3d 525, 535 (3d Cir. 1999) (same).

beyond which they needn't fear being sued."[195] But too little emphasis would enable investors to wait to see whether a poorly performed stock recovered, reap investment profits if it did, and sue for damages if it did not.[196] This mantra has sustained the statute of limitations for section 10(b) and Rule 10b-5. When its discovery provision is scrutinized, however, its usefulness is questionable. As this Part shows, the practical realities of securities fraud litigation already encourage prompt filing and the securities laws already contain many more effective features that deter dilatory conduct by plaintiffs.[197] Moreover, securities fraud is complex and difficult to discover. It is more likely that plaintiff-investors did not know about the fraud, rather than that they sat on the information and refrained from filing suit.[198] Further, this Part demonstrates that the statute of limitations imposes an empty procedural cost on parties and the judicial system.[199]

1. The Practical Realities of Securities Litigation and Prompt Filing

An essential feature of any statute of limitations that accrues upon discovery is that it encourages the prompt filing of a lawsuit.[200] Prompt filing achieves several laudable goals. First, prompt filing enhances the accuracy of evidence because evidence deteriorates over time.[201] Second, prompt filing monitors the plaintiff's

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

196. *See, e.g.*, Betz v. Trainer Wortham & Co., 519 F.3d 863, 868 (9th Cir. 2008) (Kozinski, C.J., dissenting from the denial to rehear the case en banc), *vacated*, 130 S. Ct. 2400 (2010); New Eng. Health Care Employees Pension Fund v. Ernst & Young, L.L.P., 336 F.3d 495, 499 (6th Cir. 2003); Tregenza v. Great Am. Commc'ns Co., 12 F.3d 717, 722 (7th Cir. 1993) (referring to this as a "[h]eads I win, tails you lose" situation).

197. *See infra* Part III.B.1.

198. *See infra* Part III.B.2.

199. *See infra* Part III.B.3.

200. *See, e.g.*, United States v. Marion, 404 U.S. 307, 322 n.14 (1971); Order of United Commercial Travelers of Am. v. Wolfe, 331 U.S. 586, 608 n.20 (1947); Mo., Kan. & Tex. Ry. Co. v. Harriman Bros., 227 U.S. 657, 672 (1913).

201. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 378 (1991) (Kennedy, J., dissenting) ("Just determinations of fact cannot be made when, because of the passage of time, the memories of witnesses have faded or evidence is lost.") (quoting Wilson v. Garcia, 471 U.S. 261, 271 (1985)); *Betz*, 519 F.3d at 868 (Kozinski, C.J., dissenting from the denial to rehear the case en banc) ("[P]laintiff's delay may prejudice defendant's case as memories fade, documents are lost, and witnesses become unavailable.") (quoting

conduct by "making it harder ... to file claims based on evidence whose accuracy cannot be checked."[202] Third, prompt filing deters defendant misconduct by enforcing the substantive law.[203] The private rights of action under the securities laws supplement the enforcement powers of the SEC and DOJ.[204] These private attorneys general threaten defendants into compliance with the securities laws, and their legitimacy is bolstered by their deterrent effect.[205] "Given that plaintiffs are often relied on as private attorneys general to enforce substantive rights, a policy requiring plaintiffs to file quickly enhances deterrence objectives."[206]

But a statute of limitations that accrues upon discovery is unnecessary to achieve these goals. As observed by the faculty at law and business schools as amici curiae in *Merck,* plaintiff-investors already have incentives to investigate immediately the possibility of fraud, regardless of the length of the statute of limitations or when the time limit is triggered.[207] In fact, when Congress enacted the PSLRA, it was concerned that plaintiffs had *too much* incentive to race to court.[208] Several features of securities litigation motivate plaintiffs to file early. First, the presence of institutional investors as lead plaintiffs, which has increased under the PSLRA,[209] encourages plaintiffs to investigate and file because

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Brumbaugh v. Princeton Partners, 985 F.2d 157, 162 (4th Cir. 1993)); Eriline Co. v. Johnson, 440 F.3d 648, 655 (4th Cir. 2006) ("A statute of limitations defense, by contrast, primarily serves only defendants by preventing the revival of stale claims in which the defense is hampered by lost evidence, faded memories, and disappearing witnesses, and to avoid unfair surprise.") (quoting Johnson v. Ry. Express Agency, Inc., 421 U.S. 454, 473 (1975)).

202. Suzette M. Malveaux, *Statutes of Limitations: A Policy Analysis in the Context of Reparations Litigation*, 74 GEO. WASH. L. REV. 68, 77 (2005).

203. Ochoa & Wistrich, *supra* note 40, at 492-93.

204. *See supra* note 20 and accompanying text.

205. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1536 (2006) ("Deterrence ... is the only rationale that can justify the significant costs—both public and private—that securities class actions impose on investors and the judiciary.").

206. Malveaux, *supra* note 202, at 78; *see* Ochoa & Wistrich, *supra* note 40, at 492; *see also* Riddlesbarger v. Hartford Ins. Co., 74 U.S. (7 Wall.) 386, 390 (1868) ("The policy of these statutes is to encourage promptitude in the prosecution of remedies.").

207. Brief of Amici Curiae Faculty at Law and Business Schools in Support of Respondents, *supra* note 128, at 31-33.

208. H.R. REP. NO. 104-369, at 32 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 731; S. REP. NO. 104-98, at 10 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 689.

209. 15 U.S.C. § 77z-1(a)(2)(A)(iii) (2006); *see also* Andrew S. Gold, *Experimenting with the Lead Plaintiff Selection Process in Securities Class Actions: A Suggestion for PSLRA Reform*,

these institutional investors often have sufficient resources to conduct their own prefiling investigation.[210] If a firm delays its investigation, it may miss a chance to serve as lead counsel.[211] And the frequency of participation by institutional investors as lead plaintiff has been increasing.[212] In 2009, institutional investors served as lead plaintiff in 65 percent of the securities fraud class actions that settled—the highest proportion to date.[213] Also, by employing constructive discovery, the Court further reduced the risk of plaintiff inactivity—the clock begins when a *reasonable* investor would have discovered the fraud.[214]

Second, filing early correlates with a stronger likelihood of surviving a Rule 12(b)(6) motion to dismiss. Historically, securities fraud class actions that have longer filing lags are dismissed at a higher rate than class actions with shorter filing lags.[215] For example,

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57 DEPAUL L. REV. 447, 450-51 (2008); Craig C. Martin & Matthew H. Metcalf, *The Fiduciary Duties of Institutional Investors in Securities Litigation,* 56 BUS. LAW. 1381, 1393 (2001).

210. Brief of Amici Curiae Faculty at Law and Business Schools in Support of Respondents, *supra* note 128, at 32; *see also* 15 U.S.C. § 78u-4(a)(3)(B). Congress intended to encourage the use of institutional investors as lead plaintiffs to control the plaintiffs' attorney. H.R. REP. NO. 104-369, at 33; S. REP. NO. 104-98, at 11; *see also* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2095 (1995) (noting that large institutions did not, until recently, elect to take monitoring roles in private securities class action cases despite having substantial interest in the outcome).

211. Brief of Amici Curiae Faculty at Law and Business Schools in Support of Respondents, *supra* note 128, at 33; Ralph V. De Martino & Jennifer H. Unhoch, U.S. Supreme Court Addresses the Statute of Limitations for Private Federal Securities Fraud Claims 3 (May 24, 2010), http://www.cozen.com/admin/files/publications/sec052110.pdf ("Most jurisdictions recognize the 'first to file' rule when granting class certifications. Plaintiffs' counsel who are the first to file class action complaints tend to be granted the position of lead counsel which allows them to manage the litigation and, therefore, garner the lion's share of any attorneys fees awarded in connection with a judgment or settlement. The authors believe that the incentive to be the 'first to file' will mitigate any concerns regarding plaintiffs unduly delaying commencement of a class action lawsuit.").

212. ELLEN M. RYAN & LAURA E. SIMMONS, CORNERSTONE RESEARCH, SECURITIES CLASS ACTION SETTLEMENTS: 2009 REVIEW AND ANALYSIS 10 (2009), *available at* http://securities.stanford.edu/Settlements/REVIEW_1995-2009/Settlements_Through_12_2009.pdf.

213. *Id.*

214. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1796 (2010). Moreover, for public information, "plaintiffs are presumed to have read prospectuses, quarterly reports, and other information relating to their investments." Alaska Elec. Pension Fund v. Pharmacia Corp., 554 F.3d 342, 347 (3d Cir. 2009) (quoting Mathews v. Kidder, Peabody & Co., Inc., 260 F.3d 239, 252 (3d Cir. 2001)), *cert. denied,* 130 S. Ct. 2401 (2010).

215. CORNERSTONE RESEARCH, *supra* note 134, at 8.

> [b]etween 1996 and 2006, 55 percent of the filings with a lag of more than a year have been dismissed, compared to 42 percent dismissal rate for filings with a lag between one year and six months and 36 percent for filings with a lag of less than six months.[216]

Third, any delay comes at the cost of fading memories, lost documents, and unavailable witnesses to both defendants *and* plaintiffs.[217] What is worse still, the Senate Committee on the Judiciary noted in its report on SOX that "it only takes a few seconds to warm up the shredder," and any delay invites defendants to take steps to conceal their deceit.[218] Plaintiffs have the burden of satisfying the heightened pleading standards of the PSLRA—that they allege all facts with particularity and a strong inference of scienter.[219] Plaintiffs who delay may find themselves without the time needed to satisfy these rigorous demands.[220] Moreover, securities fraud cases are so complex that an expert and a regression analysis of the stock price's reaction are indispensable tools to prosecuting a securities case, so much so that these tools have become intertwined with the substantive law of securities fraud

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216. *Id.*

217. Ochoa & Wistrich, *supra* note 40, at 480 ("Except in special circumstances (such as when a plaintiff relies on an alleged agreement with the defendant), there is no reason to assume that the evidence favorable to the defendant will deteriorate more rapidly than the evidence favorable to the plaintiff.").

218. S. REP. NO. 107-146, at 9 (2002).

219. 15 U.S.C. § 78u-4(b) (2006); *see also* Ochoa & Wistrich, *supra* note 40, at 486 ("[B]ecause the plaintiff usually bears the burden of proof on the majority of issues, ... on balance, deterioration of evidence would hurt the plaintiff more than it would hurt the defendant.").

220. Brief of Amici Curiae Faculty at Law and Business Schools in Support of Respondents, *supra* note 128, at 32; *see also* 15 U.S.C. § 78u-4(b)(2) ("In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."); J. Robert Brown, Jr., The Supreme Court and the Mission to Restrict Investor Protection: *Merck v. Reynolds* (Part 7: The Misguided Notion of Inquiry Notice) (June 23, 2009), http://www. theracetothebottom.org/securities-Issues/the-supreme-court-and-the-mission-to-restrict-investor-prote-8.html ("The two year period ... was designed to provide adequate time to put together a complex case once the facts had become apparent. The discovery of facts supporting fraud didn't necessarily mean that plaintiffs were finished. They still had to determine who was responsible and to put together an adequate case.").

itself.[221] Marshaling this evidence takes time, and plaintiffs are not likely to file first and amend later, which is a risky strategy especially given that the liberal amendment policy seems curtailed in securities litigation.[222]

Two final points: failure to meet the statute of limitations is likely to be malpractice in many situations,[223] and under our proposal, section 10(b) and Rule 10b-5 cases still retain a statute of repose to encourage investors to investigate immediately.[224] A statute of repose limits defendants' liability by limiting the time during which a cause of action can arise.[225] The Supreme Court in *Merck* pointed specifically to the statute of repose to alleviate defendants' fears that a lax statute of limitations would give rise to stale claims or subject them to liability for acts taken long ago.[226]

Not only are there sufficient mechanisms to encourage early filing, but the securities laws and the practical realities of securities litigation also contain many safeguards that prevent fraud by the plaintiffs' attorneys. First, the PSLRA mandated that district courts determine whether the attorneys complied with Rule 11's requirements.[227] Second, the PSLRA's heightened pleading

221. MICHAEL J. KAUFMAN, EXPERT WITNESSES: SECURITIES CASES § 10:1 (2009); Michael J. Kaufman & John M. Wunderlich, *Regressing: The Troubling Dispositive Role of Event Studies in Securities Fraud Litigation*, 15 STANFORD J.L. BUS. & FIN. 183, 186 (2009); *see also* Lisa L. Casey, *Reforming Securities Class Actions from the Bench: Judging Fiduciaries and Fiduciary Judging,* 2003 BYU L. REV. 1239, 1270 (stating that securities class actions typically are more factually and legally complex than individual litigant cases and prosecution of these claims requires greater investments of time and greater outlays of pretrial expenses).

222. *Cf.* Mazza, *supra* note 170, at 1 (arguing for *more* curtailment of the amendment policy in securities litigation). *See generally* Anthony Michael Sabino, *The New Uniform Statute of Limitations for Federal Securities Fraud Actions: Its Evolution, Its Impact, and a Call for Reform,* 19 PEPP. L. REV. 485, 520-21 (1992); John M. Wunderlich, *Amending Pleadings in Securities Fraud Litigation After* Tellabs, 37 SEC. REG. L.J. 361 (2009).

223. 3 RONALD E. MALLEN & JEFFREY M. SMITH, LEGAL MALPRACTICE § 23.3 (2007); SCHWARTZ, *supra* note 35, at 617.

224. 28 U.S.C. § 1658(b).

225. SCHWARTZ, *supra* note 35, at 620. Statutes of repose are premised on the idea "that a time should arrive when a person is no longer responsible for a past act." *Id.*

226. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1797 (2010) ("Merck fears that [requiring that plaintiffs discover scienter to trigger the statute of limitations] will give life to stale claims or subject defendants to liability for acts taken long ago. But Congress' inclusion in the statute of an unqualified bar on actions instituted 5 years after such violation ... giving defendants total repose after five years, should diminish that fear.") (internal quotation marks and citations omitted).

227. *See* 15 U.S.C. § 78u-4(c)(1)-(2) (stating that at the close of adjudication, "the court

standard forces plaintiffs to tip their hand and show what evidence they have to establish a claim.[228] Last, attorneys intuitively seek to avoid the reputation costs that result from fabricating allegations.[229] Reputation influences behavior,[230] and in securities litigation, a highly specialized practice area,[231] an attorney who

shall include in the record specific findings regarding compliance by each party ... with each requirement of Rule 11(b)," and that if the court makes a finding "that a party ... violated any requirement of Rule 11(b), ... the court shall impose sanctions on such party"); FED. R. CIV. P. 11(b) (requiring that attorneys' filings have a proper purpose, be warranted by law, and be based on evidentiary support after a reasonable inquiry); *see also* Marks v. CDW Computer Ctrs., Inc., 122 F.3d 363, 369 (7th Cir. 1997) ("What facts, sufficiently particular to file a claim, could [the plaintiff] have found even if he had started looking at that time? How could he have confirmed or dispelled any suspicions with the materials available to him? Would [the defendant] have had [the plaintiff] risk Rule 11 sanctions or a violation of Rule 9(b) by filing a complaint listing the 'bad blood' or 'storm warnings' and no other particularized evidence of fraud?"). The Model Rules of Professional Conduct also require that a lawyer not bring any proceeding unless there is a basis in fact for doing so. MODEL RULES OF PROF'L CONDUCT R. 3.1 (2010). A lawyer must also be candid with the court and refrain from offering evidence that the lawyer knows is false. *Id.* R. 3.3(a)(1). Moreover, in the event counsel later discovers that this evidence is false, counsel must take certain remedial measures, which may include disclosure to the court if necessary. *Id.*

228. *See* John M. Wunderlich, Note, Tellabs v. Makor Issues & Rights, Ltd.*: The Weighing Game*, 39 LOY. U. CHI. L.J. 613, 622-23 (2008) (discussing how Congress enacted the PSLRA's heightened pleading provision to curb *in terrorem* settlements and abusive practices by plaintiffs' attorneys).

229. HERBERT M. KRITZER, RISKS, REPUTATIONS, AND REWARDS: CONTINGENCY FEE LEGAL PRACTICE IN THE UNITED STATES 220-21, 250-51 (2004) (discussing the role of reputation in contingency fee practice such as large class actions); Fred C. Zacharias, *Effects of Reputation on the Legal Profession,* 65 WASH. & LEE L. REV. 173, 180 (2009) (observing that "adversaries will respond differently to settlement offers and statements made in negotiations, depending on their opponents' reputations for candor and taking reasonable positions"); *see also* Scott R. Peppet, *Lawyers' Bargaining Ethics, Contract, and Collaboration: The End of the Legal Profession and the Beginning of Professional Pluralism*, 90 IOWA L. REV. 475, 485 (2005) (analyzing a potential "reputational solution" to a bargaining problem that would enable parties to signal their willingness to cooperate by hiring an attorney with a reputation for collaboration); Douglas H. Yarn, *Lawyer Ethics in ADR and the Recommendations of Ethics 2000 To Revise the Model Rules of Professional Conduct: Considerations for Adoption and State Application*, 54 ARK. L. REV. 207, 270 n.269 (2001) (arguing that a lawyer's reputation for truthfulness and fairness increases that lawyer's effectiveness as a negotiator in future negotiations).

230. Corporations recognize the intrinsic value of reputation as evidenced from the presence of in-house public relations departments. Pub. Relations Consultants Ass'n, http://www.prca.org.uk/Whatispr (last visited Feb. 18, 2011) ("Public relations is all about reputation.").

231. *See, e.g.*, Posting of Mae Kuykendall to The Conglomerate, http://www.theconglomerate.org/2010/04/corporate-and-securities-anomalies-fictions-and-inconvenient-truths-.html (Apr. 12, 2010); Kevin LaCroix, The Future of the Plaintiffs' Securities Bar?, The D&O Diary (Nov. 6, 2008), http://www.dandodiary.com/2008/11/articles/plaintiffs-

fabricates allegations would develop a reputation for dishonesty among other attorneys, institutional investors and other potential plaintiffs, and the courts, all of which makes future representation difficult.[232] Moreover, a consequence of a practice area with highly sophisticated attorneys representing victims in a discovery rule jurisdiction is that lawyers promptly file, knowing that the safest course of action is to file suit as soon as possible.[233]

2. The Discovery of Merited Section 10(b) and Rule 10b-5 Claims

The discovery provision in the statute of limitations purports to penalize securities fraud plaintiffs who sit on their rights and wait to file suit.[234] But this justification assumes that plaintiff-investors were aware of the fraud and their attorneys intentionally waited to file suit. This assumption is misguided. It is more likely that plaintiffs did not know about the fraud, rather than that they sat on their hands with the information.[235]

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bar/the-future-of-the-plaintiffs-securities-bar. After the PSLRA, smaller plaintiffs' firms left the private class action arena. Denis T. Rice, *A Practitioner's View of the Private Securities Litigation Reform Act of 1995,* 31 U.S.F. L. REV. 283, 285 (1997).

232. KRITZER, *supra* note 229, at 220 (discussing the role of reputation in contingency fee practice such as large class actions).

233. *See* Michael D. Green, *The Paradox of Statutes of Limitations in Toxic Substances Litigation*, 76 CAL. L. REV. 965, 984-85 (1988) ("One consequence of a sophisticated bar that represents substantial numbers of victims in discovery rule jurisdictions is that lawyers run—rather than walk—directly to the courthouse with any client who manifests the slightest indication of insidious disease. Regardless of whether the client has suffered any disability or pecuniary loss, the attorney knows the safest course of action is filing a suit as promptly as possible.").

234. *E.g.*, Betz v. Trainer Wortham & Co., 519 F.3d 863, 868 (9th Cir. 2008) (Kozinski, C.J., dissenting from the denial to rehear the case en banc), *vacated*, 130 S. Ct. 2400 (2010); New Eng. Health Care Employees Pension Fund v. Ernst & Young, L.L.P., 336 F.3d 495, 499-500 (6th Cir. 2003); Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997); Nerman v. Alexander Grant & Co., 926 F.2d 717, 721 (8th Cir. 1991) ("Perhaps it was reasonable for the plaintiffs to take a 'wait and see' approach. But that election did not toll the statute of limitations. That is precisely the point of the statute of limitations: the plaintiffs had five years to 'wait and see,' and to decide whether to sue for fraud or live with the less-than-promised deal.").

235. *See* Malveaux, *supra* note 202, at 118 ("Statutes of limitations are also a poor deterrent of plaintiff misconduct where the plaintiff is unaware of her potential claim."). People are often prone to the "planning fallacy"—a systemic tendency toward unrealistic optimism about the time it takes to complete projects. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 7 (2008);

First, securities fraud, by its nature, is secretive; it is concealment of the truth.[236] Justice Kennedy observed in *Lampf* that

> [t]he real burden on most investors ... is the initial matter of discovering whether a violation of the securities laws occurred at all. This is particularly the case for victims of the classic fraud-like case that often arises under § 10(b).... The most extensive and corrupt schemes may not be discovered within the time allowed for bringing an express cause of action under the 1934 Act.[237]

Enron's fraud, for example, announced in 2001, traced back to 1997.[238] And securities fraud is often uncovered through an unconventional investigation or happenstance. The financial crisis exposed Bernard Madoff's massive Ponzi scheme.[239] Also, a recent study found that securities fraud is uncovered by employees, nonfinancial-market regulators, and the media more often than traditional watchdogs such as the SEC, auditors, analysts, or bond or equity holders.[240] This outcome is somewhat expected because

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Andrew J. Wistrich, *Procrastination, Deadlines, and Statutes of Limitations*, 50 WM. & MARY L. REV. 607, 621 (2008). This fallacy is more pronounced for longer tasks than shorter ones, such as preparing a complicated lawsuit. This fallacy suggests that plaintiffs will underestimate the duration of the task of filing a lawsuit, misschedule their time, and miss the deadline. Wistrich, *supra* at 625-26.

236. One needs only to consult the laundry list of different types of fraud to see the myriad ways defrauders deceive the investing public. *See generally* M. Owen Donley III, *A (Very Brief) Encyclopedia of Securities Fraud*, 16 BUS. L. TODAY 35 (2007).

237. Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 377 (1991) (Kennedy, J., dissenting).

238. *Accounting Reform and Investor Protection: Hearings Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. 1 (2002) (statement of Sen. Paul Sarbanes, Chairman, S. Comm. on Banking, Housing, and Urban Affairs).

239. RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 221-22 (2009) ("The receding stock market tide exposed Bernard Madoff, who is said to have confessed to having pulled off the biggest Ponzi scheme in history. The scheme would have lasted longer and the losses to investors would have been greater had the stock market crash been postponed. The crash reduced the value of Madoff's hedge fund, but more important (because the fund probably had little in the way of assets), the general economic collapse caused requests for redemptions of investments in hedge funds and other investment funds to soar, and Madoff could not honor his investors' requests for redemption and as a result his scheme collapsed.").

240. *See generally* Alexander Dyck et al., *Who Blows the Whistle on Corporate Fraud?* (Univ. of Chi. Booth Sch. of Bus., Research Paper No. 08-22, 2008), *available at* http://ssrn.com/abstract=891482.

increasing investment options and an increased holding of diversified portfolios has made sifting through the incredible amount of information companies pour out daily difficult.[241]

Second, meritorious securities fraud claims still must allege a "strong inference" of scienter with sufficient particularity,[242] and crafting this kind of allegation takes time. Discovery of scienter is particularly difficult because the standard for determining scienter is less than clear.[243] Scholars disagree whether a corporation is a collective of persons, whose mental state can be inferred from those persons,[244] or whether the corporation has an independent existence and culture separate from its individual employees with a state of

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241. Amicus Curiae Brief of the Council of Institutional Investors in Support of Respondents at 7, Merck & Co. v. Reynolds, 130 S. Ct. 1784 (2010) (No. 08-905), 2009 WL 3477292 ("Companies introduce numerous types of information into the marketplace on a daily basis. Each company alone may make more than ten filings per year with the SEC, not counting restatements. Additionally, companies regularly file press releases, maintain websites containing company information, news, and events, and, in the case of pharmaceutical companies, conduct studies regarding their existing products, as well as those still in development, and release reports of the results.").

242. 15 U.S.C. § 78u-4(b) (2006).

243. The Ninth Circuit aptly explained the problem:

> The PSLRA requires a plaintiff to plead a complaint of securities fraud with an unprecedented degree of specificity and detail "giving rise to a strong inference of deliberate recklessness." This is not an easy standard to comply with—it was not intended to be—and plaintiffs must be held to it. But how much detail is *enough* detail? When is an inference of deliberate recklessness *sufficiently* strong? There is no bright-line rule. Sometimes it is easy to tell, but often it is not. The acid test is a motion to dismiss. We need to bear in mind that we are not operating in the world of notice pleadings. In this technical and demanding corner of the law, the drafting of a cognizable complaint can be a matter of trial and error.

Eminence Capital, L.L.C. v. Aspeon, Inc., 316 F.3d 1048, 1052 (9th Cir. 2003) (per curiam) (internal citations omitted). Also, consider the questions posed by Professors Abril and Olazábal:

> Does [corporate scienter] reside in the mind of the ... CEO? In the mind of the chief financial officer who prepared the report ...? In the minds of the regional sales managers, some of whom falsified numbers included in the fraudulent report? In the minds of the hundreds of rank and file employees who bought into the aggressive culture of meeting Wall Street's financial performance targets at any and all costs?

Patricia S. Abril & Ann Morales Olazábal, *The Locus of Corporate Scienter,* 2006 COLUM. BUS. L. REV. 81, 83; *see also* Mauro, *supra* note 144 (quoting David Frederick of Kellogg, Huber, Hansen, Todd, Evans & Figel, who argued and won the case for Merck shareholders, as stating that *Merck* is especially significant because scienter is "usually the hardest part of the securities fraud to find out about").

244. Eric Colvin, *Corporate Personality and Criminal Liability*, 6 CRIM. L.F. 1, 1-2 (1995).

mind all its own.[245] At the individual level, "because of [the] limitations on mind reading," state of mind must be inferred from conduct rather than determined directly.[246] The federal appellate courts have adopted different tests to allege scienter, adding further confusion to the mix.[247] *Tellabs* held that a "strong inference" of scienter depends on a balancing of both culpable and nonculpable inferences of scienter—a weighing of competing probabilities.[248] There is no clear test for scienter; the outcome of this weighing is subject to the district judge.[249]

Further, the PSLRA requires that all allegations be alleged "with particularity,"[250] without the benefit of discovery.[251] Professor Charles W. Murdock highlights four ways plaintiff-investors can acquire information this detailed:

> (1) the board of directors commissions a special study ... (2) the company goes into bankruptcy and the bankruptcy court orders a special study; (3) the accountants decide to restate the company's financials; or (4) the plaintiff locates an informant from within the company who has knowledge of the relevant facts.[252]

245. Abril & Olazábal, *supra* note 243, at 104-05.

246. *See, e.g.*, United States v. Gonzalez, 608 F.3d 1001, 1007 (7th Cir. 2010).

247. *Compare* Novak v. Kasaks, 216 F.3d 300, 307, 311 (2d Cir. 2000) (stating that securities fraud plaintiffs may allege a "strong inference" of scienter by alleging either: (1) facts to show the defendant had both motive and opportunity to commit fraud, or (2) facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness), *with In re* Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 979 (9th Cir. 1999) (stating that securities fraud plaintiffs may allege a "strong inference" of scienter by alleging actual knowledge or recklessness), *and Tellabs I*, 437 F.3d 588, 601 (7th Cir. 2006) (stating that courts engage in a holistic evaluation to determine whether securities fraud plaintiffs alleged a "strong inference" of scienter).

248. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 323-24 (2007) ("The strength of an inference cannot be decided in a vacuum. The inquiry is inherently comparative: How likely is it that one conclusion as compared to others, follows from the underlying facts? To determine whether the plaintiff has alleged facts that give rise to the requisite 'strong inference' of scienter, a court must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff.").

249. *See* Allan Horwich & Sean Siekkinen, *Pleading Reform or Unconstitutional Encroachment? An Analysis of the Seventh Amendment Implications of the Private Securities Litigation Reform Act*, 35 SEC. REG. L.J. 4, 7 (2007); Suja A. Thomas, *Why the Motion to Dismiss is Now Unconstitutional*, 92 MINN. L. REV. 1851, 1890 (2008).

250. 15 U.S.C. § 78u-4(b) (2006).

251. *Id.* § 78u-4(b)(3)(b).

252. Murdock, *supra* note 94, at 831-32; *see also* Richard Casey & Jared Fields, *Piggybacking Through the Pleading Standards: Reliance on Third-Party Investigative*

But each path proves difficult for plaintiffs. First, both the board of directors—even when comprised of "independent" directors—and the company's auditors and analysts are uniquely susceptible to capture,[253] and they are often likewise named as defendants in the securities fraud complaint.[254] Second, although materials prepared in the context of a company's bankruptcy—for example, reports by the bankruptcy examiner, depositions, or other discovery—may provide a wealth of detailed information, courts refuse to grant plaintiffs access to this information because it would circumvent the PSLRA's discovery stay and turn bankruptcy materials into tools that fuel litigation.[255] And if the bankruptcy case is handled

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Materials To Satisfy Particularity Requirements in Securities Class Actions, 7 SEC. LITIG. REP. 11 (2010) (discussing how securities fraud plaintiffs use information disclosed in federal enforcement actions, bankruptcy examiner reports, confidential sources, or other public sources to plead sufficient facts).

253. *See* MACEY, *supra* note 71, at 64 ("[I]t is virtually impossible to identify, much less to monitor and control, the myriad ways that board independence can be compromised."); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1418 (2002) ("[T]he audit firm always knew that the individual audit partner serving the large client could become conflicted because the audit partner's job depended on satisfying its single client; but, the audit firm also knew that it could monitor its individual audit partners to manage this conflict. For a long time, monitoring seemingly worked—at least passably well. More recently, incentive-based compensation has exacerbated the monitoring problem, and similarly the evolution of the auditing firm into a financial conglomerate has seriously compromised old systems of internal control."); George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 143-44 (2010) ("CEOs always influence, and often dominate, the selection of outside directors.... CEOs also control the information received by outside directors. The CEO can curry their favor in various ways and can threaten to remove uncooperative members. The CEO (who is almost always a director) and her allies on the board can seize the board's initiative, and 'groupthink' discourages anyone inclined to oppose them. Further efforts to ensure board independence are probably doomed to failure because of the boards' 'unique susceptibility to capture by the managers they are supposed to monitor.'"); Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1169 (2003) ("[T]he balance of power between accounting firms and their clients has shifted dangerously away from the equilibrium imbedded in the market model and back in the direction of the companies the accounting firms are supposed to monitor. This change threatens to undermine the investing public's basic faith in the quality of financial reporting. If investors think that there is a risk the books do not reflect the nature of the companies' businesses and the risks associated with the investment, they will not invest in companies.").

254. Parties not employed by the issuing firm are commonly referred to in securities fraud cases as "secondary actors," which included the company's lawyers, accountants, and auditors, among others. Pac. Inv. Mgmt. Co. v. Mayer Brown L.L.P., 603 F.3d 144, 148 n.1 (2d Cir. 2010).

255. *See* John M. Wunderlich, *Bankruptcy's Protection for Non-Debtors From Securities*

poorly, as it was for Enron, plaintiffs may not be able to wait for a bankruptcy examiner's report.[256] Third, the publication of a financial restatement, without more, is not enough to create a strong inference of scienter.[257] And fourth, practical difficulties aside,[258] the viability of pleading securities fraud claims with allegations from confidential informants has been severely undermined since *Tellabs*.[259]

Barring a securities fraud claim premised on the assumption that the plaintiffs discovered or should have discovered the fraud much earlier belies the realities of securities litigation. Plaintiffs with even the most merited claim must still "thread the eye of a needle

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Fraud Suits, 15 FORDHAM J. CORP. & FIN. L. (forthcoming 2011); *see also In re* Refco, Inc. Sec. Litig., No. 05 Civ. 8626(GEL), 2006 WL 2337212, at *1-2 (S.D.N.Y. Aug. 8, 2006) (denying securities fraud plaintiffs' motion to lift stay of discovery to obtain SEC investigation materials and bankruptcy examiner's report to amend complaint because plaintiffs had not shown undue prejudice); *In re* Recoton, Corp., 307 B.R. 751, 756 (Bankr. S.D.N.Y. 2004) (allowing securities fraud plaintiffs access to bankruptcy materials because discovery would be subject to a protective order "prohibiting its use for any purpose whatsoever other than in connection with this bankruptcy proceeding and prohibiting its disclosure ... to the plaintiffs in the [securities class action]"); *In re* Baldwin United Corp., 46 B.R. 314, 316-17 (Bankr. S.D. Ohio 1985) (stating that the bankruptcy examiner's report should not "fuel the ... fires" of further securities litigation).

256. LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 151 (2005) ("Enron and the other parties who wished to sue on Enron's behalf had only two years in which to file their cases or be barred by the statute of limitations. Because the case was handled so awkwardly, nearly six months passed before the examiner was even appointed. The effect was to rush the investigation. The examiner worked quickly but was still completing his report when the deadline expired. That left parties who discovered their causes of action through the examiner's work little or no time in which to digest the 4,500-page report, retain counsel, and prepare their lawsuits for filing.").

257. *See, e.g.*, Zucco Partners, L.L.C. v. Digimarc Corp., 552 F.3d 981, 1000 (9th Cir. 2009); *see also In re* Thornburg Mortg., Inc. Sec. Litig., 695 F. Supp. 2d 1165, 1202-03 (D.N.M. 2010); Stocke v. Shuffle Master, Inc., 615 F. Supp. 2d 1180, 1191 (D. Nev. 2009).

258. Casey & Fields, *supra* note 252, at 11 ("Few individuals who know the facts relating to alleged securities fraud are inclined to cooperate with plaintiffs' attorneys. Moreover, prospective [confidential witnesses] may be limited by confidentiality agreements or, in the case of accountants, professional obligations.").

259. *See* Jordan Eth & Timothy Blakely, *The Use and Abuse of Confidential Witnesses: The Battle Continues After* Tellabs, *in* SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2009, at 607 (PLI Corp. Law and Practice Course Handbook Series No. B-1762, 2009); Lyle Roberts, *Pleading in the Dark: The Use (and Potential Abuse) of Confidential Witness Statements in Federal Securities Fraud Complaints*, *in* SECURITIES LITIGATION & ENFORCEMENT INSTITUTE 2009, *supra* at 153; *see also* Kaufman & Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants*, *supra* note 157; Kaufman & Wunderlich, *Congress, the Supreme Court, and the Proper Role of Confidential Informants*, *supra* note 157.

made smaller and smaller over the years by judicial decree and congressional action."[260] It takes time to craft a complaint and complete an investigation without discovery that will surpass these hurdles.

3. The Discovery Provision's Increased Costs Associated with Securities Litigation

Another justification for the statute of limitations in general is that it reduces the volume of litigation.[261] Reducing the volume of frivolous securities litigation has been an imperative of Congress as of late.[262] But the incorporation of the discovery provision actually thwarts this aim and increases the costs associated with litigating these already colossal claims.

The statute of limitations does not prevent a securities lawsuit from being filed; rather it reduces the incentive to do so by providing defendants with a defense.[263] "The effectiveness of this defense in reducing the number of untimely filings depends on the plaintiff's assessment of the futility of pursuing the claim, which in turn depends on both the certainty and the severity of the sanction."[264] But *Merck*'s discovery standard introduces uncertainty with the application of the statute of limitations. First, *Merck* has incorporated the pliable concept of constructive discovery,[265] which expands the scope of legitimate disagreement over an issue unrelated to the merits, making it less certain that the claim is barred.[266] Additionally, *Merck* requires that plaintiffs have, or should have, discovered evidence of scienter,[267] which is a highly contextualized inquiry that is often proved with circumstantial

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260. Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) (per curiam).

261. Ochoa & Wistrich, *supra* note 40, at 495.

262. *See* H.R. REP. NO. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 (stating that Congress intended to end "the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action").

263. Ochoa & Wistrich, *supra* note 40, at 495.

264. *Id.*

265. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1796 (2010).

266. *See* Green, *supra* note 233, at 983.

267. *Merck*, 130 S. Ct. at 1796.

evidence,[268] making it even less certain that the claim is barred.[269] Second, *Merck*'s constructive discovery standard just compounds a problem already existent with sanctions for statute of limitations in general: although threatened by the loss of the claim to a successful statute of limitations defense, Rule 11 sanctions are not warranted for filing a complaint past the statute of limitations.[270] Because the statute of limitations is an affirmative defense[271] that can be waived if not raised,[272] one court has held that a claim filed after the limitation period has expired cannot be considered a frivolous claim.[273] Sanctions would also be less appropriate in securities litigation because to conclude that the statute was triggered, the court must find evidence of securities fraud.[274] Thus, a court would impose Rule 11 sanctions against plaintiffs where the court found evidence of securities fraud, which is incoherent.

"Another consideration is that, given the complexity of existing limitation rules and the manner in which they have evolved, it has become increasingly difficult to dispose of time-barred claims as a threshold or preliminary matter (that is, by demurrer or summary judgment) rather than at trial."[275] Before *Merck*, the federal appellate courts, using the inquiry-notice standard, readily stated that

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268. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 390 n.30 (1983); *see also Merck*, 130 S. Ct. at 1797 ("Where § 10(b) is at issue, however, the relation of factual falsity and state of mind is more context specific.").

269. *See* Ochoa & Wistrich, *supra* note 40, at 496 ("[T]he only cost to the plaintiff is the time, energy and money expended in pursuing a possibly untimely claim. These costs can be substantial, but if the plaintiff is represented on a contingent fee basis, the financial burden may be minimal.").

270. Rule 11 sanctions here are distinguishable from Rule 11 sanctions discussed in Part III.A.2, where sanctions would be appropriate if the plaintiff filed a claim without sufficient evidence of scienter—a necessary element of Rule 10b-5—and thus conceded that he did not file in good faith. *See supra* notes 185-94 and accompanying text. But here, Rule 11 sanctions are not appropriate because the plaintiff would have acted in good faith, but erroneously predicted how the court would weigh culpable inferences.

271. *E.g.*, Ma v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 597 F.3d 84, 88 n.4 (2d Cir. 2010); Tello v. Dean Witter Reynolds, Inc., 494 F.3d 956, 974 (11th Cir. 2007); Johnson v. Aljian, 490 F.3d 778, 781 n.13 (9th Cir. 2007).

272. *See, e.g.*, United States v. Hickey, 580 F.3d 922, 928 n.1 (9th Cir. 2009), *cert. denied,* 130 S. Ct. 2115 (2010).

273. Currie v. Schon, 704 F. Supp. 698, 702 (E.D. La. 1989).

274. *See In re* Merck & Co. Sec., Derivative & ERISA Litig., 543 F.3d 150, 172 n.16 (3d Cir. 2008) (commenting on the absurdity of the dissent's conclusion that there were actionable misrepresentations that *barred* litigation).

275. Ochoa & Wistrich, *supra* note 40, at 496.

whether discovery of facts constituting the violation should be imputed to plaintiffs is a fact-intensive inquiry, typically left for a jury.[276] There is no reason why the constructive discovery standard set forth in *Merck* should be any less so:

> The facts constituting such 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.[277]

This increases the plaintiffs' chance of recovery and increases the time and resources the judiciary must spend to determine the timeliness of these claims.[278] To make matters worse, this determination expends resources that in no way contribute to merits resolution—it is a pure procedural cost.[279] *Merck*, though, has incorporated scienter, which the Supreme Court has encouraged resolving at the Rule 12(b)(6) motion to dismiss stage,[280] and this *may* encourage courts to resolve this issue when considering motions to dismiss.

Last, increasing procedural barriers to securities fraud actions "may contribute to rising securities litigation costs and rising settlement values."[281] Imposing procedural costs on plaintiffs in

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276. *E.g.*, Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 235 (5th Cir. 2009) (per curiam); *Tello*, 410 F.3d at 977 & n.2; Lentell v. Merrill Lynch & Co., 396 F.3d 161, 169 (2d Cir. 2005); La Grasta v. First Union Sec. Inc., 358 F.3d 840, 848 (11th Cir. 2004); Young v. Lepone, 305 F.3d 1, 9 (1st Cir. 2002); Marks v. CDW Computer Ctrs., Inc., 122 F.3d 363, 368-69 (7th Cir. 1997).

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

278. Ochoa & Wistrich, *supra* note 40, at 496.

279. *See* Green, *supra* note 233, at 983-84.

280. District courts have to conduct a mini-trial at the motion to dismiss stage, weighing inferences for and against the plaintiff, and must resolve whether, on balance, the plaintiffs' allegations gave rise to scienter. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 322-23 (2007); *see also In re* ProQuest Sec. Litig., 527 F. Supp. 2d 728, 746 (E.D. Mich. 2007) ("The analysis required [by *Tellabs*], particularly with respect to pleading scienter, is akin to holding a mini-trial on the merits of the case based only on the complaint. This poses a great difficulty in resolving a motion to dismiss and letting the case go forward.").

281. Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J.L. REFORM 323, 380-81 (2010) [hereinafter Kaufman & Wunderlich, *Class Certification Merits Trials*]; Wunderlich, *supra* note 228, at 663.

response to erroneously perceived abuses—in this case, the misperception that the discovery provision encourages prompt filing, prevents fraud by plaintiffs, and conserves expenses for defending time-barred claims—does not stop plaintiffs from bringing suit; rather plaintiffs compensate for the increased risk of dismissal by bringing claims with higher damages.[282] Discovery costs and other pre-trial costs then rise to meet the rising level of claimed damages as these costs are proportional to the size of the claim.[283] Therefore, the statute of limitations, as it is a procedural cost with no corresponding benefit, exacerbates the costs of litigation and settlement rather than curbs them.

IV. MARKET FUNCTIONS, BEHAVIORAL ECONOMICS, AND THE CASE FOR RETAINING REPOSE FOR SECURITIES FRAUD ACTIONS

The bulk of scholarship that focuses on reforming various statutes of limitations advocates abolishing the limitation period entirely.[284] We agree with the general critique that these scholars level at statutes of limitations, but securities litigation presents a unique problem that justifies some measure of repose. Thus, we argue that a statute of limitations that accrues upon discovery should be abolished for section 10(b) and Rule 10b-5 claims, but repose should be retained.

As shown by *Merck*, even a pro-plaintiff interpretation of the discovery provision in the statute of limitations impedes meritorious cases.[285] The cost incurred by the discovery provision comes with no related benefit. Securities litigants already have significant incentive to investigate and file promptly.[286] The discovery provision rests on the erroneous assumption that plaintiffs are sitting on their hands with already discovered claims, but this

282. Kaufman & Wunderlich, *Class Certification Merits Trials*, *supra* note 281, at 380-81; Wunderlich, *supra* note 228, at 663.

283. Kaufman & Wunderlich, *Class Certification Merits Trials*, *supra* note 281, at 380-81; Wunderlich, *supra* note 228, at 663; *see also* Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 417-20 (1973) (describing the factors that come into settlement).

284. *See supra* Part III.A (discussing various scholars' approaches to reforming statutes of limitations).

285. *See supra* Part III.A.

286. *See supra* Part III.B.1.

ignores the myriad hurdles plaintiffs face in securities litigation even before discovery.[287] Rather, the discovery provision merely increases procedural costs for the parties and the judicial system.[288] Nevertheless, contrary to existing scholarship, securities fraud needs repose. Part IV.A justifies repose from securities fraud due to insights from behavioral economics and because of the impact securities fraud litigation has on the settled economic expectations of nonculpable economic actors. Part IV.B then addresses the question that follows from this argument: assuming repose is justified, what should it look like?

A. Loss Aversion and Nonculpable Market Participants

Some scholars have advocated for discarding the statute of limitations and repose completely.[289] Other scholars propose abolishing limitations periods but offer alternatives to extract a "price" for delayed filing. For example, Judge Wistrich proposes an "incremental approach" that "penalize[s] plaintiffs for delay in filing by gradually decreasing the value of their claims."[290] Professors Ehud Guttel and Michael T. Novick have proposed jettisoning the all-or-nothing structure of statutes of limitation and instead "extract[ing] a price that compensates the defendant for his evidentiary loss. This price consists of the total damages claimed by the plaintiff, discounted by the probabilistic value of the lost evidence."[291]

These proposals have promise and may be justified in other contexts, but repose is needed for securities fraud litigation. Congress has already expressed its desire that liability for securi-

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287. *See supra* Part III.B.2.

288. *See supra* Part III.B.3.

289. *See* Green, *supra* note 233 (proposing abolishing the statute of limitations in toxic tort litigation); Malveaux, *supra* note 202 (proposing abolishing the statute of limitations in reparations litigation); Eli J. Richardson, *Eliminating the Limitations of Limitations Law*, 29 ARIZ. ST. L.J. 1015 (1997) (arguing that all statutes of limitations should be abolished).

290. Wistrich, *supra* note 235, at 643.

291. Ehud Guttel & Michael T. Novick, *A New Approach to Old Cases: Reconsidering Statutes of Limitation*, 54 U. TORONTO L.J. 129, 132-33 (2004); *see also* Justin Hughes, *Fair Use Across Time*, 50 UCLA L. REV. 775 (2003) (arguing that courts should adjust the scope of copyright protection to account for the passage of time by expressly considering time as a factor in fair use analysis); Joseph P. Liu, *Copyright and Time: A Proposal*, 101 MICH. L. REV. 409 (2002) (advancing a similar proposal).

ties fraud ends *at some point*.[292] Repose, although draconian in result, is justified by the phenomenon of loss aversion and the impact securities litigation has on other market participants.[293]

First, the concept of loss aversion as explained in behavioral economics means that persons are more motivated by the prospect of a loss than by a gain.[294] "The subjective utility of losing a good exceeds that of gaining it."[295] Thus, "we would have to reward plaintiffs for filing on time by doubling or tripling the value of their claims merely to achieve the same effect that we presently achieve by extinguishing the value of their claims."[296] In securities litigation, where damages are already bemoaned as excessive,[297] tripling the value of the plaintiffs' claim would impose exorbitant costs. Furthermore, when Congress enacted the PSLRA, it specifically removed securities fraud as a RICO predicate and thus eliminated securities fraud plaintiffs' ability to recover triple their damages.[298] Accepting the premises that people are loss averse and that Congress has already eschewed a regulatory scheme that triples plaintiffs' reward for bringing a securities fraud claim, barring securities fraud actions after a set time will both incentivize prompt filing and remain consistent with Congress's intent.

Second, repose protects settled economic expectations of not just the defendant, but a multitude of economic actors.[299] Repose protects nonculpable market players such as investors, employees, and

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292. *E.g.*, 15 U.S.C. §§ 77m, 78i(e), 78r(c), 78cc(b) (2006); 28 U.S.C. § 1658(b).

293. *See* Wistrich, *supra* note 235, at 619-20.

294. THALER & SUNSTEIN, *supra* note 235, at 33; Nava Ashraf et al., *Adam Smith, Behavioral Economist*, *in* EXOTIC PREFERENCES: BEHAVIORAL ECONOMICS AND HUMAN MOTIVATION 87, 90-91 (2007); Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, *in* CHOICES, VALUES, AND FRAMES 143, 150 (Daniel Kahneman & Amos Tversky eds., 2008).

295. Edward J. McCaffery, Daniel Kahneman & Matthew L. Spitzer, *Framing the Jury: Cognitive Perspective on Pain and Suffering Awards*, *in* BEHAVIORAL LAW AND ECONOMICS 259, 261 (Cass Sunstein ed., 2000).

296. Wistrich, *supra* note 235, at 620.

297. *E.g.*, Brief for Chamber of Commerce of United States of America as Amicus Curiae Supporting Petitioners at 29-37, Merck & Co. v. Reynolds, 130 S. Ct. 1784 (2010) (No. 08-905), 2009 WL 2564718; *see also* Alicia Davis Evans, *The Investor Compensation Fund*, 33 J. CORP. L. 223, 240 (2007).

298. *See* 18 U.S.C. § 1964(c) (2006); *see also* S. REP. NO. 104-98, at 19 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 698-99.

299. Ochoa & Wistrich, *supra* note 40, at 464-66.

lenders, to name a few. Professor Ochoa and Judge Wistrich capture the essence of this argument:

> [S]uppose a corporation markets a drug that is discovered twenty years later to have caused harmful, long-term side effects. Suppose further that the corporation would be bankrupted by the resulting liability. There is no denying the legitimacy of the victim's claims for compensation. On the other hand, during those twenty years, thousands of people may have invested in the corporation, hundreds of people may have accepted jobs with it, dozens of lenders may have extended credit to it, and scores of firms may have entered business partnerships with it. As a result of the corporation's liability, those investments may be forfeited, those jobs may be lost, those loans may not be repaid, and those business partnerships may collapse. While there may be justice in the destruction of the corporate defendant, as time passes, the investors, employees, lenders, and business partners acquire reliance interests that may be disrupted by, and that must be weighed against, the victims' claims to compensation.[300]

This concern is more apparent in securities fraud where scholars suggest that the costs of securities class actions—both the settlement and the litigation expenses of both sides—fall largely on the defendant corporation, and so its shareholders ultimately bear these costs indirectly.[301] This "circularity" problem, though, occurs only at the margins—most of the class recovery does not come from the class members themselves.[302]

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300. *Id.* at 467-68; *see also* Holmes, *supra* note 1, at 477 ("[T]he foundation of the acquisition of rights by lapse of time is to be looked for in the position of the person who gains them, not in that of the loser."); Malveaux, *supra* note 202, at 76 (recognizing that companies benefit greatly from the knowledge that they are immune from suit and can engage in commercial transactions unencumbered by the risk of litigation).

301. Coffee, *supra* note 205, at 1536; James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 509-11 (1997). Judge Jed Rakoff recently rejected Bank of America's settlement with the SEC, observing that "[i]t is not fair, first and foremost, because it does not comport with the most elementary notions of justice and morality, in that it proposes that the shareholders who were the victims of the Bank's alleged misconduct now pay the penalty for that misconduct." SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 509 (S.D.N.Y. 2009).

302. Cox, *supra* note 301, at 509. Professor James Cox has explained,

> The question of entity liability is not ... limited to securities law violations and there seems little reason to so isolate the debate of the propriety of entity

B. Event-Accrual and the Five-Year Statute of Repose

Assuming that repose is necessary, but a statute of limitations that is triggered upon discovery should be abolished, what should the limitations period for securities fraud look like? Part IV.B proposes a five-year limitations period that accrues upon the happening of the fraud.

To begin, we acknowledge that any cut-off date will be arbitrary,[303] but also note that Congress has already expressed a value judgment that repose for section 10(b) and Rule 10b-5 is appropriate after either two years or five years.[304] So we accept these periods as a starting point. Further, there are already settled expectations that, at the latest, no liability attaches after five years in Congress's plan. This is important because adherence to the five-year period does not *increase* the risk that defendants will take strategic advantage of this absolute bar to liability. Thus, Congress should retain only the longer five-year statute of repose that is triggered upon the happening of the fraud (event-accrual).

The five-year period is also preferable to the two-year period as it provides plaintiffs the necessary time to discover the claim and

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> liability to securities violations. Managerial misbehavior ... is a portion of the risk that accompanies ownership. It is a risk internalized through the concept of entity liability.
>
> The financial burdens of a securities fraud settlement borne by the innocent stockholders of the corporate violator is indistinguishable from the burden borne by the shareholders of the corporation that produces a defective product or violates the environmental laws. Being a burden of ownership, it is inherent in the feature of enterprise liability that the enterprise internalize the costs of its activities.

Id. at 511.

303. *E.g.*, Johnson v. Ry. Express Agency, Inc., 421 U.S. 454, 463-64 (1975) ("Although any statute of limitations is necessarily arbitrary, the length of the period allowed for instituting suit inevitably reflects a value judgment concerning the point at which the interests in favor of protecting valid claims are outweighed by the interests in prohibiting the prosecution of stale ones."); Tioga R.R. v. Blossburg & Corning R.R., 87 U.S. 137, 150 (1873) (Hunt, J., concurring) ("Statutes of limitation are in their nature arbitrary. They rest upon no other foundation than the judgment of a State as to what will promote the interests of its citizens. Each determines such limits and imposes such restraints as it thinks proper."); Lantz v. Comm'r, 607 F.3d 479, 482 (7th Cir. 2010) ("They borrow an existing statute of limitations rather than create one because 'the length of a limitations period is arbitrary—you can't reason your way to it—and courts are supposed not to be arbitrary; when they are, they get criticized for it.'") (quoting Hemmings v. Barian, 822 F.2d 688, 689 (7th Cir. 1987)).

304. *See* 28 U.S.C. § 1658(b) (2006).

develop the complaint.[305] Resolving securities fraud claims on their merits, as opposed to procedural grounds, is consistent with the purpose of the judiciary to resolve disputes based on substantive law. It comports with notions of fairness and due process, and preserves the dignitary value of the judiciary by affording an aggrieved person a right to be heard.[306] Additionally, a longer period of liability furthers the enforcement of the securities laws, which in particular depends on private attorneys general for holistic enforcement.[307] As Professor Ochoa and Judge Wistrich observe, the loss of a valid claim because of the statute of limitations results in underenforcement of the substantive law.[308] Adopting a longer limitations

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305. *See supra* Part III.B.2; *see also* Yair Listokin, *Efficient Time Bars: A New Rationale for the Existence of Statutes of Limitations in Criminal Law*, 31 J. LEGAL STUD. 99, 115 (2002) ("The 'continuing conspiracy' doctrine ... offers an example of a case where the statute of limitations should be extended ('tolled'). When overt (but otherwise legal) acts associated with an earlier conspiracy are committed, they cause harm in addition to the harm caused by the original conspiracy. As a result, they should be deterred. Extending the statute of limitations for the original conspiracy is one way of deterring these later harmful actions, even if the extended statute of limitations adds little to deterrence of the original crime."); Thomas J. Miceli, *Deterrence, Litigation Costs, and the Statute of Limitations for Tort Suits,* 20 INT'L REV. L. & ECON. 383, 393 (2000) ("[T]he optimal statute length appears to be longer under a negligence rule as compared to a strict liability rule. The reason is that, when the statute is lengthened, it increases incentives for care (deterrence), thereby making it harder for plaintiffs to prove negligence at trial. Thus, fewer cases are filed at any point in time, which lowers expected litigation costs. Since this benefit partially offsets the extra litigation costs incurred by lengthening the statute, the optimal statute is longer.").

306. Ochoa & Wistrich, *supra* note 40, at 501-03. Professor Owen Fiss, making an argument against settlement, observes that

> adjudication uses public resources, and employs ... public officials chosen by a process in which the public participates. These officials, like members of the legislative and executive branches, possess a power that has been defined and conferred by public law, not by private agreement. Their job is not to maximize the ends of private parties, nor simply to secure the peace, but to explicate and give force to the values embodied in authoritative texts such as the Constitution and statutes: to interpret those values and to bring reality into accord with them. This duty is not discharged when the parties settle.

Owen M. Fiss, Comment, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984). This sentiment is equally applicable to resolving cases based on procedural grounds, like the statute of limitations.

307. In congressional testimony, former SEC Chairman Arthur Levitt stated, "Private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws." S. REP. NO. 104-98, at 38 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 716.

308. Professor Ochoa and Judge Wistrich state,

> [T]he loss of a valid claim on the ground of limitation of actions (or on any other procedural ground) impairs the implementation of substantive law policy. It

period is more consistent with promoting the resolution of these claims on their merits.

Next, event-accrual is preferable to discovery-accrual for several reasons. Under discovery-based accrual, courts conclude that the defendants have committed an actionable wrong, but deny any remedy. As the majority in the Third Circuit's *Merck* decision remarked about the dissent's conclusion that there were actionable misrepresentations that *precluded* litigation, "It is ironic that the dissent, although noting what might be viewed as Merck's misrepresentations, would apply the statute of limitations to deprive plaintiffs of the opportunity to prove a viable case against Merck for such misrepresentations."[309] This result is absurd; the logic is tortured. Event-accrual avoids this nonsensical conclusion.

Moreover, event-accrual achieves all the laudable aims that a statute of limitations with discovery-accrual misses. Event-accrual provides a bright-line rule that is simple in application, which has many benefits.[310] A bright-line rule removes the uncertainty that plagues *Merck*'s "discovery" standard.[311] Once the time set forth in a statute of repose is up, plaintiffs can be certain that their claims

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> results in the underenforcement of the substantive law by allowing some wrongdoers to escape liability for reasons unrelated to the objectives of the substantive law. Not only will some wrongdoers fail to receive their "just deserts," but they will also be underdeterred from future wrongdoing because they were not required to compensate their victims for the harm caused and to suffer the punishment of civil liability. Others who are instructed by their examples will also be less than optimally deterred from violating the substantive law rules. As a consequence, the substantive law rules will be followed less often than they would have been had the victims' claims not been barred by the limitation system.

Ochoa & Wistrich, *supra* note 40, at 506.

309. *In re* Merck & Co. Sec., Derivative & ERISA Litig., 543 F.3d 150, 172 n.16 (3d Cir. 2008).

310. Pac. Inv. Mgmt. Co. v. Mayer Brown L.L.P., 603 F.3d 144, 157 (2d Cir. 2010) ("A bright line rule ... has many benefits in application. [It] is relatively easy for district courts to apply and avoids protracted litigation and discovery .... Furthermore, as the Supreme Court has explained, securities law is an area that demands certainty and predictability. Uncertainty can lead to many undesirable consequences, for example, newer and smaller companies may find it difficult to obtain advice from professionals. A professional may fear that a newer or smaller company may not survive and that business failure would generate securities litigation against the professional, among others. Uncertainty also increases the costs of doing business and raising capital.") (internal quotation marks and citations omitted).

311. *See supra* Part III.B.3.

are time-barred. In turn, sanctions become more effective because plaintiffs will have lost any colorable argument that a claim past the statute of repose was made in good faith.[312] Thus, event-accrual will greatly influence plaintiffs' decisions to timely file. In any event, if claims are filed that lie outside the statute of repose, they can be easily dispensed with by the judiciary at the preliminary stage, thus saving the courts and the parties costs of later litigation.[313]

One final note, a longer limitations period stems the erosion of the private 10b-5 right of action through procedural rules. If securities fraud litigation is disfavored, the substantive law should be changed to restrict its availability or eliminate the private 10b-5 right of action altogether rather than hamper plaintiff-investors with a short, arbitrary cutoff date.[314] Congress and the courts have erected barriers in class certification, pleading, and summary judgment, all the while maintaining the visage of supporting investors' rights to recover for stock fraud.[315] But these procedural barriers are improperly used to "achieve indirectly what could not be achieved directly."[316]

CONCLUSION

Even when the discovery provision in the statute of limitations for section 10(b) and Rule 10b-5 claims is interpreted in favor of plaintiff-investors, as was the case in *Merck*, it still creates pleading traps for the unwary, introduces a new ground to forum shop, and is otherwise harmful to plaintiff-investors. Discovery-accrual serves no legitimate goal that a statute of repose that accrues upon the happening of the fraud cannot better achieve. Discovery-accrual

312. *See* De La Fuente v. DCI Telecomm., Inc., 82 F. App'x 723, 724-26 (2d Cir. 2003) (nonprecedential decision affirming Rule 11 sanctions against counsel that frivolously opposed dismissal of securities claims barred by statute of repose).

313. *See, e.g.*, Take-Two Interactive Software, Inc. v. Brant, No. 06 Civ. 05279(LTS), 2010 WL 1257351, at *6 (S.D.N.Y. Mar. 30, 2010) (dismissing easily allegations that fell outside the five-year repose period by relying solely on dates of alleged fraud); Plymouth County Ret. Ass'n v. Schroeder, 576 F. Supp. 2d 360, 376 (E.D.N.Y. 2008) (same); *In re* Juniper Networks, Inc. Sec. Litig., 542 F. Supp. 2d 1037, 1051 (N.D. Cal. 2008) (same); *In re* Affiliated Computer Servs. Derivative Litig., 540 F. Supp. 2d 695, 701 (N.D. Tex. 2007) (same).

314. *See* Ochoa & Wistrich, *supra* note 40, at 499.

315. *See generally* Murdock, *supra* note 157, at 186.

316. *See* Ochoa & Wistrich, *supra* note 40, at 499.

ignores the realities of securities litigation. Plaintiffs are already significantly motivated to investigate and file, and penalizing them for sitting on their hands erroneously assumes that the plaintiffs discovered, or could have discovered, facts sufficient to survive the onerous pleading requirements of the PSLRA in the first instance. The discovery provision creates procedural costs borne by plaintiff-investors, defendants, and the courts with no added benefit. Thus, for section 10(b) and Rule 10b-5, the discovery provision should be abolished. Only the five-year statute of repose, which starts upon the defendant's commission of the fraud, should be retained. This bright-line rule prevents the filing of time-barred claims, makes the availability of sanctions certain, and can be readily resolved before a jury must be empanelled. Further, in SOX, Congress saw fit to provide a five-year measure of repose.[317] This time period alone sufficiently enables plaintiffs to file meritorious claims, but also protects settled economic expectations.

317. *See supra* note 73 and accompanying text.