

No. 08-905

IN THE
Supreme Court of the United States

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

Petitioners,

v.

RICHARD REYNOLDS, *et al.*,

Respondents.

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

**BRIEF OF THE SECURITIES INDUSTRY
AND FINANCIAL MARKETS ASSOCIATION
AS *AMICUS CURIAE* IN SUPPORT
OF PETITIONERS**

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INTEREST OF *AMICUS CURIAE*¹

The Securities Industry and Financial Markets Association (“SIFMA”) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and the Bond Market Association. It brings together the shared interests of more than 600 securities firms, banks, and asset managers that have a vital interest in the outcome of this appeal. SIFMA’s mission is to promote policies and practices that expand and improve capital markets, foster the development of new products and services, and create efficiencies for member firms, while preserving and enhancing the public’s trust and confidence in the industry and the markets. SIFMA works to represent its members’ interests locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia

¹ The parties have consented to the filing of this brief. Petitioners and respondents have filed with the Clerk of the Court letters granting blanket consent to the filing of *amicus curiae* briefs.

Pursuant to Rule 37.6, *amicus curiae* affirms that no counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae*, its members, or its counsel made a monetary contribution to its preparation or submission. Willkie Farr & Gallagher LLP, counsel for *amicus curiae*, further states that it represents certain of the independent directors of the Board of Merck & Co., Inc. (“Merck”) in other litigation concerning Merck, some of whom are also petitioners in this proceeding.

Securities Industry and Financial Markets Association, is based in Hong Kong. Unfortunately, SIFMA's members are often sued as defendants in class actions alleging violations of the Securities Exchange Act of 1934 ("1934 Act") and the Securities Act of 1933 ("1933 Act"). Thus, SIFMA is familiar with the everyday norms of securities litigation practices and, accordingly, the interactions between claims under the 1934 and 1933 Acts. This *amicus* brief focuses on those practices and interactions.

The question presented here—whether a plaintiff must be on inquiry notice of *scienter* before the statute of limitations set forth in 28 U.S.C. § 1658(b) begins to run in private securities fraud cases—is an issue of recurring importance to public companies, to the financial services industry, and to investors. All participants in the capital markets have a vital interest in ensuring that the standard for determining when the statute of limitations under § 1658(b) begins to run is clearly defined and that the application of that standard in real-world cases yields consistent, meaningful results. This brief makes two points. First, it describes clearly established law that a plaintiff who does not investigate does not get additional time for lack of notice. That proposition is sufficient to reverse the Third Circuit. Second, it focuses on four impractical and unworkable consequences that would flow if this Court were to endorse the Third Circuit's unduly narrow approach to this critical issue.

SUMMARY OF ARGUMENT

The federal securities laws protect defendants from having to defend against stale allegations of fraud by imposing a two-year statute of limitations for private claims brought under § 10(b) of the 1934 Act. 28 U.S.C. § 1658(b). The Circuits agree that the statute of limitations is triggered when the plaintiff has either actually or constructively discovered “the facts constituting the violation.” They also agree that whether a plaintiff has constructive notice of such facts turns on whether the plaintiff received sufficient “storm warnings” of the alleged fraud such that a reasonable investor would have investigated further. But they do not agree on when the duty to inquire is triggered in § 10(b) cases. Section 1658(b) merely sought to provide plaintiffs an extra year in which to investigate a possible fraud; it did not seek to rewrite when inquiry notice begins.

Under the Third Circuit approach at issue in this case, no duty to inquire exists (and the statute of limitations does not begin to run) until investors receive sufficient storm warnings that defendants acted with *scienter* in perpetrating a fraud. *In re Merck & Co. Sec., Derivative & “ERISA” Litig.*, 543 F.3d 150, 172 (3d Cir. 2008). According to the Third Circuit, it would be unfair to start the statute of limitations running earlier because, under the PSLRA, plaintiffs are required to plead *scienter* with particularity. Under the Third Circuit’s approach, therefore, plaintiffs are permitted to do nothing in

circumstances where they are already on notice of the possibility that defendants (intentionally or not) have misled them, until, *without* conducting an investigation, a hypothetical reasonable investor would have perceived evidence of *scienter*. As we explain below, a rule providing that the statute of limitations does not begin to run until a plaintiff passively receives evidence of *scienter* departs from settled principles of law and creates a number of unnecessary and intractable problems that Congress never intended and the law should not allow.

First, § 1658(b) did not, as respondents suggest, change the basic contours of when plaintiffs are on inquiry notice of a potential claim. Before § 1658(b) was enacted, the law was clear that inquiry notice was triggered by awareness of an injury, regardless of whether the plaintiff had knowledge of the defendant's culpability. The law was also clear that plaintiffs who failed to investigate following discovery of an injury would not be given additional time to bring claims. Thus, the Third Circuit erred in excusing respondents' failure to investigate and bring claims within two years of the alleged misstatement.

Second, the Third Circuit's approach is unrealistic and unworkable for four reasons.

i. The Third Circuit's approach ignores that plaintiffs, usually through class-action law firms, *already* conduct extensive pre-suit investigations before filing § 10(b) claims, and begin those

investigations as soon as misstatements are revealed. Lawyer-driven litigation remains the norm in the securities law arena. As lawyers, of course, plaintiffs' counsel know how to investigate; it is their stock in trade. But plaintiffs' counsel also have an additional incentive to ferret out potential fraud, "storm warnings" of *scienter* aside, because that is how they get clients and cases and, hence, how they get paid. Indeed, the promotional materials of class-action firms—including those firms representing the class here—trumpet their investigative abilities as a means of attracting clients. Moreover, plaintiffs' firms have commonly entered into "monitoring" arrangements with large investors, who are the most likely to be selected as lead plaintiffs in securities class actions pursuant to the PSLRA. *See, e.g., Iron Workers Local No. 25 Pension Fund v. Credit-Based Asset Servicing & Securitization, LLC*, 616 F. Supp. 2d 461, 464 (S.D.N.Y. 2009). The class-action law firms "monitor" the investment portfolios of potential lead plaintiffs—which often cover hundreds of securities—in exchange for a promise to be retained as counsel in the event the investor elects to sue. The proper application of when the "duty to inquire" begins for § 10(b) claims should reflect, not disregard, these everyday practices.

ii. The Third Circuit's approach—that there must be notice of *scienter* before the duty to inquire arises for *scienter*-based claims—would give rise to intractable problems in the application of the limitations period in a wide number of garden-variety

securities suits and lead to inconsistencies with other statutes of limitations under the federal securities laws. It is not uncommon, for example, for plaintiffs to assert claims under §§ 11 and 12 of the 1933 Act that “sound in fraud” and thus are subject to Federal Rule of Civil Procedure 9(b). Notice of *scienter* is not required in those cases before the limitations period begins to run. If it were, that would require courts to apply different limitation periods to the same claims depending on how the facts are pled. It is also not uncommon for 1933 Act and 1934 Act claims to be brought in the same suit based on the same alleged misrepresentations. Under the Third Circuit’s approach, plaintiffs on constructive notice of a possible misrepresentation would be required to investigate for the purposes of their 1933 Act claims, but would not be required to investigate their 1934 Act claims until notice of *scienter* would have been discovered by the “hypothetical reasonable investor” without conducting an investigation. That plainly makes no sense as a practical matter and cannot be what Congress intended. A plaintiff already under a duty to investigate a potential misstatement should not be permitted to turn a blind eye to the possibility that the misstatement was intentionally made.

iii. The Third Circuit’s approach is unworkable. Under the Third Circuit’s approach, the determination of when plaintiffs should have been on inquiry notice of fraud is determined by analyzing when “the hypothetical reasonable investor” would have discovered and recognized storm warnings of

scienter, not on whether the actual plaintiff investigated and what it actually discovered. *Alaska Elec. Pension Fund v. Pharmacia Corp.*, 554 F.3d 342, 347 (3d Cir. 2009) (clarifying the standard introduced in this case). The Third Circuit’s standard would require courts to engage in rank speculation about what such a “hypothetical investor” might have found depending on what the investor might have done. That is obviously unlikely to yield the consistency that the uniform application of the securities laws requires. *See Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 188 (1994) (§ 10(b) is “an area that demands certainty and predictability”). It also undermines the very purpose that securities claims limitations periods are meant to serve: to enable defendants to secure early dismissal of stale claims without undergoing the burden and expense that the defense of securities fraud claims notoriously entails.

iv. The Third Circuit’s approach is unlimited and would have enormous ramifications for the doctrine of inquiry notice well beyond the § 10(b) context. According to the Third Circuit’s rationale, the statute of limitations does not begin to run until a plaintiff is on inquiry notice of those facts it is required to plead in order to state a claim under § 10(b) because those facts must be pled with particularity under the PSLRA. Numerous other sorts of claims must also be supported by particularized allegations of fact, including all claims governed by the heightened pleading requirements of

Rule 9(b). Indeed, even under the notice pleading standard of Rule 8, every complaint must be supported by factual allegations that allow the court to draw the reasonable inference that the defendant is liable for the misconduct alleged, not facts that are merely consistent with a defendant's possible liability. *See Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 557 (2007); *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009). If the statute of limitations is tied to requirements to plead facts, plaintiffs in all sorts of cases will be encouraged to pursue stale claims on the basis that they required more time to discover facts sufficient to meet whatever pleading standard applies.

Where (as here) a plaintiff has not conducted any investigation, no purpose would be served by extending the time within which to sue. Rather, it would run contrary to the clear purpose of the PSLRA to permit plaintiffs to excuse their failure to investigate and pursue their claims promptly until sufficient evidence of *scienter* fortuitously fell into their laps.

The proper standard should excuse a plaintiff's failure to file suit within two years of inquiry notice of the misrepresentation *only if* plaintiff pleads what investigatory steps it did take, what it discovered and when, and what specific facts enable it to plead *scienter* when it could not have before. The Third Circuit's decision should therefore be reversed.

ARGUMENT

I. THE THIRD CIRCUIT'S APPROACH DEPARTS FROM WELL-ESTABLISHED PRINCIPLES GOVERNING WHEN STATUTES OF LIMITATIONS BEGIN TO RUN.

Congress did not intend to “chang[e] the basic standards of the law” by enacting § 1658(b) in 2002. 148 Cong. Rec. 12,502 (2002) (statement of Sen. Leahy). Those “basic standards” support an interpretation of § 1658(b) under which the two-year limitations period for fraud claims begins to run from actual or constructive notice of the alleged misstatement, not from discovery of *scienter*, and is not extended for a plaintiff who fails to investigate.

a. It is undisputed that § 1658(b) incorporates the principle of inquiry notice. Before 2002, that principle had established that once a plaintiff becomes aware of certain information suggesting an event and injury, “the plaintiff should be on notice that further inquiry is needed” in order to pursue timely claims. 2 Calvin W. Corman, *Limitation of Actions* § 11.5.8, at 203 (1991).

b. Before § 1658(b) was enacted, the law was also clear that the information necessary to trigger inquiry notice was awareness of the event giving rise to the alleged injury—*not* awareness of the defendant’s culpability. Two court of appeals

decisions that addressed this issue before § 1658(b) was enacted squarely held that the limitations period began running upon constructive notice of the alleged misstatement, without respect to *scienter*, see *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001) and *Sterlin v. Biomune Systems*, 154 F.3d 1191, 1203 (10th Cir. 1998), while other court of appeals decisions made no mention of a *scienter* requirement for inquiry notice, see *Berry v. Valence Technology, Inc.*, 175 F.3d 699 (9th Cir. 1999) (collecting cases).

These cases were a logical outgrowth of the Supreme Court's interpretation of the concept of inquiry notice. In *United States v. Kubrick*, 444 U.S. 111, 116 (1979), the Court rejected a medical malpractice plaintiff's argument that the applicable statute of limitations under the Federal Tort Claims Act did not begin to run until the plaintiff had actual or constructive knowledge of negligence. The Court held that the limitations period began to run once the plaintiff should have discovered the "critical facts" of his injury, at which point he had to inquire to ascertain whether the treatment was negligent. *Id.* at 122. Recognizing that the plaintiff did not investigate following his injury, the Court went on to say that "[t]o excuse him from promptly doing so by postponing the accrual of his claim would undermine the purpose of the limitations statute, which is to require the reasonably diligent presentation of tort claims against the Government." *Id.* at 123.

Likewise, in *Rotella v. Wood*, 528 U.S. 549, 554 (2000), the Court rejected the proposition that the limitations period for civil RICO claims begins to run upon actual or constructive notice of both the injury and the pattern of racketeering. In doing so, the Court specifically considered and dismissed the argument that evidence of a pattern of racketeering was required to trigger the limitations period because that element must meet the heightened pleadings standard of Rule 9(b). *Id.* at 560-61. Thus, the Court explained that “in applying a discovery accrual rule, we have been at pains to explain that discovery of the injury, not discovery of the other elements of a claim, is what starts the clock.” *Id.* at 555; *see also Wood v. Carpenter*, 101 U.S. 135, 141 (1879) (“[W]hatever is notice enough to excite attention and put the party on his guard and call for inquiry, is notice of every thing to which such inquiry might have led.” (quoting *Kennedy v. Green*, 3 Myl & K. 699, 722, 40 Eng. Rep. 266, 275 (Ch. 1834) (opinion of Lord Brougham))).

As these cases demonstrate, at the time § 1658(b) was enacted, inquiry notice in the securities law context and other contexts was triggered by notice of the alleged event causing injury, regardless of notice of the other elements of the claim at issue. Section 1658(b) was not designed to “chang[e] the basic standards of law” in this area. 148 Cong. Rec. 12,502. Rather, as the Senate Judiciary Committee report explained, § 1658(b) was simply designed to give plaintiffs an extra year from discovery of a misstatement to investigate before being required to

plead fraud with the particularity required by the PSLRA:

The one year statute of limitations from the date the fraud is discovered is also particularly harsh on innocent defrauded investors. . . . Especially in securities fraud cases, the complexities of how the fraud was executed often take well over a year to unravel, even after the fraud is discovered.

* * *

With the higher pleading standards that . . . govern securities fraud victims, it is unfair to expect victims to be able to negotiate such obstacles in the span of 12 months.

S. Rep. No. 107-146, at 9 (2002). Congress did not, as respondents suggest, seek to give plaintiffs an extra year *plus* a radical alteration of the judicially established trigger for inquiry notice.

c. It was also well established before 2002 that plaintiffs who failed to investigate would not be allowed additional time to sue under an inquiry notice rule. *See United States v. Diamond Coal & Coke Co.*, 255 U.S. 323, 333 (1921) (where a plaintiff “fail[s] to make inquiry,” the plaintiff is not entitled to the discovery rule); *see also Kubrick*, 444 U.S. at 123 (refusing to excuse plaintiff’s failure to investigate).

That legal rule is dispositive here because respondents concede they did not undertake any investigation into the matters asserted in their complaint. *See, e.g.*, Pet. App. 58a (Roth, J., dissenting); *id.* at 98a (district court); *cf.* C.A. App. 5032-5033 (statement of Melvyn Weiss) (conceding, in response to the district court's question as to whether "you" or "your client" conducted an investigation, that "we didn't do it ourselves").

Thus, the Third Circuit erred in granting respondents more than two years to sue when they failed to investigate upon discovering the alleged misstatements. If this Court were to uphold the Third Circuit's decision, it would depart from its settled approach to inquiry notice and read into § 1658(b) a change in the law that Congress did not intend.

II. THE THIRD CIRCUIT'S APPROACH IS IMPRACTICAL AND UNWORKABLE.

A. The Proper Inquiry Notice Standard Should Reflect The Practical Reality That Plaintiffs' Lawyers Already Conduct Extensive Investigations Before Passively Receiving Evidence Of *Scienter*.

The Court has sought to interpret the securities laws in a manner consistent with economic reality. *See, e.g., Reves v. Ernst & Young*, 494 U.S.

56, 61 (1990) (interpreting what constitutes a “security” based on “economic reality”). The Court’s interpretation of what constitutes inquiry notice sufficient to trigger the statute of limitations for § 10(b) claims, as set forth in § 1658(b), should similarly reflect economic reality. As reflected in its opinion, the Third Circuit apparently believed that it would be unfair to burden § 10(b) plaintiffs with any investigatory obligations absent “storm warnings” of each element of a § 10(b) claim. The reality is, however, that the driving force behind § 10(b) class actions is plaintiffs’ lawyers (not investors) who *already* conduct extensive investigations of potential securities fraud claims as soon as misstatements are discovered because (a) that is what they are trained to do, (b) that is what the rules require them to do, and (c) they have enormous economic incentives to do so.

Despite the PSLRA, it remains the norm that securities class-action litigation is lawyer-driven, no doubt because the potential for huge fees remains as alluring as ever. *See* Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 Colum. L. Rev. 1489, 1496 (2006) (noting, of the first decade since the PSLRA’s enactment: “If anything, it is more likely that litigation has gone up rather than gone down over the entire period.”); *Iron Workers*, 616 F. Supp. 2d at 463 (noting that “increased legal fees” continue to drive plaintiffs’ firms to vie for lead counsel status in large securities suits). In 2008 there was an “unprecedented” amount

of securities litigation against firms in the financial industry “since the passage of the [PSLRA],” Cornerstone Research, *Securities Class Action Filings, 2008: A Year in Review* 2 (2009), <http://securities.cornerstone.com/pdfs/YIR2008.pdf>, and the wave of litigation against that sector continues to build this year, Stephanie Plancich & Svetlana Starykh, NERA, *Recent Trends in Securities Class Action Litigation: 2009 Mid-Year Update* 5 (July 2009), http://www.nera.com/image/Recent_Trends_Report_0709.pdf. From 1998 to 2008, securities class actions resulted in \$51.8 billion of settlements. U.S. Chamber Institute for Legal Reform, *Securities Class Action Litigation, The Problem, Its Impact, and the Path to Reform* 8 (July 2008), http://www.instituteforlegalreform.com/get_ilr_doc.php?docId=1213. Accordingly, plaintiffs’ lawyers, who typically collect one-third of a settlement, reaped an estimated \$17 billion in fees over that same period. *Id.* at 19. The average value of settlements so far in 2009 is at an all-time high (excluding settlements over \$1 billion). Plancich & Starykh, *supra* at 22-23. An analysis of current trends predicts that securities class-action settlement amounts will continue to increase in the future. Ellen M. Ryan & Lauren E. Simmons, Cornerstone Research, *Securities Class Action Settlements 2008 Review and Analysis* 19 (2009), http://securities.cornerstone.com/pdfs/Cornerstone_Research_Settlements_2008_Analysis.pdf.

Perhaps most astonishing of all, one study found that even after the PSLRA, and *before* the

current economic crisis, more than 40% of companies listed on major U.S. exchanges had been named as defendants in securities fraud class actions. Comm’n on the Regulation of U.S. Capital Mkts. in the 21st Century, *Report and Recommendations* 30 (Mar. 2007), <http://www.uschamber.com/publications/reports/0703capmarketscomm.htm>. Plainly, the PSLRA has not dampened the ardor of securities class-action counsel to bring lawsuits.

The economic reality is that plaintiffs’ firms *already* conduct extensive pre-suit investigations before evidence of *scienter* falls in their laps. The marketing materials of class-action firms trumpet the abilities of the plaintiffs’ bar to ferret out corporate wrongdoing. For instance, the website for co-lead plaintiffs’ counsel in this case states, “In order to help institutional funds properly track potential securities frauds and recoup losses, BLB&G employs a state-of-the-art proprietary portfolio monitoring and case evaluation system.” Bernstein, Litowitz, Berger & Grossman LLP, Institutional Investor Services, http://www.blbglaw.com/institutional_investor_services/index. The website goes on to explain that the firm “review[s] the fund’s portfolio losses on a regular basis, *investigate[s] potential claims* and prepare[s] detailed reports of [its] findings.” *Id.*, http://www.blbglaw.com/institutional_investor_services/portfolio_monitoring (emphasis added). Similarly, the website for the other co-lead plaintiffs’ counsel below touts portfolio monitoring and investigatory capabilities that enable the firm “to alert its clients in

a prompt manner that their investments have been harmed *by fraud* or other corporate misconduct.” Brower Piven, <http://www.browerpiven.com/institutionalinvestors.html> (emphasis added). That same website also contains a “Report Fraud” feature that solicits evidence of fraud from corporate insiders and others to aid investigations into whether a misstatement or omission was fraudulent. *Id.*, <http://browerpiven.com/reportfraud.html>.

Indeed, a number of recent cases have brought to light certain arrangements that members of the plaintiffs’ bar have developed to secure the appointment of their clients as lead plaintiffs in securities fraud class actions (and thus substantial fees for the law firms). Under these arrangements, known as “monitoring” arrangements, plaintiffs’ firms agree to provide free “monitoring” of the portfolios of large institutional investors (*i.e.*, potential lead plaintiffs) in exchange for the right to be retained as counsel if the investor decides to bring a lawsuit upon detection of purported fraud or other irregularities. *See, e.g., Iron Workers*, 616 F. Supp. 2d at 464 (monitoring arrangement between major plaintiffs’ firm and a large pension fund); *Adams v. Labaton, Sucharow & Rudoff LLP*, No. 07-7017, 2009 U.S. Dist. LEXIS 35085, at *5-6 (S.D.N.Y. Mar. 30, 2009) (monitoring arrangements with the State of New Mexico); *In re JP Morgan Chase & Co. S’holder Derivative Litig.*, 08-974, 2008 U.S. Dist. LEXIS 71353, at *29 (S.D.N.Y. Sept. 19, 2008) (monitoring arrangements with “professional plaintiff” that

resulted “in at least twenty-five cases to date”); *In re Am. Italian Pasta Co. Sec. Litig.*, No. 05-725, 2007 U.S. Dist. LEXIS 21365, at *21 (W.D. Mo. Mar. 26, 2007) (monitoring arrangement with a large pension fund).

There can be no serious dispute, therefore, that imposing a duty to inquire when a misstatement is discovered, but before evidence of *scienter* is passively received, would not impose a new and burdensome duty. On the contrary, it would merely recognize what is already the established practice.

B. The Third Circuit’s Approach Would Lead To Inconsistencies With The Application Of Other Statutes Of Limitations Under The Federal Securities Laws.

As the Court in *Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson*, 501 U.S. 350, 360 (1991), held, the statute of limitations for § 10(b) should be interpreted so as to ensure that “the complex web of regulations” in the 1933 and 1934 Acts achieves its “central goal.” That goal would be undermined if the Third Circuit’s approach of tethering statutes of limitations to pleading standards were to be adopted.

1. The Third Circuit's Approach Would Create Conflict And Confusion With Respect To The Limitations Period Applicable To 1933 Act Claims That "Sound In Fraud" Or Are Based On Opinions.

Claims under the 1933 Act, including the oft-asserted §§ 11 and 12 claims, are subject to that Act's one-year limitations provision, which is set forth in § 13. 15 U.S.C. § 77m. The one-year limitations period for 1933 Act claims begins to run once plaintiffs knew or should have known of the alleged misstatement or omission, regardless of defendant's intent. *Id.*; *In re Alstom SA, Sec. Litig.*, 406 F. Supp. 2d 402, 417 (S.D.N.Y. 2005).

Although *scienter* is not a necessary element of all claims under §§ 11 and 12, it can be where plaintiffs assert a 1933 Act claim that "sounds in fraud." For example, §§ 11 and 12 claims that are based on allegedly false *opinions* require proof that "the opinion or belief [was] not truly held" because the speaker's belief is the only fact that is represented. *In re Global Crossing Ltd. Sec. Litig.*, 313 F. Supp. 2d 189, 210-11 (S.D.N.Y. 2003); *see also Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991) (securities claim premised on opinion requires, in addition to objective unreasonableness, that the speaker misstated "the psychological fact of the speaker's belief in what he says"). These kinds of

§§ 11 and 12 claims are especially common in the wake of the current economic crisis, with companies increasingly being attacked for matters of opinion concerning valuations (*e.g.*, judgment-driven valuations about illiquid securities) or forward-looking projections (*e.g.*, statements about how a company expects to perform at a later date). *See Securities Class Action Filings, 2008* at 21 (noting that “[t]he share of class actions alleging Section 11 and 12(2) claims increased to its highest level in 2008,” and many such claims were premised on “overstatements of assets” and “problems with estimates”). Another example of §§ 11 and 12 claims sounding in fraud are those based on forward-looking statements. Under the PSLRA, forward-looking statements are not actionable unless they are made with “actual knowledge . . . that the statement was false or misleading.” 15 U.S.C. § 77z-2(c)(1)(B)(i). And similarly, “control person” claims under § 15 of the 1933 Act can be asserted only against defendants who are “culpable participants in the fraud perpetuated by the controlled persons.” *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973); *Wallace v. Buttar*, 239 F. Supp. 2d 388, 397 (S.D.N.Y. 2003) (“the control person must have participated in the action with knowledge that the securities laws were being violated, or with reckless indifference as to whether a violation occurred”), *rev’d on other grounds*, 378 F.3d 182 (2d Cir. 2004).

Thus, certain claims brought under those sections must satisfy heightened pleading

requirements that are similar to those imposed by the PSLRA with respect to § 10(b) claims. Specifically, §§ 11 and 12 claims that “sound in fraud” must be pled with the particularity required by Rule 9(b). *See, e.g., Rombach v. Chang*, 355 F.3d 164, 171 (2d Cir. 2004) (“So while a plaintiff need allege no more than negligence to proceed under Section 11 and Section 12(a)(2), claims that do rely upon averments of fraud are subject to the test of Rule 9(b).”).

If the Third Circuit is correct that inquiry notice of fraud claims requires a reason to suspect *scienter* when claims sound in fraud and are subject to a heightened pleading requirement, then logically the limitations period under § 13 would begin to run later for §§ 11 and 12 claims that “sound in fraud” than for those that do not. But § 13 provides for a limitations period of one year after inquiry notice of a misstatement or omission for *all* 1933 Act claims—whether based on false statements of fact, false opinions, forward-looking statements, or control person allegations. 15 U.S.C. § 77(m).

The Third Circuit’s premise that there should be a different statute of limitations for securities claims that sound in fraud is contradicted by Congress’s choice of a unitary statute of limitations in § 13. To hold otherwise would result in an interpretation of § 13 that creates different limitations periods for §§ 11 or 12 claims depending on how they are pled. Such an interpretation is an invitation for mischief. It would encourage plaintiffs

to engage in artful pleading of §§ 11 and 12 claims in order to avail themselves of a longer limitations period than what § 13 intended. Indeed, one lower court that addressed precisely this issue recognized as much:

[T]he adoption of the Plaintiffs' position—that a longer limitations period should be applied when a complaint's Section 11 or 12(a)(2) claims "sound in fraud," but that a shorter period is applicable where the claims only raise allegations of negligence—creates uncertainty in an area of the law the purpose of which is expressly to provide certainty for defendants as to when their exposure to liability ends.

Alstom, 406 F. Supp. 2d at 417 (holding that the longer fraud limitations period of § 1658(b) did not apply to §§ 11 and 12 claims "sounding in fraud").

The alternative approach urged here would avoid such problems without depriving plaintiffs of meritorious fraud claims. That is because inquiry notice would run on a uniform basis, without respect to evidence of *scienter*, for all securities claims, and plaintiffs could avoid having their fraud claims time-barred if they could prove that evidence of *scienter* became reasonably available only through an actual investigation conducted after the duty to inquire was triggered by notice of a false statement or omission.

2. The Third Circuit's Approach Would Nonsensically Require Plaintiffs To Investigate A Misrepresentation But Inquire No Further As To The Possibility Of Fraud.

It would make no sense to hold that the limitations periods for related claims asserted under different provisions of the securities laws based on the same set of facts run from different points in time. As a practical matter, the Third Circuit's approach would require the same plaintiffs to investigate a purported misrepresentation for purposes of potential claims pursuant to the 1933 Act, but go no further and inquire as to whether the misrepresentation was fraudulent for a potential § 10(b) claim. *See, e.g., In re Flag Telecom Holdings, Ltd. Sec. Litig.*, ___ F.3d ___, Nos. 07-4017, 07-4025, 2009 WL 2169197, at *6 (2d Cir. July 22, 2009) (class actions asserting both 1933 and 1934 Act claims "are far from unusual") (citing cases). The entire reason Congress extended the statute of limitations for fraud from one to two years was to give plaintiffs one more year following discovery of a misrepresentation to amass the evidence necessary to plead and prove all of the elements, including *scienter*, of a § 10(b) claim. The Third Circuit has essentially rewritten the statute to allow plaintiffs alleging fraud an additional year *plus* some additional uncertain period before inquiry

notice is triggered to be adjudicated in each § 10(b) case.

**3. The Third Circuit's Approach
Would Encourage Plaintiffs
To Dress Up Stale 1933 Act
Claims As Fraud Claims.**

The Third Circuit's *scienter*-based distinction as to when the limitations period for fraud claims begins to run creates even more incentive on the part of securities plaintiffs and their counsel to dress up time-barred 1933 Act claims as § 10(b) fraud claims. This is because plaintiffs barred from bringing claims under §§ 11 and 12 for a misstatement that was or should have been discovered more than a year ago would seek to recast those claims as § 10(b) fraud claims subject to the longer two-year limitations period that did not begin running until they passively received evidence of *scienter*. The Court should not adopt a rule that encourages an end-run around the time limit imposed by Congress on §§ 11 and 12 claims. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 (1976) (rejecting interpretations of § 10(b) that would “nullify the effectiveness of the carefully drawn procedural restrictions on th[e] express actions” in §§ 11 and 12).

C. The Third Circuit's Approach Is Unworkable.

According to the Third Circuit, inquiry notice of *scienter* is necessary to give investors additional time to investigate their claims so as to meet the heightened pleading standards of the PSLRA. Where, however, a plaintiff has not conducted any investigation (as was the case here), no purpose would be served by extending the time within which to sue beyond two years from inquiry notice that there was a misrepresentation. Rather, it would run contrary to the clear purpose of the PSLRA to permit plaintiffs to excuse their failure to investigate and pursue their claims promptly simply because a “hypothetical” investor conducting a “hypothetical” investigation would not have uncovered facts sufficient to support an inference of *scienter*. The Third Circuit’s standard is unworkable because it requires courts to engage in speculation at each and every step of that purported standard in order to determine whether or not a claim is time-barred.

First, the court must speculate as to what type of information would constitute evidence of *scienter* sufficient to place a hypothetical investor on notice of a possible fraud. Short of an admission of wrongdoing—*e.g.*, a guilty plea to criminal securities fraud with respect to the same misrepresentations that are alleged in a class-action plaintiff’s complaint—it is hard to imagine what “storm warnings” of *scienter* could possibly suffice. Indeed,

even readily available information, such as an insider's trading activity, may not be viewed by reasonable investors in the same way. Some investors might consider stock sales by senior management shortly before their company made purported misstatements as evidence of *scienter*, whereas others might overlook such a fact or discount it because they also discovered the sales were made automatically for estate planning, tax purposes, or the like. *See, e.g., In re Bristol-Myers Squibb Sec. Litig.*, 312 F. Supp. 2d 549, 561 (S.D.N.Y. 2004) (trades by insiders "to pay taxes" do not support *scienter*).

Second, the court will need to speculate on what type of reasonable investigation a hypothetical plaintiff would have conducted in an effort to uncover evidence of *scienter*. In such a process, the court would engage in pure conjecture as to how a hypothetical investor would have proceeded with that investigation upon discovery of each piece of evidence that the court speculates he or she would have learned during that hypothetical investigation.

Third, based on its supposition as to the steps that the hypothetical investigation would have involved, the court must further speculate as to both (i) what pieces of evidence that investor would have discovered with regard to *scienter*, and (ii) the precise day on which that investor would have learned each and every one of those pieces of evidence. The court must engage in both levels of speculation in order to determine whether that evidence, overall, is enough

to put a hypothetical investor on inquiry notice of a § 10(b) claim and, if so, the exact date on which the hypothetical investor would have uncovered sufficient evidence to cause the statute of limitations to begin to run. This would result in massive confusion and uncertainty for courts and litigants alike.

The uncertainty that results from the hypothetical investor test is contrary to this Court's admonition. As the Court has long recognized, unchecked § 10(b) litigation "presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975). Without clear, consistent standards, decisions are "'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business." *Cent. Bank*, 511 U.S. at 188 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)). This uncertainty only increases the *in terrorem* effect inherent in securities fraud class actions that lends them "a settlement value to the plaintiff out of any proportion to its prospect of success at trial." *Blue Chip Stamps*, 421 U.S. at 740.

The uncertainty would make access to the U.S. capital markets more expensive as companies would have to accrue for potential litigation over longer periods of time and litigate stale lawsuits with substantial discovery expense. In comparison, foreign markets—which limit or prohibit private class actions—would become more attractive to both U.S.

and foreign companies, depriving U.S. investors of bona fide investment opportunities. *See* H.R. Rep. No. 104-50, at 20 (1995) (“Fear of [securities] litigation keeps companies out of the capital markets.”). Consequently, private securities litigation would continue to undermine the competitive footing of the U.S. capital markets. *See* Interim Report of the Comm. on Capital Mkts. Regulation at 11 (2006), *available at* http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (“Foreign companies commonly cite the U.S. class action enforcement system as the most important reason why they do not want to list in the U.S. market.”). Former Treasury Secretary Paulson crystallized the relevant policy concerns as follows: “Our markets are, indeed, the best in the world. Yet we must be vigilant, and we must do everything we can to ensure they stay that way. . . . [T]he fundamental question we must ask is: Have we struck the right balance between investor protection and market competitiveness . . . ?” Henry M. Paulson, Jr., Opening Remarks at Treasury’s Capital Markets Competitiveness Conference (Mar. 13, 2007), <http://www.ustreas.gov/press/releases/hp306.htm>. The Third Circuit’s approach upsets the right balance.

Consider, for example, a public company that announces it is undertaking an internal investigation into potential securities fraud. Even after arriving at a conclusion that no fraud had occurred, the company could not take any comfort in concluding that the

clock was running on a potential § 10(b) claim because plaintiffs and courts may disagree over what a hypothetical investor should have done in response to that news. Some courts might hold that the hypothetical investor still had no evidence of *scienter*, and therefore the limitations period had not begun. Other courts might hold otherwise. Companies, and their ability to conduct business competitively, would be caught in limbo.

Instead, if plaintiffs wish to excuse their failure to file suit earlier, they should be required to plead the steps they did take, what they discovered and when, and why specific newly discovered facts enabled plaintiffs to plead *scienter* that could not have been alleged before, consistent with Rule 11 and the PSLRA. *See, e.g., Wood* 101 U.S. at 143 (“The circumstances of the discovery must be fully stated and proved, and the delay which has occurred must be shown to be consistent with the requisite diligence.”); *Del Campo v. Camarillo*, 98 P. 1049, 1054 (Cal. 1908) (plaintiffs “must clearly show that they did not discover the existence or commission of the alleged frauds until within a reasonable time before the action was begun, that they proceeded promptly upon such discovery, and that their failure to make the discovery sooner was not due to their own lack of diligence”). This approach would give the lower courts an objective basis for evaluating whether pleading a complaint for securities fraud was truly beyond plaintiffs’ reach. Applying this approach to the example above, courts could easily and objectively

evaluate whether a plaintiff seeking to assert a timely fraud claim in the wake of a corporate internal investigation conducted a diligent investigation but could not find evidence of *scienter* within the two-year limitations period.

D. The Third Circuit's Approach Would Affect The Statutes Of Limitations Applicable To Virtually Any Claim That Is Filed In Federal Court.

The expansive principle behind the inquiry notice rule adopted by the Third Circuit could not be limited to § 10(b) claims or even to those arising under the federal securities laws. Rather, by linking the quantum of information necessary to trigger the duty to inquire to the specific pleading requirements applicable to § 10(b) claims under the PSLRA, the rule adopted by the Third Circuit would affect statutes of limitations based on discovery for numerous claims that must be supported by allegations of fact.

For example, any plaintiff who “alleg[es] fraud or mistake . . . must state with particularity the circumstances constituting fraud or mistake.” Fed. R. Civ. P. 9(b). Under the rule adopted by the Third Circuit, therefore, a plaintiff alleging a claim that sounds in fraud—whether based on the securities laws or otherwise—would be under no duty to inquire into whether it has a potential claim until storm

warnings of all the circumstances constituting the fraud, including *scienter*, fell into its lap.

The limitations period would also be extended for claims not subject to the heightened pleading standards for fraud. As *Twombly* and *Iqbal* make clear, to state a claim for relief under Rule 8, a complaint must “plead[] *factual content* that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged.” *Iqbal*, 129 S. Ct. at 1949 (emphasis added). A complaint that “pleads facts that are ‘merely consistent with’ a defendant’s liability” is insufficient, because “it ‘stops short of the line between possibility and plausibility of ‘entitlement to relief.’””) *Id.* (quoting *Twombly*, 550 U.S. at 557). Thus, even in cases governed by the notice pleading standard of Rule 8, the Third Circuit’s test would relieve a plaintiff of any duty to investigate a potential claim (and effectively toll the statute of limitations from running) until it passively received *all* the necessary facts that, if proven true, would render that claim plausible.

Extending a statute of limitations based on pleading standards is thus a proposition without limit and will invite litigation and mischief in any case to which the inquiry notice doctrine applies. Plaintiffs in all sorts of cases will be encouraged to pursue stale claims on the grounds that they lacked notice of the facts necessary to state a claim, stripping the duty to inquire of any real meaning and depriving defendants

and our crowded courts of the protections that the statute of limitations were meant to provide.

CONCLUSION

For the reasons stated, the Third Circuit's decision should be reversed.

Respectfully submitted,

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