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In The
Supreme Court of the United States

MERCK & CO., INC., ET AL., PETITIONERS

v.

RICHARD REYNOLDS, ET AL.

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

BRIEF FOR CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICUS CURIAE SUPPORTING PETITIONERS

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TABLE OF CONTENTS

	Page
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iv
INTEREST OF AMICUS CURIAE	1
SUMMARY OF ARGUMENT	3
ARGUMENT	7
THE COURT OF APPEALS' READING OF 28 U.S.C. § 1658(b)(1) CANNOT BE RECONCILED WITH ITS TEXT, STRUCTURE, PURPOSE, AND HISTORY AND ENCOURAGES PLAINTIFFS TO SIT ON THEIR POTENTIAL SECURITIES FRAUD CLAIMS RATHER THAN DILIGENTLY INVESTIGATE ANY POSSIBLE FRAUD	7
A. Section 1658(b)(1) Requires A Private Plaintiff To Bring A Securities Fraud Action Within Two Years After He First Suspects, Or Has Reason To Suspect, The Possibility Of Fraud On The Part Of The Defendant	8
1. The text of Section 1658(b)(1) requires a plaintiff to bring his claim within two years after he is on notice of the possibility of fraud	9
2. The structure of Section 1658(b) confirms that notice of the possibility of fraud triggers the running of the two-year statute of limitations	16

TABLE OF CONTENTS—Continued

Page

3. There would have been no logical purpose for Congress to extend the statute of limitations to two years if plaintiffs were not expected to investigate possible fraud claims during that period 18

4. The decision below cannot be reconciled with the policies that undergird statutes of limitations 20

B. At Most, A Private Plaintiff Should Be Allowed Additional Time To Investigate His Claim Only If He Actually Conducts A Reasonable, Diligent Investigation 24

C. Allowing Stale Claims To Survive Will Increase Pressure On Defendants To Settle Securities Class Actions And Will Impose Undue Costs On The Nation's Economy 29

CONCLUSION 38

TABLE OF AUTHORITIES

Page

CASES:

Bailey v. Glover, 88 U.S. (21 Wall.) 342 (1875)....6, 25, 26

Berry v. Valence Technology, Inc., 175 F.3d 699 (9th Cir. 1999) 13

Betz v. Trainer Wortham & Co., 519 F.3d 863 (9th Cir. 2008) 17

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).......................................6, 29, 31, 34

Brumbaugh v. Princeton Partners, 985 F.2d 157 (4th Cir. 1993) 21, 23, 29, 30

Caviness v. Derand Resources Corp., 983 F.2d 1295 (4th Cir. 1993) 23

Commissioner v. Keystone Consolidated Industries, Inc., 508 U.S. 152 (1993)......................12

Dodds v. Cigna Securities, Inc., 12 F.3d 346 (2d Cir. 1993), *cert. denied*, 511 U.S. 1019 (1994)........20

Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005)...13

Franze v. Equitable Assurance, 296 F.3d 1250 (11th Cir. 2002)..23

Fujisawa Pharmaceutical Co., Ltd. v. Kapoor, 115 F.3d 1332 (7th Cir. 1997)...........................21, 22

Great Rivers Cooperative of Southeast Iowa v. Farmland Industries, Inc., 120 F.3d 893 (8th Cir. 1997)...23

Hibbs v. Winn, 542 U.S. 88 (2004) 17

TABLE OF AUTHORITIES—Continued

Page

Holmberg v. Armbrecht, 327 U.S. 392 (1946) 25

Jensen v. Snellings, 841 F.2d 600 (5th Cir. 1988) 22, 23

Kennedy v. Greene, 3 Myl. & K. 722, 40 Eng. Rep. 266 (Ch. 1834)..12

Kirby v. Lake Shore & Michigan Southern Railroad Co., 120 U.S. 130 (1887)..........................13

Klehr v. A. O. Smith Corp., 521 U.S. 179 (1997)....26, 29

Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991)..........4, 9, 13, 18, 25

Law v. Medco Research, Inc., 113 F.3d 781 (7th Cir. 1997) 24

LC Capital Partners, LP v. Frontier Insurance Group, Inc., 318 F.3d 148 (2d Cir. 2003) 28

Marks v. CDW Computer Centers, Inc., 122 F.3d 363 (7th Cir. 1997) 25

New England Health Care Employees Pension Fund v. Ernst & Young, LLP, 336 F.3d 495 (6th Cir. 2003), *cert. denied*, 540 U.S. 1183 (2004) 24

Rotella v. Wood, 528 U.S. 549 (2000) ... 10, 11, 12, 13, 15

Royal Air Properties, Inc. v. Smith, 312 F.2d 210 (9th Cir. 1962) 22

SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)..31

Sterlin v. Biomune Systems, 154 F.3d 1191 (10th Cir. 1998) 24

TABLE OF AUTHORITIES—Continued

Page

Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308 (2007)....................14, 15

Tregenza v. Great American Communications Co., 12 F.3d 717 (7th Cir. 1993), *cert. denied*, 511 U.S. 1085 (1994)....................21, 23

United States v. Diamond Coal & Coke Co., 255 U.S. 323 (1921)....................11, 27

United States v. Kubrick, 444 U.S. 111 (1979)....................10, 12, 21

Wood v. Carpenter, 101 U.S. 135 (1879)....................12, 26

STATUTES AND RULES:

Securities Exchange Act of 1934, 15 U.S.C.

§ 78i(e)....................9, 11, 12

§ 78j(b)....................7

§ 78u-4....................19

§ 78u-4(b)(1)....................14

§ 78u-4(b)(2)....................14

28 U.S.C.

§ 1658(b)....................*passim*

§ 1658(b)(1)....................*passim*

§ 1658(b)(2)....................16, 18

Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737....................*passim*

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745....................19

TABLE OF AUTHORITIES—Continued

Page

Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227.......30, 32

Rule 10b-5, 17 C.F.R. § 240.10b-5......................7, 9, 18

Fed. R. Civ. P. 9(b)...15

OTHER AUTHORITIES:

Brief for the United States as Amicus Curiae, *Trainer Wortham & Co. v. Betz*, No. 07-1489 (U.S. Apr. 22, 2009)..13, 15

S. Rep. No. 107-146 (2002)..................................19, 20

Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497 (1991).......................35

Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487 (1996)..31

Michael R. Bloomberg & Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership* (2007)....................32

John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986)..................................36

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TABLE OF AUTHORITIES—Continued

Page

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BRIEF FOR CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS AMICUS CURIAE SUPPORTING PETITIONERS

The Chamber of Commerce of the United States of America respectfully submits this brief as amicus curiae in support of petitioners.[1]

INTEREST OF AMICUS CURIAE

The Chamber of Commerce of the United States of America is the world's largest business federation. The Chamber represents an underlying membership of more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files amicus curiae briefs in cases that raise issues of concern to the Nation's business community.

The Chamber and its members recognize the importance of the federal securities laws to deter and

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[1] Pursuant to Rule 37.3(a), blanket letters from the parties consenting to the filing of this brief have been filed with the Clerk of the Court. No counsel for a party authored this brief in whole or in part, and no party or counsel for a party made a monetary contribution intended to fund the preparation or submission of the brief. No person other than amicus curiae, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

remedy wrongdoing to investors. Amicus and its members are concerned, however, that the expansive standard for the statute of limitations in private securities fraud actions articulated by the court of appeals will lead to further proliferation of securities fraud actions that will undermine the goals of our federal securities laws and threaten the health and stability of our capital markets. The court of appeals' holding in this case potentially eliminates an otherwise valid statute of limitations defense in many securities fraud actions.

Securities fraud actions are subject to a two-year statute of limitations "after the discovery of the facts constituting the violation." 28 U.S.C. § 1658(b)(1). But under the ruling below, that statute of limitations does not commence—even when a plaintiff possesses concrete evidence of the possibility of fraud—until the plaintiff has, in effect, all the facts necessary to file a viable complaint. Not only is there no basis for that conclusion in the text or purpose of the statute, that expansive standard undermines this Court's longstanding rationale behind the discovery rule in statutes of limitations by allowing plaintiffs to ignore, rather than diligently investigate, their potential claims.

Accordingly, amicus and its members have a strong interest in this Court's reversal of the decision below to ensure proper application of the two-year statute of limitations in securities fraud cases across the country.

SUMMARY OF ARGUMENT

A. 1. The statute of limitations in 28 U.S.C. § 1658(b)(1), which bars securities fraud claims brought more than two years after the "discovery of the facts constituting the violation," begins to run when the plaintiff knows or should know of the possibility of securities fraud. The court of appeals held to the contrary, concluding that the limitation period does not begin to run until the plaintiff knows or should know information specifically relating to each element of the claim, including scienter. That holding cannot be squared with the text of the statute.

When, as here, a statute of limitations incorporates a discovery rule, a plaintiff need not have information specifically relating to each element of his cause of action to trigger the running of the limitations clock. Rather, once a plaintiff has information sufficient to alert him to the possibility of a claim, the plaintiff is obligated to investigate whether the defendant's conduct is actionable, and the limitation period is the time to do so. That was the longstanding construction of discovery rules when Congress enacted Section 1658(b), and Congress should be presumed to have incorporated that settled meaning.

Congress's use of the phrase "facts constituting the violation" in Section 1658(b)(1) further supports that a plaintiff need not possess "facts sufficient to state a cause of action" before the two-year period

begins to run. As this Court has made clear, a plaintiff must prove more than "a violation" of Section 10(b) to prevail on a securities fraud claim. At a minimum, the phrase "facts constituting the violation" is best understood as referring to the core facts concerning the defendant's conduct, and not the defendant's state of mind.

2. The structure of Section 1658(b)—with its two separate, alternative time bars—confirms that the court of appeals' construction is misplaced. Under that lax interpretation of the two-year limitation period, the five-year period of repose would almost always be the only effective time limitation. That interpretation, which would effectively write the two-year limitation period off the books, should be rejected.

3. Under the court of appeals' reading of Section 1658(b)(1), no logical purpose would have been served by its enactment. When Congress codified the limitation period announced by this Court in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), the sole change it made was to extend the limitation period from one year to two. If the court below were correct, that extension would make no sense. In the court of appeals' view, the limitation period does not even begin to run until the plaintiff possesses all the facts necessary to file a viable complaint under the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737. But that would mean that Congress provided potential plaintiffs an extra

year—twice the amount of time that they previously had—solely for the purpose of *drafting* an already thoroughly investigated complaint. The only reading of the extension that makes sense is that Congress sought to provide plaintiffs additional time to conduct an investigation into possible securities fraud so that they could uncover enough facts to meet the heightened pleading standards of the PSLRA, not to give them an additional year once they already had enough information to file a viable complaint.

4. The ruling below undermines the policies behind statutes of limitations, which encourage prompt investigation and initiation of claims to preserve a defendant's ability to present a defense and to provide clarity as to when legal action is foreclosed. Contrary to those fundamental principles, the decision below encourages potential plaintiffs who are aware of the possibility of fraud to sit back and watch the price of their stock before deciding whether to bring suit, rather than launch a diligent inquiry.

B. If the Court nevertheless concludes that Section 1658(b)(1) allows a plaintiff some period of time to conduct an investigation before the two-year period begins to run, the Court should also hold that the statute of limitations continues to run unless the plaintiff himself actually conducts a reasonable, diligent investigation. In some circuits, the clock does not start ticking until after the period of time it would have taken a hypothetical reasonable plaintiff to conduct an investigation and discover the alleged fraud, regardless of whether the plaintiff undertakes

a reasonably diligent inquiry. But this Court has long recognized that the discovery rule is available only to plaintiffs who exercise reasonable diligence in discovering the fraud. *See, e.g.*, *Bailey v. Glover*, 88 U.S. (21 Wall.) 342, 348 (1875).

Moreover, such an "inquiry notice plus hypothetical diligence" rule would prove unworkable in practice. It would require the court to conceive, in a vacuum, what a hypothetical diligent investigation would have entailed and would have uncovered, without regard to what the plaintiff actually did.

C. Securities class actions, by their nature, present "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). Congress recognized that when it enacted checks on private securities litigation. It is implausible to believe that in enacting Section 1658(b), Congress intended to permit stale securities actions in which potential plaintiffs have undertaken no investigation after they were put on notice of the possibility of fraud. Yet under the court of appeals' rule, the statute of limitations under Section 1658(b)(1) becomes an open-ended inquiry, and the ability to cut off stale claims through that limitation provision is greatly diminished. Those stale claims become more difficult to defeat, not due to any merit but because memories fade and older records must be recovered. The impact of such abusive securities class actions on the Nation's economy is already severe, and the court of appeals' rule would only exacerbate it.

Securities class actions that survive a motion to dismiss and enter the discovery phase exert enormous pressure on defendants to settle. The huge costs associated with discovery in these cases combined with the potential for devastating damages awards dramatically boost settlement values of even the least meritorious claims. It is critical, therefore, that the standard for the running of the limitation period be sufficiently rigorous to cut off stale claims at an early stage. The court of appeals' lax rule would permit more securities class actions to move beyond the motion-to-dismiss stage and would encourage the filing of additional class actions. That would impose undue burdens on the Nation's economy.

ARGUMENT

THE COURT OF APPEALS' READING OF 28 U.S.C. § 1658(b)(1) CANNOT BE RECONCILED WITH ITS TEXT, STRUCTURE, PURPOSE, AND HISTORY AND ENCOURAGES PLAINTIFFS TO SIT ON THEIR POTENTIAL SECURITIES FRAUD CLAIMS RATHER THAN DILIGENTLY INVESTIGATE ANY POSSIBLE FRAUD

Section 1658(b) of Title 28 bars a private suit brought pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, of the Securities and Exchange Commission (SEC) if the suit is filed more than "2 years after the discovery of the facts constituting the violation" or "5 years after such violation," whichever is earlier. 28 U.S.C. § 1658(b).

The text and purpose of that limitation provision compel the conclusion that a suit filed by a private plaintiff is time-barred if the plaintiff has known or should have known of the possibility of securities fraud by the defendant—*i.e.*, has been on inquiry notice—for more than two years. Any other reading would encourage plaintiffs to sit on their potential claims rather than diligently investigate any possible fraud.

The court below nonetheless held that a plaintiff who suspects (or should suspect) that the defendant made a material misrepresentation is not on notice of the possibility of fraud until that plaintiff has information specifically relating to whether the defendant "h[e]ld those opinions or beliefs in earnest." Pet. App. 33a. Under that construction of Section 1658(b)(1), the two-year statute of limitations does not commence until a plaintiff has knowledge of all the elements of his claim—including evidence of scienter—and can adequately plead a securities fraud cause of action. Pet. App. 29a-30a. That conclusion should be rejected.

A. Section 1658(b)(1) Requires A Private Plaintiff To Bring A Securities Fraud Action Within Two Years After He First Suspects, Or Has Reason To Suspect, The Possibility Of Fraud On The Part Of The Defendant

In enacting Section 1658(b), Congress codified the statute of limitations for private securities actions

that this Court announced in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). At the time of *Lampf,* no provision expressly established a limitation period for a private right of action under Section 10(b) or Rule 10b-5, because neither Congress nor the SEC had contemplated the existence of such an action. Looking to the statute of limitations found in Section 9(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(e), this Court held that actions pursuant to Section 10(b) and Rule 10b-5 must be commenced "within one year after the discovery of the facts constituting the violation and within three years after such violation." *Lampf*, 501 U.S. at 364; *see id.* at 364 n.9. In 2002, Congress adopted that judicial construct with only one modification: it extended the statute of limitations to "2 years after the discovery of the facts constituting the violation," and lengthened the period of repose to "5 years after such violation." 28 U.S.C. § 1658(b).

1. The text of Section 1658(b)(1) requires a plaintiff to bring his claim within two years after he is on notice of the possibility of fraud

a. Section 1658(b) requires a private cause of action for securities fraud to commence two years after "discovery of the facts constituting the violation" of the securities laws. 28 U.S.C. § 1658(b)(1). That statutory text—"*discovery* of the facts constituting the violation"—expressly incorporates a discovery rule into the statute of limitations. As explained below, that means that the clock begins to run when the

plaintiff first suspects (or has reason to suspect) the possibility of fraud on the part of the defendant. At that point, a prospective plaintiff is obligated to investigate his potential claims, and the limitation period continues to run while he does so. A plaintiff need not possess information specifically relating to each element of his cause of action for the limitation period to begin.

When applying a discovery rule to limitation periods, this Court has long made clear that a plaintiff need not have information specifically relating to each element of his cause of action to start the running of the clock. *See Rotella v. Wood*, 528 U.S. 549, 555 (2000). For example, in *United States v. Kubrick*, 444 U.S. 111 (1979), the Court held that the limitation period in the Federal Tort Claims Act begins to run as soon as the plaintiff knows the "critical facts that he has been hurt and who has inflicted the injury." *Id.* at 122. At that point, the claim has "accrue[d]," because a plaintiff armed with those facts is on notice that he must promptly investigate whether the defendant's conduct in causing the injury was tortious and therefore actionable. As the Court explained, the limitation trigger does not await the completion of the plaintiff's investigation: that "would undermine the purpose of the limitations statute, which is to require the reasonably diligent presentation of * * * claims." *Id.* at 123.

Likewise, in *Rotella*, the Court held that the statute of limitations for private civil claims under the Racketeer Influenced and Corrupt Organizations Act (RICO) begins running before the plaintiff possesses knowledge of a key element of a civil RICO cause of action—namely, a pattern of racketeering activity. *Rotella*, 528 U.S. at 554. The limitation period is triggered, at the latest, when the plaintiff knows or should know of his injury, even if he has no facts supporting the requisite pattern of activity. *Id.* at 554 & n.2. As the Court explained, despite the potential complexities of some RICO patterns and the enormous difficulty a plaintiff may face in uncovering them, once the plaintiff knows or should know of an injury, he is on inquiry notice and must "investigate the cause of his injuries" while the clock for him to bring suit continues ticking. *Id.* at 557. Otherwise, the limitation period would effectively be open ended, thereby "prov[ing] a godsend to stale claims, and doom[ing] any hope of certainty in identifying potential liability." *Id.* at 559.

Moreover, when Congress enacted Section 9(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(e), it had been well established that the limitation clock starts to tick as soon as a plaintiff is on inquiry notice of the possibility of a claim and continues to run while the plaintiff is investigating the potential fraud. *See United States v. Diamond Coal & Coke Co.*, 255 U.S. 323, 335 (1921) (discussing whether particular facts known to the plaintiff "constituted such indications of fraud as to give notice

to the [plaintiff], or at least to put it upon inquiry"); *Wood v. Carpenter*, 101 U.S. 135, 141 (1879) ("Whatever 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. Greene*, 3 Myl. & K. 722, 40 Eng. Rep. 266, 275 (Ch. 1834) (opinion of Lord Brougham))); *see also* John P. Dawson, *Fraudulent Concealment and Statutes of Limitation*, 31 Mich. L. Rev. 875, 886 (1933) (once there is evidence of a misrepresentation, "a 'duty' to investigate appears and the sanction of this 'duty' is the commencement of the statutory period"). Both the holding in *Lampf* and the text of Section 1658(b) are based on Section 9(e), which has identical "discovery of the facts constituting the violation" language. *See* 15 U.S.C. § 78i(e).

Accordingly, given the Court's longstanding construction of discovery rules, it should be presumed that Congress intended Section 1658(b)'s discovery rule to be construed the same way. *See, e.g.*, *Commissioner v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 159 (1993). The rationale articulated in cases such as *Kubrick* and *Rotella* is equally applicable here: a plaintiff who is on notice of the possibility of securities fraud should be encouraged to promptly investigate it, and a lax limitation period would "only have the effect of postponing whatever

public benefit" private securities actions might realize. *Rotella*, 528 U.S. at 558.[2]

b. If Congress had intended Section 1658(b) to have the meaning attributed to it by the court below, it could have triggered the limitation period on the "discovery of the facts sufficient to state a cause of action" or on the "discovery of the elements of a claim for securities fraud." But Congress did not do so, and this Court should not read that language into the statute. That those words should not be read into the statute is particularly so in the context of securities claims. As this Court has repeatedly recognized, to prevail in a private securities fraud action, a plaintiff must prove more than just a "violation" of Section 10(b). *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (listing elements of claim for securities fraud). Thus, in the context of a securities fraud claim, the phrase "facts constituting the

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[2] When Congress enacted Section 1658(b), it was also well established that "discovery" encompassed both actual and constructive discovery. *See Kirby v. Lake Shore & Mich. S. R.R. Co.*, 120 U.S. 130, 134-135, 138 (1887) (construing statute that runs from "the discovery by the aggrieved party of the facts constituting the fraud" as commencing when the "fraud was, or should with due diligence have been, discovered"); *see also Berry v. Valence Tech., Inc.*, 175 F.3d 699, 703-704 (9th Cir. 1999) (collecting cases). Thus, there is universal agreement among the circuits (in which the government concurs) that "discovery of the facts constituting the violation" encompasses both actual and constructive discovery. Brief for the United States as Amicus Curiae at 7, *Trainer Wortham & Co. v. Betz*, No. 07-1489 (U.S. Apr. 22, 2009) (quoting *Lampf*, 501 U.S. at 363).

violation" is naturally read as not encompassing all of the facts necessary to adequately plead a cause of action.

At the very least, the plain meaning of the phrase "facts constituting the violation" does not encompass facts relating specifically to scienter. Rather, that phrase is better understood as reflecting the core facts concerning the defendant's conduct, and not the defendant's state of mind. That understanding is one that is practical and logical, as it would commence the statute of limitations upon facts that are outwardly observable and would not turn on the possession of facts specifically relating to the defendant's "opinions or beliefs" and whether they were held in "earnest." Pet. App. 33a.

Indeed, in the PSLRA, Congress distinguished between those two concepts in the context of securities fraud claims. *Compare* 15 U.S.C. § 78u-4(b)(1) (requiring a plaintiff to "specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading"), *with* 15 U.S.C. § 78u-4(b)(2) (requiring a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind"). In summarizing that distinction, this Court stated that "[t]he PSLRA, requires plaintiffs to state with particularity both the *facts constituting the alleged violation*, and the facts evidencing scienter." *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007) (emphasis added). The Court's use of the phrase "facts constituting the alleged violation"

(in contradistinction to facts evidencing scienter) demonstrates that, in ordinary English, the former phrase does not necessarily encompass facts relating to scienter.

c. For the foregoing reasons, the government is incorrect in suggesting that "[t]he phrase 'facts constituting the violation' is naturally understood to refer to facts that, if pleaded in a securities-fraud complaint, would be sufficient to survive a motion to dismiss." Brief for the United States as Amicus Curiae at 9, *Trainer Wortham & Co. v. Betz*, No. 07-1489 (U.S. Apr. 22, 2009). According to the government, that standard for the commencement of the limitation period is highlighted by the heightened pleading requirements of the PSLRA and Rule 9(b) of the Federal Rules of Civil Procedure. *Id.* at 9 n.2. But this Court has held that a heightened pleading standard, such as the one imposed by the PSLRA, is irrelevant to the question when the limitation period starts. *See Rotella*, 528 U.S. at 560. Indeed, Congress imposed the PSLRA standard—like other heightened pleading standards—to deter "abusive litigation," *Tellabs*, 551 U.S. at 313. It is thus quite doubtful that Congress intended that pleading standard to obviate any requirement that a plaintiff diligently investigate his potential private securities claims.

In any event, even if the interplay between Section 1658(b) and the PSLRA were to result in some claims being dismissed, that result would not be contrary to the intent of Congress. Because the five-year statute of repose bars a private securities

fraud action even if the plaintiff is blamelessly ignorant of the fraud, *see* 28 U.S.C. § 1658(b)(2), Congress clearly contemplated that not every potential securities fraud would be actionable.

2. The structure of Section 1658(b) confirms that notice of the possibility of fraud triggers the running of the two-year statute of limitations

The structure of Section 1658(b) confirms that a plaintiff need not possess information relating to each element of his cause of action to trigger the running of the two-year statute of limitations. Under Section 1658(b), a claim for securities fraud can be time-barred in one of two ways: if the plaintiff does not file within two years of "discovery of the facts constituting the violation" or if he does not file within 5 years "after such violation," whichever is earlier. 28 U.S.C. § 1658(b). The five-year period of repose thus serves as the outer limit for a securities fraud claim, even if a potential plaintiff is completely unaware (and has no reason to be aware) that he has a securities fraud claim.

Under the approach adopted by the court below, however, that alternative five-year limit would nearly always be the only effective time limitation on a securities fraud claim. The facts of this case illustrate why that is so. Respondents base their claims on statements made in March and April of 2000. Pet.

App. 7a-8a. Even though the Federal Drug Administration warned in a September 2001 letter that those statements were "false, lacking in fair balance, or otherwise misleading," *id.* at 11a (citation omitted), the court below nevertheless held that respondents were not on inquiry notice until October 2003, *see id.* at 18a, 47a. But by that point, less than two years remained in the five-year repose period. Thus, under the court of appeals' approach, that five-year limitation would be the only possible time bar to respondents' suit.

If that is the effect in this relatively straightforward case—where a federal agency uncovered the allegedly fraudulent or misleading nature of the statements—the court of appeals' approach would "effectively write[ ] the [two-year] statute of limitations off the books" for the vast majority of cases. *See Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 878 (9th Cir. 2008) (Kozinski, C.J., dissenting from denial of rehearing *en banc*). That could not have been what Congress contemplated when it provided for two separate, alternative time bars. *See, e.g.*, *Hibbs v. Winn*, 542 U.S. 88, 101 (2004) ("A statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant * * * ." (quoting 2A N. Singer, Statutes and Statutory Construction § 46.06, pp. 181-186 (rev. 6th ed. 2000) (footnotes omitted))).

3. There would have been no logical purpose for Congress to extend the statute of limitations to two years if plaintiffs were not expected to investigate possible fraud claims during that period

a. Before the enactment of Section 1658(b), securities fraud actions pursuant to Section 10(b) and Rule 10b-5 had to be brought within the time limitation judicially established by this Court in *Lampf*, namely, "within one year after the discovery of the facts constituting the violation and within three years after such violation." *Lampf*, 501 U.S. at 364. The sole change effected by Congress's passage of Section 1658(b) was to extend the limitation and repose periods to two years and five years, respectively. 28 U.S.C. § 1658(b)(1) and (2).

If the limitation period does not begin to run until the *completion* of any investigation, the addition of that year would make no sense. Under that reading, all that would remain to be done once the limitation period begins to run would be the drafting of the complaint. But there is no reason to believe, and every reason to doubt, that Congress provided an additional year—twice the previous limitation period—solely for that purpose. Instead, the only reading of Section 1658(b)(1) that makes sense is that the limitation period begins to run as soon as a plaintiff is on inquiry notice, *i.e.*, when the plaintiff first suspects (or has reason to suspect) the possibility of fraud on the part of the defendant. The additional

year provides plaintiffs more time to investigate potential wrongdoing so as to obtain enough information to file a viable complaint under the heightened pleading requirements of the PSLRA.

b. The legislative history of Section 1658(b), which was part of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, confirms that Congressional purpose and indicates that Congress contemplated that the limitation period begins to run upon notice of the possibility of fraud.

The Senate Report expressed concern that the one-year/three-year period unduly limited the ability of plaintiffs to obtain recovery, especially in cases involving complex fraud. *See* S. Rep. No. 107-146, at 8 (2002). With regard to the one-year period, the Senate Judiciary Committee reported that the period was insufficient because "the best cons are designed so that even after victims are cheated, they will not know who cheated them, or how. 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." *Id.* at 9. The Senate Report noted that "[w]ith the higher pleading standards that also govern securities fraud victims [sic], it is unfair to expect victims to be able to negotiate such obstacles in the span of 12 months (See 15 U.S.C. § 78u-4)." *Ibid.*

Additionally, the Senate Report expressed concern that, because plaintiffs had only one year to investigate the fraud once they were placed on

inquiry notice, the short period "set[ ] up a perverse incentive for victims to race into court, so as not to be barred by time, and immediately sue." *Id.* at 9. The Report observed that "[p]laintiffs who wish[ed] to spend more time *investigating* the matter * * * [were] punished under the [then] current law." *Ibid.* (emphasis added). Thus, the Report indicated an intent to provide plaintiffs additional time to investigate the fraud and therefore "to discourage frivolous cases." *Ibid.*

Eight members of the Senate Judiciary Committee expressly added, in accord with the statements in the main Senate Report, that the bill was "intended to be consistent with established case law in that the 'discovery' limitations period for private antifraud actions under section 10(b) of the Exchange Act begins to run when the plaintiff is on 'inquiry notice' of a fraud." *Id.* at 29. They defined "inquiry notice" as "[w]hen 'the circumstances would suggest to an investor of ordinary intelligence that she has been defrauded.'" *Ibid.* (quoting *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993), *cert. denied*, 511 U.S. 1019 (1994)).

4. The decision below cannot be reconciled with the policies that undergird statutes of limitations

a. Statutes of limitations represent a legislative judgment that at some point the right of a defendant to be free from stale claims prevails over the right of

a plaintiff to bring his claim. *Kubrick*, 444 U.S. at 117. That judgment is founded on the principle that the passage of a large amount of time following alleged wrongdoing prejudices a defendant's ability to present a meritorious defense. Construing the limitation period in Section 1658(b)(1) as beginning to run on notice of the possibility of fraud furthers that principle: it discourages potential plaintiffs from waiting until the full fraud reveals itself and to instead "tak[e] the actions necessary to bring the fraud to light." *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993).

In contrast, the court of appeals' construction of Section 1658(b)(1) fundamentally conflicts with that principle by encouraging potential plaintiffs to engage in a "wait-and-see approach" before investigating and potentially uncovering any fraud. Under that view, potential plaintiffs have every incentive to ignore the possibility of fraud because, absent evidence specifically relating to scienter, a failure to investigate will not prevent them from bringing suit much later. And in fact, by delaying, a potential plaintiff can "sit back and * * * see how the price of his stock behave[s] in the interim." *Fujisawa Pharm. Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir. 1997) (Posner, C.J.). "If the stock rebound[s] from the cellar they would have investment profits, and if it stay[s] in the cellar they would have legal damages. Heads I win, tails you lose." *Tregenza v. Great Am. Commc'ns Co.*, 12 F.3d 717, 722 (7th Cir. 1993) (Posner, C.J.), *cert. denied*, 511 U.S. 1085 (1994); *see*

also Jensen v. Snellings, 841 F.2d 600, 607 (5th Cir. 1988) (inquiry notice standard is "intended to ensure fairness to defendants against claims that have been allowed to slumber") (internal quotation marks and citation omitted). That result is completely at odds with the principle underlying the two-year limitation period of Section 1658(b)(1).

But it is precisely the tactic used in this case. Even though the FDA had issued its warning letter and concerns over Vioxx had been well publicized, *see* Pet. App. 11a, 15a, 18a, the first Vioxx-related class action complaint for securities fraud was not filed until shortly after Merck's stock price dropped considerably in November 2003, *see* Pet. Br. 7. The drop in stock price then precipitated an onslaught of 16 securities fraud actions, including this one. *Ibid.* Such tactical delay on the part of plaintiffs is completely at odds with the principle behind the limitation period of Section 1658(b)(1). *See Fujisawa*, 115 F.3d at 1334 ("On this view, the potential plaintiff can complete his investigation, draft his complaint, and put the complaint in a drawer to be taken out in a year if the price of the stock has fallen."); *Royal Air Props., Inc. v. Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962) ("The purpose of the Securities Exchange Act is to protect the innocent investor, not one who * * * waits to see how his investment turns out before he decides to invoke the provisions of the Act.").

b. Statutes of limitations are supposed to provide a defendant "the security of knowing when legal action against him has been foreclosed."

Brumbaugh, 985 F.2d at 162. The approach of the court below provides no such security. Rather, under such an approach, plaintiffs have "a wide choice of times at which to sue within a three-year period * * * [based on an] opportunistic use of federal securities law," and defendants thus face significant uncertainty about whether legal action will be forthcoming. *Tregenza*, 12 F.3d at 722. That is especially significant given the extraordinarily high costs imposed on defendants in securities lawsuits. *See* pp. 29-37, *infra*.

By contrast, commencing the limitation period at the moment a potential plaintiff is placed on notice of the possibility of fraud provides a clear rule for plaintiffs and defendants alike. And it is a rule that is capable of being consistently administered by federal courts, as demonstrated by the rulings of the four circuits that have adopted it. *See Franze v. Equitable Assurance*, 296 F.3d 1250, 1255 (11th Cir. 2002); *Jensen v. Snellings*, 841 F.2d 600, 608 (5th Cir. 1998); *Great Rivers Coop. of Se. Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, 898-899 (8th Cir. 1997); *Caviness v. Derand Res. Corp.*, 983 F.2d 1295, 1303 (4th Cir. 1993). Because whether a plaintiff knew (or should have known) "facts constituting the violation" is an objective inquiry, a court administering such a rule can ordinarily identify the discrete event or events that first placed the plaintiff on notice.

B. At Most, A Private Plaintiff Should Be Allowed Additional Time To Investigate His Claim Only If He Actually Conducts A Reasonable, Diligent Investigation

For the reasons discussed above, the Court should hold that the limitation period in Section 1658(b)(1) begins to run when the plaintiff is on inquiry notice—*i.e.*, when the plaintiff knows or should know of the possibility of fraud. If, however, the Court concludes that Section 1658(b)(1) allows a plaintiff some additional period of time to conduct an investigation, it should allow that additional time only if the plaintiff actually conducts a reasonable, diligent investigation.

1. Several courts of appeals have held that inquiry notice does not immediately commence the running of the statute of limitations, but instead that the clock starts ticking only after the period of time it would have taken a reasonable plaintiff to conduct an investigation and discover the alleged fraud. *See, e.g.*, *New England Health Care Employees Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003), *cert. denied*, 540 U.S. 1183 (2004); *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998); *Law v. Medco Research, Inc.*, 113 F.3d 781, 786 (7th Cir. 1997). Under that approach, the investigation period is purely hypothetical, without regard to what kind of investigation, if any, the plaintiff actually undertook. Accordingly, in those circuits, the plaintiff can take advantage of whatever additional time a

hypothetical reasonable plaintiff might have needed to develop all the facts necessary to file a complaint (*plus* 2 years from that date), regardless of whether the plaintiff himself acted reasonably and conducted a diligent investigation. *See, e.g.*, *Marks v. CDW Computer Ctrs., Inc.*, 122 F.3d 363, 368 (7th Cir. 1997) (clock "does not begin to run unless and until the investor is able, with the exercise of reasonable diligence (whether or not actually exercised), to ascertain the information needed to file suit").

2. There is no basis for giving a plaintiff the benefit of the time it would take a hypothetical reasonable plaintiff to conduct an investigation if the plaintiff himself has not actually conducted a reasonable investigation. To be sure, as a matter of equity, this Court has incorporated the discovery rule into periods of limitation in cases involving fraud. *See, e.g.*, *Holmberg v. Armbrecht*, 327 U.S. 392, 397 (1946); *Bailey v. Glover*, 88 U.S. (21 Wall.) 342, 348 (1875). But, as discussed above (pp. 9-13, *supra*), Congress already expressly included that rule in the two-year limitation period in Section 1658(b)(1); those cases thus provide no support for further extending the two-year period. *See Lampf*, 363 U.S. at 350 (incorporating the discovery rule and rejecting equitable tolling of the statute of repose). At the very least, if this Court is inclined to alter its longstanding construction of the discovery rule to hold that the two-year period commences at some point after a plaintiff is on inquiry notice of the possibility of fraud, it would be fundamentally inconsistent with the

discovery rule's equitable principles to provide the benefit of any additional time to a potential plaintiff who has failed to undertake a reasonable, diligent investigation. Rather, at most, the running of the statute of limitations should be forestalled only if and while the plaintiff himself conducts a diligent inquiry.

This Court has long held that the discovery rule is available only to a plaintiff who exercises reasonable diligence in discovering his claim. In *Bailey v. Glover*, the Court announced the rule that the statute of limitations for a party injured by fraud "does not begin to run until the fraud is discovered," but only if that party "remains in ignorance of [the fraud] without any fault or want of diligence or care on his part." 88 U.S. at 348. And the Court explained in *Wood v. Carpenter* that a "party seeking to avoid the bar of the statute on account of fraud must aver and show that he used due diligence to detect it." 101 U.S. at 141; *see* 2 Calvin W. Corman, *Limitation of Actions* § 11.5.1, at 186 (1991) ("Under the federal equitable tolling doctrine, concealment of fraudulent conduct tolls the running of the statute of limitations in favor of the defrauded party until that party learns of the fraudulent conduct of the opposing party, provided the defrauded party could not have discovered it at an earlier date by the exercise of reasonable diligence."); *id.* § 11.5.6, at 198 ("Failure to discover fraud due to negligence or acquiescence precludes its assertion as the basis for tolling the applicable statute of limitations."); *cf. Klehr v. A. O. Smith Corp.*, 521 U.S. 179, 194 (1997) (concluding for

civil RICO statute of limitations that "'reasonable diligence' does matter, and a plaintiff who is not reasonably diligent may not assert 'fraudulent concealment'").

Moreover, a "fundamental principle" on which the discovery rule rests is the equitable doctrine of laches: *i.e.*, the doctrine that a plaintiff who sleeps on his rights is not entitled to pursue his claim. *Diamond Coal*, 255 U.S. at 334. Under that doctrine, "failure to make inquiry" may "take the case out of the equitable principle by which the positive bar of the statute could be avoided." *Id.* at 333. Thus, the doctrine of laches has long been "reflected in the requirement of diligence in 'discovering' the defendant's fraud." John P. Dawson, *Undiscovered Fraud & Statutes of Limitation*, 31 Mich. L. Rev. 591, 632 (1933). Failure to engage in diligence to discover the fraud results in forfeiture of the discovery rule's benefits.

Accordingly, the rule of some circuits that automatically gives a plaintiff additional time after he is on inquiry notice before the limitation period begins, regardless of the reasonableness or diligence of the plaintiff's investigatory efforts, cannot be squared with fundamental, longstanding principles animating the federal discovery rule. That background understanding, which Congress gave no sign of altering, was well settled when Congress enacted Section 1658(b) and Section 9(e) of the 1934 Act, on which Section 1658(b) is based. There is no reason to believe that Congress intended to give the

unreasonable plaintiff—*i.e.*, one who is on inquiry notice of the possibility of fraud, and yet who does not conduct a diligent inquiry—any more than two years from notice of the possibility of fraud.

3. Such an "inquiry notice plus hypothetical diligence" rule also would be unworkable. The amount of time it should take to investigate and uncover the alleged fraud is measured by the purely theoretical inquiry of what a hypothetical reasonable plaintiff would have done. In essence, courts have to conceive in a vacuum what a diligent investigation would look like and how much time it would take to complete; what the plaintiff actually did is irrelevant. That exercise would be all the more crucial, and yet all the more difficult, where the plaintiff did not actually conduct any investigation at all.

By contrast, a rule that allows the plaintiff a period to investigate only if he has acted diligently has the virtue of calling for examination of the plaintiff's actual conduct to see whether it was objectively reasonable. And, of course, if the plaintiff has not completed any investigation at all, his conduct is per se unreasonable, and the statute of limitations should begin to run as soon as he is on inquiry notice. *See LC Capital Partners, LP v. Frontier Ins. Group, Inc.*, 318 F.3d 148, 154 (2d Cir. 2003) ("If the investor makes no inquiry once the duty arises, knowledge will be imputed as of the date the duty arose.").

4. Finally, a rule that gives all plaintiffs the benefit of what a reasonable plaintiff would have done, regardless of the plaintiff's actual diligence or neglect, would unfairly reward the lax plaintiff. It would not provide incentive to potential plaintiffs to make prompt inquiry into possible wrongdoing, but rather would encourage a wait-and-see approach of sitting on the sidelines to see if someone else will uncover wrongdoing. *Cf. Brumbaugh*, 985 F.2d at 162 ("Merely bringing suit after the scheme has been laid bare through the efforts of others, in this case the IRS, will not satisfy the requirements of due diligence when there have been prior warnings that something was amiss."). Thus, if the Court were to adopt some sort of "inquiry notice plus investigation" rule, any such rule should be tempered by the requirement that the period for investigation is available only to plaintiffs who actually conduct a diligent inquiry. *See Klehr*, 521 U.S. at 194.

C. Allowing Stale Claims To Survive Will Increase Pressure On Defendants To Settle Securities Class Actions And Will Impose Undue Costs On The Nation's Economy

As both this Court and Congress have repeatedly recognized, private securities fraud 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). It is thus

inconceivable that Congress, against the backdrop of its attempts to curtail abusive securities class actions through the PSLRA and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227, would have created an open-ended limitation period, thereby exacerbating the problem of abusive securities litigation. By limiting stale lawsuits, Section 1658(b) acts as a check on the dangers that securities class actions pose to shareholders in particular and to the United States economy as a whole.

1. It is vital that the standard for triggering the running of the limitation period for securities actions be sufficiently rigorous to terminate stale securities class actions at the earliest stages of litigation, before discovery begins and the enormous pressure to settle starts to mount. Even outside the charged context of securities class actions, when a case that should have been barred moves beyond the motion-to-dismiss stage, the defendant is prejudiced in defending itself, because "[m]emories fade, documents are lost, [and] witnesses become unavailable." *Brumbaugh*, 985 F.2d at 162. Plaintiffs are thus better positioned to "coerce settlements simply because aging has improved an originally meritless claim." *Ibid*. Those concerns are even more real in securities class actions, as even suits with virtually no prospect of success can coerce significant settlements.

2. Meritless, abusive securities class actions impose a deleterious effect on the national economy. On average, securities class actions reduce a

defendant company's equity value by 3.5%. Anjan V. Thakor, *The Unintended Consequences of Securities Litigation* 14 (U.S. Chamber Institute for Legal Reform 2005), *available at* http://www.heartland.org/custom/semod_policybot/pdf/18330.pdf. Smaller companies, which are "the economy's engine for innovation and growth," suffer a disproportionate loss of equity value, in part because they are less able to achieve economies of scale in litigation costs. *Id.* at 9-10. Abusive securities litigation destroys far more of defendants' wealth than it creates for plaintiffs. *Id.* at 14.

Indeed, this Court has acknowledged that such actions destroy the value of the stock of innocent shareholders, rather than protecting their interests. *See Blue Chip Stamps*, 421 U.S. at 739 (costs associated with securities class actions are "payable in the last analysis by innocent investors for the benefit of speculators and their lawyers" (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 867 (2d Cir. 1968) (Friendly, J., concurring))). Securities class actions often result only in "a transfer of wealth from current shareholders to former shareholders," and for those class members who are still shareholders at the time of suit, defendants' payments to plaintiffs "amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up." Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 Stan. L. Rev. 1487, 1503 (1996).

Abusive securities litigation also imposes burdens on the United States capital markets. Such litigation has been a driving force behind a growing perception that the United States legal system is more hostile for business than many of our international competitors, most notably the United Kingdom. *See* Michael R. Bloomberg & Charles E. Schumer, *Sustaining New York's and the US' Global Financial Services Leadership* ii (2007) ("Bloomberg-Schumer Report"). The result has been a rapid decline in the competitiveness of the United States capital markets, driven in large part by foreign firms' concerns over shareholder litigation in the United States. *See* Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* x (2006). It is clear that "foreign companies [are] staying away from US capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital." Bloomberg-Schumer Report at 101. The consensus is that "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of business—and driven away potential investors." *Id.* at ii.

And despite Congress's efforts to reign in abusive securities litigation by enacting the PSLRA and SLUSA, the clear trend is that the number of securities class action filings is rising. Comparing the two-year period from July 2005 to June 2007 with the period from July 2007 to June 2009, securities class action filings jumped by an astounding 60 percent.

See Cornerstone Research, *Securities Class Action Filings: 2009 Mid-Year Assessment*, at 3.

3. In addition to the costs imposed on the Nation's economy, abusive securities class action suits affect defendants in a way that is unique from other types of litigation. These class actions contain unique elements that encourage, if not compel, defendants to settle even the most insubstantial of claims. An overly generous reading of the statute of limitations would allow the pursuit of otherwise stale claims that should be time-barred and could result in billions of additional dollars of unwarranted settlements being extracted from the Nation's businesses.

If a securities class action moves into discovery, the legal costs of defending the suit impose an enormous burden on defendants. *See, e.g.*, James A. Kassis, *The Private Securities Litigation Reform Act of 1995: A Review of Its Key Provisions and an Assessment of Its Effects at the Close of 2001*, 26 Seton Hall Legis. J. 119, 124 (2001) (describing the discovery process as "financial blood letting"). Those costs are exponentially multiplied for stale cases, as the defendant must go even further back into document files and electronic archives and must dredge up forgotten memories of events that occurred more distantly in the past.

But the legal costs associated with abusive discovery are only one aspect of a broader problem. Depositions and other extensive discovery often draw the attention of key employees away from the

business's day-to-day operations and also its long-term strategies. Plaintiffs with "largely groundless claim[s]" can take advantage of liberal discovery rules "to simply take up the time of a number of other people," which represents a draining "social cost rather than a benefit." *Blue Chip Stamps*, 421 U.S. at 741.

The plaintiffs' bar is keenly aware of defendants' concerns about the enormous costs associated with securities class actions. They also know that securities class actions, with their potential for devastating damages awards, are high-stakes, bet-the-company litigation for any corporation. Thus, one of the key strategies of the plaintiffs' bar is to attempt to survive a motion to dismiss and then extract a large settlement. That is because "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment." *Blue Chip Stamps*, 421 U.S. at 740. Once a securities class action makes it past the motion-to-dismiss stage, "the mere existence of an unresolved lawsuit has settlement value to the plaintiff * * * because of the threat of extensive discovery and disruption of normal business activities which may accompany a lawsuit which is groundless in any event, but cannot be proved so before trial." *Id.* at 742-743.

So rather than focus on the merits of a securities class action, defendants often must settle such suits merely to avoid the prospect, no matter how unlikely, of potentially ruinous liability. Even a mere five percent chance of an adverse judgment in a class action alleging $1 billion in damages could make a $25 million settlement look attractive. And such a settlement could look even more palatable if the defendant's insurance will cover a portion of that amount. Indeed, empirical research has shown that the best predictors of whether a securities class action will be filed and what the ultimate settlement amount will be are the decline in stock price and the amount of the defendant's insurance coverage—two factors wholly divorced from the merits of the suit. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 516-518 (1991).

The success of the settlement-extraction strategy by the plaintiffs' bar is evident. The past decade has seen an average of nearly 100 securities class action settlements each year. Total class action settlements over that time have averaged approximately $5.6 billion per year. Ellen M. Ryan & Laura E. Simmons, Cornerstone Research, *Securities Class Action Settlements: 2008 Review & Analysis*, at 1. In 2008, the trend of ever increasing securities class action settlement figures continued, with the median settlement coming in at $8 million, an eight percent increase over the median settlement for the prior nine years, even after adjusting for inflation. *Id.* at 2.

That success, in turn, encourages plaintiffs, and their counsel, to file even more suits. *See generally* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669 (1986).

If anything, that trend demonstrates that a more lenient statute of limitations is entirely unnecessary to preserve meritorious claims. While, in general, a more stringent statute of limitations might preclude some meritorious claims, that is unlikely in the securities claim context if a plaintiff has two years after he is on notice of the possibility of fraud to file suit. In the experience of amicus and its members, the plaintiffs' bar files private securities class actions almost immediately upon the discovery of the smallest possibility of fraud—often within days or weeks of the plaintiff being placed on inquiry notice. Indeed, private securities fraud claims are often filed shortly after the SEC announces enforcement action (or another governmental agency releases a critical report, such as the FDA's warning letter in this case), and the private plaintiff generally simply repeats the allegations of the pending enforcement action. *See, e.g.*, *id.* at 682; Neil M. Gorsuch and Paul B. Matey, *Settlements in Securities Fraud Class Actions: Improving Investor Protection*, at 27 (2005), *available at* http://208.112.47.239/upload/0405WPG orsuch.pdf. Thus, if a private plaintiff does not file suit promptly upon inquiry notice, that likely has little (or

nothing) to do with any lack of ability to investigate the claim. Rather, it likely says more about the view of the plaintiffs' bar of the merit (or lack thereof) of the potential claim—and may even be a strategic attempt to game the market. The limitation period of Section 1658(b)(1) should not be read in a lax way that would make those claims—which are more likely to be abusive than to be meritorious—viable.

An open-ended statute of limitations, such as the one announced by the court below, should therefore be rejected, because it would make it more likely that otherwise stale claims would survive. That, in turn, would only further plaintiffs' ability to extract exorbitant settlements from amicus's members through abusive litigation and would encourage the filing of additional class actions, with their attendant burdens on innocent shareholders and the Nation's economy.

CONCLUSION

For the reasons set forth above and in petitioners' brief, the judgment of the court of appeals should be reversed.

Respectfully submitted,

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