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Inquiry Notice: *Merck & Co. v. Reynolds* and the Need for Requiring Private Investors to Investigate Potential Securities Fraud

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I. Introduction

Under SEC Rule 10b-5, it is illegal for any person "[t]o make any untrue statement of a material fact . . ." or "[t]o engage in any act . . . which operates or would operate as a fraud or deceit upon any person . . . in connection with the purchase or sale of any security."[1] This rule applies to securities traded on stock exchanges.[2] Although no express cause of action for private securities fraud exists, courts have interpreted the securities acts to allow private citizens to sue for damages on the basis of an implied private cause of action.[3] Under the applicable statute of limitations, these causes of action must be brought either within five years of the violation or within two years from "discovery of the facts constituting the violation."[4]

Unfortunately, securities frauds can be very difficult for private investors to discover. First, securities frauds are inherently complex. Plenty of information is available for investors who wish to learn about a particular security, even for newly offered stocks, but much of the information available is in the form of facts that are frequently difficult to interpret without financial education.[5] Since so much information is available, finding a misrepresentation becomes difficult, especially for individual investors who may have less time available for research. Second, a securities fraud cause of action requires "scienter, i.e., a wrongful state of mind."[6] It is difficult to prove that a company knew its sales campaign would fail when the company made representations concerning the product because if the company wants to sell stock, it will typically avoid making such information publically available.

In *Merck & Co. v. Reynolds*, the Supreme Court resolved a circuit split by clarifying the standard that lower courts should use in determining when a securities fraud case accrues. Following *Merck*, evidence that would

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1. 17 C.F.R. § 240.10b-5 (2010).
2. *Id.*
3. *See, e.g.*, Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341 (2005).
4. 28 U.S.C. § 1658(b) (2006).
5. *See* Joseph S. Hellman & Harold M. Hoffman, *What to Look for in a Stock Prospectus*, A.B.A. J., Apr. 1, 1986, at 96, 96.
6. *Dura Pharm., Inc.*, 544 U.S. at 341.

merely cause a reasonably prudent investor to begin investigating a potential fraud is no longer sufficient to start the statute of limitations running.[7] Instead, investors must file within two years after a diligent investor reasonably should have discovered the "facts constituting the violation."[8] The Supreme Court's standard does away with the often confusing and inconsistently-applied terminology previously used, such as the "inquiry notice" and "storm warnings" terms.[9] Overall, the *Merck* standard has received praise from investors.[10] Investors need not worry that the limitations period might run out before they have sufficient information to plead because *Merck* provides that facts indicating scienter must be discovered before a cause of action can accrue.[11] This note will argue, however, that the *Merck* standard will lead to a decrease in diligent investigation of potential securities frauds by private investors and an overall increase in securities frauds. To avoid this, the Supreme Court should have placed a "duty to inquire" on private plaintiffs in securities fraud cases, thereby charging plaintiffs with constructive knowledge of the fraud if the plaintiff fails to investigate once sufficient warnings of fraud exist.

Part II of this note details the origin of the private securities fraud statute of limitations and the split that arose among circuit courts regarding when the cause of action accrues for securities fraud. Part III takes a close look at the *Merck* case, including the facts and procedural history of the case as well as an analysis of the majority opinion. Part IV demonstrates how the language of the statute does not immediately foreclose an inquiry notice standard, a standard which would be more practical and more consistent with applicable policy considerations. Part V concludes.

II. Law Before the Case

Circuit courts spent many years wrestling with the proper standard for the statute of limitations for private securities fraud actions. As this section shows, the results of this struggle were confusing and often inconsistent, even within the same circuit, as courts attempted to strike a balance

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7. Merck & Co. v. Reynolds, 130 S. Ct. 1784, 1789-90 (2010).

8. *Id.*

9. *Id.* at 1798.

10. *See, e.g.*, Ralph V. De Martino & Jennifer H. Unhoch, *U.S. Supreme Court Addresses the Statute of Limitations for Private Federal Securities Fraud Claims*, COZEN O'CONNOR (May 21, 2010), http://www.cozen.com/admin/files/publications/sec052110.pdf.

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

between protecting investors and encouraging diligent investigation into potential frauds.

A. The Supreme Court Speaks in Lampf

In 1991, the Supreme Court provided the starting point for the analysis of the statute of limitations for private securities fraud actions under Securities and Exchange Commission Rule 10b-5. In *Lampf, Pleva, Lipkind, Prupis, & Petigrow v. Gilbertson*, a law firm was sued under Rule 10b-5 for misrepresentations it made in the offering memoranda for several limited partnerships which "induced [the plaintiffs] to invest in the partnerships."[12] The district court granted summary judgment for defendants, holding that the case was barred by the statute of limitations; the Ninth Circuit reversed and remanded, holding that summary judgment was not proper.[13] Both courts agreed that the proper standard for the statute of limitations for Rule 10b-5 claims was to borrow the most closely related state statute of limitations.[14]

The Supreme Court, however, resolved a circuit split regarding the proper standard for accrual of the statute of limitations for private securities fraud under 28 U.S.C. § 1658 by holding that the statute of limitations for Rule 10b-5 claims should be borrowed from federal law, not state law.[15] The Court reasoned that since the Rule 10b-5 claim is an "implied [claim] under a [federal] statute that also contained an express [claim] with its own time limitation," the same statute should be used to determine the limitations period for the implied claim.[16] In applying this reasoning, the Court held that the closest analogue in the 1934 Securities Exchange Act was 15 U.S.C. § 78i(e),[17] which provided the limitations period for willful security price manipulation, since § 78i(e) was related to the "precise dangers" involved in implied § 10(b) claims.[18] The Court also considered the language of an amendment to § 13 of the 1933 Securities Act, which specifically provided for both actual and constructive discovery, but the Court chose to apply the language of § 78i(e) over that of the 1933 Act.[19]

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12. 501 U.S. 350, 352-53 (1991).
13. *Id.* at 353-54.
14. *Id.*
15. *Id.* at 358 n.4, 359.
16. *Id.* at 359.
17. 15 U.S.C. § 78i(e) (2006).
18. *Lampf*, 501 U.S. at 360-61.
19. *See id.* at 360 n.7, 364 n.9; *see also* 15 U.S.C. § 77m (2006) ("No action shall be maintained to enforce any liability created under section 77k or 77l(a)(2) of this title unless brought within one year after the discovery of the untrue statement or the omission, *or after*

*B. The Post-*Lampf *Circuit Split*

Following the Supreme Court's decision in *Lampf*, the circuit courts began applying and interpreting the § 78i(e) statute of limitations vis-à-vis private causes of action under Rule 10b-5. Under § 78i(e), "[n]o action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation."[20] The key question presented by the statute, then, is when has "discovery of the facts constituting the violation" occurred? From the very beginning, courts held that "discovery" in the securities fraud context includes not only actual discovery but also constructive discovery.[21] In determining when such constructive discovery occurred, the circuits crafted two distinct standards: the "inquiry plus reasonable diligence" standard and a strict "duty to inquire" standard. These standards have not always been clearly or consistently applied.[22] Importantly, the term "inquiry notice" (and the related term "storm warnings"), which appears frequently in this context, is used primarily to determine when "discovery" is deemed to have occurred; "inquiry notice" is the standard for defining discovery, rather than a judicially-imposed accrual point.

1. Inquiry Plus Reasonable Diligence—A Balance Between Preventing Opportunism by Investors and the Need to Meet Heightened Pleading Requirements

The most plaintiff-friendly standard is the "inquiry plus reasonable diligence" standard. Under this standard, courts engage in a two-part inquiry to determine whether sufficient "storm warnings" existed to put a reasonable investor on inquiry notice of the claim.[23] "Storm warnings" are simply warning signs that an investor would recognize as indicative of

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such discovery should have been made by the exercise of reasonable diligence . . . ." (emphasis added)).

20. 15 U.S.C. § 78i(e) (2006).

21. *See, e.g.*, Tregenza v. Great Am. Commc'ns Co., 12 F.3d 717, 722 (7th Cir. 1993); *see also* Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1009 (1998).

22. *See generally* Joseph Robertson, Note, *Inquiry Notice Gone Awry: A Doctrine Abused in* Debenedictis v. Merrill Lynch, 94 CORNELL L. REV. 1491 (2009) (explaining a difference in the application of "inquiry notice" based on storm warnings between the Second and Third Circuits).

23. Young v. Lepone, 305 F.3d 1, 8 (1st Cir. 2002).

possible fraud.[24] "Inquiry notice" refers to the point where sufficient "storm warnings" exist to cause a reasonable investor to investigate the potential fraud further.[25] Courts applying the "inquiry plus reasonable diligence" standard have typically held that once an investor is on inquiry notice, the statute of limitations does not begin to run until the investor, exercising reasonable diligence, *should have* discovered the facts constituting the violation.[26] Therefore, in order to obtain the benefit of the later accrual point, the plaintiff does not need to prove that he actually exercised reasonable diligence once sufficient "storm warnings" existed to indicate the possibility of fraud.[27] If diligence would not have uncovered the fraud, the statutory period does not begin to run until the fraud could have been discovered.

Prior to the Supreme Court's decision in *Merck*, a large majority of the circuit courts embraced this rule because it struck a good balance between various policy concerns. Seven different circuit courts subscribed to the inquiry plus reasonable diligence standard,[28] several of which were strongly influenced by the Tenth Circuit's reasoning in *Sterlin v. Biomune Systems, Inc.*[29] In *Sterlin*, the court based its decision to adopt the inquiry plus reasonable diligence standard on the balance between two important policies: the interest in preventing investors from sitting on their hands and the need to provide investors sufficient time to develop their claims.[30] In balancing these policies, the Tenth Circuit focused on the fact that "particularized pleading requirements" could end up barring otherwise valid claims because investors would not be able to discover the facts needed for the pleading.[31] Since delaying accrual of discovery until the fraud could have been discovered would still help in preventing opportunism, both policies could be properly served.[32]

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24. *Id.*
25. *Id.*
26. Betz v. Trainer Wortham & Co., 519 F.3d 863, 876-77 (9th Cir. 2008).
27. Sterlin v. Biomune Sys., 154 F.3d 1191, 1202 n.20 (10th Cir. 1998).
28. *See, e.g.*, *Betz*, 519 F.3d at 876-77; Sudo Props., Inc. v. Terrebonne Parish Consol. Gov't., 503 F.3d 371, 376 (5th Cir. 2007); New England Health Care Emps. Pension Fund v. Ernst & Young, L.L.P., 336 F.3d 495, 501 (6th Cir. 2003); *Lepone*, 305 F.3d at 10 (1st Cir. 2002); *Sterlin*, 154 F.3d at 1201; Fujisawa Pharm. Co. v. Kapoor, 115 F.3d 1332, 1334 (7th Cir. 1997); Howard v. Haddad, 962 F.2d 328, 330 (4th Cir. 1992).
29. *E.g.*, *New England Health Care*, 336 F.3d at 501; *Lepone*, 305 F.3d at 9.
30. *Sterlin*, 154 F.3d at 1202.
31. *Id.*
32. *Id.*

2. The Eleventh Circuit's Exposition of Inquiry Notice Jurisprudence with Regard to the Sarbanes-Oxley Act

The Eleventh Circuit's standard was practically identical in effect to the "inquiry plus reasonable diligence" standard, although the circuit used different phrasing and adopted its standard in order to effectuate the Sarbanes-Oxley Act (SOA). Prior to the SOA, the Eleventh Circuit held that "discovery occurs when a potential plaintiff has inquiry notice or actual notice of a violation."[33] Although the court still defined inquiry notice as the point where a reasonable investor would start investigating, the court held that inquiry notice does not require the plaintiff to be fully aware of the "nature and extent of the fraud"; instead, the possibility of fraud would be enough to constitute discovery sufficient to begin the running of the statute of limitations.[34]

In the year following *Theoharous*, however, Congress enacted the Sarbanes-Oxley Act. The Eleventh Circuit accordingly revisited the inquiry notice standard in *Tello v. Dean Witter Reynolds, Inc.* and decided that, in light of the expansion of the limitations period for securities fraud in the Sarbanes-Oxley Act, "inquiry notice designates the point in time when the SOA statute of limitations begins to run for the purpose of reasonably diligent investigation to substantiate the securities fraud at issue."[35] However, accrual would occur only when the plaintiff has sufficient facts enabling him to sue within the two-year statutory period.[36] This standard is reminiscent of the "inquiry plus reasonable diligence" standard in that it focuses on ensuring that plaintiffs are able to sue, but the Eleventh Circuit did not require that plaintiffs have all the necessary facts to file suit before accrual occurs.[37]

The Eleventh Circuit's reasoning as to why plaintiffs should be protected drew on concerns expressed in the SOA's legislative history rather than pleading requirements themselves. Two major concerns considered by the Senate were the inherent complexity of securities frauds and the lack of deterrence of such frauds.[38] The complexity of securities frauds makes it difficult for investors to discern whether a fraud has occurred; therefore,

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33. Theoharous v. Fong, 256 F.3d 1219, 1228 (11th Cir. 2001).
34. *Id.*
35. Tello v. Dean Witter Reynolds, Inc., 410 F.3d 1275, 1288 (11th Cir. 2005).
36. *Id.* at 1293.
37. *See id.* at 1283.
38. *Id.* at 1285-86.

concealment of the fraud can be more easily accomplished.[39] Since concealment is relatively easy, fewer private actions can be brought within the time limit, thus preventing investors from being able to deter securities frauds through private lawsuits. The court also recognized that, according to the Supreme Court, the statutes guarding against securities frauds should be flexibly construed in order to accomplish the purposes for which the statutes were enacted.[40] Therefore, in order to remedy the problem of the ease with which securities fraud can be concealed, the court held that the purpose of the statutory period is to allow plaintiffs time to develop and substantiate their claims.[41]

3. The "Duty to Inquire" Approach and the Impact of a Failure to Investigate

The "duty to inquire" approach is almost identical to the "inquiry plus reasonable diligence" standard, but it is less favorable to plaintiffs in one key aspect: the consequences of a failure to investigate. Under this approach, the statutory period "begins to run only after the plaintiff 'obtains actual knowledge . . . or notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge.'"[42] However, if the plaintiff fails to undertake an inquiry after sufficient facts existed indicating the possibility of fraud, the plaintiff is deemed to have had knowledge of the fraud as of the date the duty to inquire arose.[43] The effect of this imputation of knowledge is to deny to the plaintiff the benefit of the later accrual point when reasonable diligence would have led to discovery of the facts. In *LC Capital Partners, LP v. Frontier Insurance Group, Inc.*, the Second Circuit applied this standard on review of a motion to dismiss and held the plaintiff's claim was barred by the statute of limitations because the plaintiff had been on inquiry notice at least a year before undertaking any actual investigation.[44] Only the Second and Third Circuits adopted this standard.[45]

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39. *See id.* at 1286.
40. *Id.* at 1287.
41. *Id.* at 1287-88.
42. Staehr v. Hartford Fin. Servs. Grp., 547 F.3d 406, 411 (2d Cir. 2008).
43. *Id.* (quoting Dodds v. Cigna Sec., 12 F.3d 346, 350 (2d Cir. 1993)).
44. LC Capital Partners, LP v. Frontier Ins. Grp., 318 F.3d 148, 156-57 (2d Cir. 2003).
45. *See, e.g.*, *id.* at 154; DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209, 216 (3d Cir. 2007) (holding that once defendants showed the existence of sufficient storm warnings, plaintiffs must respond by showing that they did exercise reasonable diligence and did not discover the fraud).

The Second and Third Circuits based their decision to impute knowledge of the fraud due to a failure to investigate on a different, but still important, policy concern. These circuits generally favored the encouragement of private policing by punishing investors who refuse to investigate potential fraud.[46] In *In re NAHC Securities Litigation*, the Third Circuit held that once the defendant establishes sufficient evidence of storm warnings, the burden of proof shifts to the plaintiff, requiring a showing that the plaintiff exercised reasonable diligence and still could not discover the fraud.[47] The court noted that, as in a previous case, "excus[ing] Appellant's lack of inquiry because, in retrospect, reasonable diligence would not have uncovered their injury . . . would, in effect, discourage investigation . . . ."[48] Essentially, this duty to inquire is meant to incentivize investors to be vigilant in keeping abreast of potential securities fraud claims by encouraging investigation once sufficient facts exist to suggest potential fraud.

III. Statement of the Case

A. Facts and Procedural History

Merck & Co. v. Reynolds began as a securities fraud class action brought by various investors who had purchased Merck's securities between May 21, 1999, and October 29, 2004.[49] The plaintiffs alleged that Merck had committed securities fraud by concealing material information regarding the risk of heart attacks caused by one of the drugs sold and marketed by Merck—VIOXX.[50] Because this information had been concealed, the prices of Merck's securities were artificially high when the investors purchased them.[51] Many other complaints relating to VIOXX were filed in different districts, prompting the Judicial Panel on Multidistrict Litigation to consolidate the various lawsuits into one action in the District of New Jersey.[52] The complaint for the consolidated action alleged six counts, three of which involved violations of §§ 10(b), 20(a), and 20A of the Exchange

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46. *In re* NAHC, Inc. Sec. Litig., 306 F.3d 1314, 1327 (3d Cir. 2002); Armstrong v. McAlpin, 699 F.2d 79, 88 (2d Cir. 1983).

47. *In re NAHC*, 306 F.3d at 1327.

48. *Id.* (alteration in original) (quoting Mathews v. Kidder, Peabody & Co., 260 F.3d 239 (3d Cir. 2001)).

49. *In re* Merck & Co. Sec., Derivative & "Erisa" Litig., 483 F. Supp. 2d 407, 410 (D.N.J. 2007).

50. *Id.* at 416.

51. *Id.*

52. *Id.*

Act and SEC Rule 10b-5.[53] The plaintiffs asserted that these three alleged violations were filed before the statute of limitations for securities fraud had expired under the Sarbanes-Oxley Act.[54]

Defendants responded to the consolidated action by filing a motion to dismiss under Rule 12(b)(6), alleging in part that the action was barred by the statute of limitations.[55] In order to determine when the statute of limitations began to run against the plaintiffs, the district court applied the Third Circuit's inquiry notice standard.[56] Under this standard, the two-year provision of the statute would begin to run once the plaintiffs "in the exercise of reasonable diligence should have discovered the general fraudulent scheme."[57] Again, inquiry notice occurs once plaintiffs have "sufficient information" or "storm warnings" to indicate the probability of fraud; once plaintiffs are on inquiry notice, they have a duty to inquire further into the suspected fraud.[58] If defendants have established that plaintiffs were on inquiry notice, the plaintiffs must then offer evidence proving that they had exercised due diligence but were unable to uncover the fraud.[59]

The district court considered when the plaintiffs would have been on inquiry notice. The drug involved in the case, VIOXX, was approved for prescription use as a painkiller by the FDA in 1999; unlike other painkillers, however, VIOXX was designed to avoid inhibiting a particular enzyme, thus reducing the risk of gastrointestinal side effects.[60] A study conducted by Merck in March of 2000, called the "VIGOR" study, confirmed that VIOXX had its intended effect but also indicated that the patients who had taken VIOXX were more likely to suffer heart attacks than those who had taken the comparison medication naproxen.[61] Merck played down the significance of these results, arguing that naproxen had reduced the risk for heart attacks, not that VIOXX had increased the risk.[62] Given that no data supported Merck's hypothesis, the VIGOR study became the subject of extensive scientific and financial analysis throughout

53. *Id.* at 416-17.
54. *Id.*; 28 U.S.C. § 1658(b) (2006).
55. *In re Merck & Co.*, 483 F. Supp. 2d at 416-17.
56. *Id.* at 418.
57. *Id.* (citing *In re* NAHC, 306 F.3d 1314, 1326 (3d Cir. 2002)).
58. *Id.* (citations omitted).
59. *Id.*
60. *Id.* at 410.
61. *Id.* at 410-11.
62. *Id.* at 411.

2000 and 2001, with no consensus regarding which drug was affecting the risk of heart attacks.[63]

"On September 17, 2001, the FDA issued a Warning Letter to Merck," indicating that Merck had been misrepresenting VIOXX's safety by discounting the results of the VIGOR study and ordering Merck to stop its misleading promotional campaign and correct the information it had distributed.[64] This letter was widely discussed by the media throughout the following week and also spurred several new lawsuits, including two alleging consumer fraud.[65] Despite these lawsuits, Merck kept VIOXX on the market until September 30, 2004; the voluntary withdrawal decision followed from early results of another VIOXX study Merck was performing that demonstrated an increased rate of heart attacks in the patients taking VIOXX as compared to those who were taking a placebo.[66]

The district court determined that the plaintiffs had been on inquiry notice as early as October 2001, such that their claims were time-barred once filed in November 2003.[67] The court reasoned that the results from the VIGOR study, combined with the FDA's warning letter and the surrounding media coverage, showed that a reasonable investor would have recognized such signs as warnings of fraud.[68] Furthermore, the court characterized the FDA warning letter as a direct accusation of fraud which was sufficient, in light of the circumstances, to start the clock on the two-year statute of limitations.[69]

The Court of Appeals for the Third Circuit reversed and remanded, holding that the district court's characterizations of the FDA warning letter and other alleged warnings were insufficient to put investors on inquiry notice of securities fraud.[70] Since the FDA's standards for a misrepresentation differ from those for securities fraud, they added nothing to what had already been stated in the VIGOR study and had no significant effect on the market price for Merck's securities; therefore, the letter was not a sufficient accusation of fraud to put investors on inquiry notice.[71]

63. *Id.* at 411-13.
64. *Id.* at 413-14.
65. *Id.* at 414-15.
66. *Id.* at 416.
67. *Id.* at 424-25.
68. *Id.* at 419-21.
69. *Id.* at 421-22.
70. *In re* Merck & Co., Sec., Derivative & "Erisa" Litigation, 543 F.3d 150, 172 (3d Cir. 2008).
71. *Id.* at 169-71.

Subsequently, the Supreme Court granted certiorari to decide when the statute of limitations for private securities fraud accrues.[72]

B. The Supreme Court's Analysis

The Supreme Court granted certiorari in order to decide two issues: (1) when a private securities fraud cause of action accrues and (2) whether scienter is one of the "facts constituting the violation" that must be discovered prior to accrual.[73] The Court affirmed the Second Circuit, holding that accrual occurs when the plaintiff either actually discovers or, with reasonable diligence, would have discovered the facts showing the fraud, including scienter.[74]

1. The Meaning of "Discovery"

As a prelude to its analysis, the Court first decided that the term "discovery" in the statute of limitations referred not only to facts that were actually known but also to those facts that "a reasonably diligent plaintiff would have known."[75] Although the Court agreed with the parties that discovery includes constructive discovery, the Court felt that explaining why this is so was important for its analysis of when the limitations period accrues.[76]

According to the Court, in the context of statutes of limitations, "discovery" is usually a reference to the "discovery rule," which delayed accrual for fraud cases until the plaintiff had a complete case, so long as the plaintiff was not at fault or lacking in diligence as to the discovery of the fraud claim.[77] Over time, legislatures codified this rule and, in the process of interpreting those statutes, courts usually held that "discovery" refers to both actual and constructive discovery.[78] The Court also noted that all the courts of appeals which have interpreted the meaning of the phrase "facts constituting the violation," both under the original *Lampf* standard and the identical language added by Congress in the SOA, have interpreted the phrase to include the facts actually known and those that should have been discovered by the exercise of reasonable diligence.[79] The Court found this

72. *See* Merck & Co., Inc., v. Reynolds, 130 S. Ct. 1784, 1784 (2010).
73. *Id.* at 1789-90.
74. *Id.*
75. *Id.* at 1796.
76. *Id.* at 1793.
77. *Id.* at 1793-94.
78. *Id.* at 1794.
79. *Id.* at 1795.

history to be relevant because Congress is assumed to be aware of and to take into account relevant judicial precedent when enacting new laws.[80]

2. Scienter as one of the "Facts Constituting the Violation"

The Court then held that scienter is one of the "facts constituting the violation" that must be present before the statute of limitations accrues.[81] Scienter, defined as "a mental state embracing intent to deceive, manipulate, or defraud," is a fact that makes up an essential part of a § 10(b) claim.[82] Since the applicable heightened pleading standards for such a claim require facts, claims that did not demonstrate scienter would simply be dismissed. If the defendants could hide the facts related to scienter throughout the limitations period, a claim could be time-barred before it could even get to court, thus enabling defendants to perpetrate the very fraud the "discovery" rule in the statute of limitations seeks to prevent.[83] This issue proved to be dispositive in *Merck*, as the Court found no indications of scienter in the FDA warning letter or the products-liability complaints, thus leading to the conclusion that the plaintiffs' case was timely filed.[84]

3. Inquiry Notice

Lastly, the Court rejected Merck's propositions regarding the use of inquiry notice for accrual purposes.[85] Since the statute states that accrual occurs only after discovery of the facts constituting the violation, inquiry notice cannot be the proper standard because inquiry notice initiates the limitations period once the plaintiff merely has reason to start investigating.[86] The Court therefore rejected Merck's argument that inquiry notice should still be the point of accrual when the actual plaintiff fails to undertake a reasonable investigation after being placed on inquiry notice.[87] The Court did add, however, that rejecting the inquiry notice standard would treat all plaintiffs equally, both those who are diligent and those who are not, because a plaintiff who entirely failed to investigate might not have

80. *Id.* at 1795-96.
81. *Id.* at 1796.
82. *Id.*
83. *Id.*
84. *Id.* at 1798-99.
85. *Id.* at 1797-98.
86. *Id.* at 1797.
87. *Id.* at 1797-98.

found sufficient facts to file a complaint that would satisfy the heightened pleading standards.[88]

IV. Analysis

In *Merck*, the Supreme Court's reasoning did not properly take into account the purpose of the SOA and the ambiguity in 28 U.S.C. § 1658(b)(1). The Court rejected the circuit courts' inquiry notice jurisprudence without giving full consideration to the comparative practical implications of the various formulations for when "discovery" occurs and the competing policy considerations embedded in the securities laws. By considering the issues raised by policy and practicality, the Court would have recognized that the "duty to inquire" standard is a better standard, thus giving lower courts a clearer understanding of how to construe securities fraud statutes.

A. Inquiry Notice Is Not Inconsistent with Accrual after Discovery of the Facts Constituting the Violation

The Court's unprovoked exposition of the meaning of the term "discovery" in 28 U.S.C. § 1658(b)(1) precluded the court from being able to read the inquiry notice standard into that statute of limitations. However, "discovery" could be read to refer to the "discovery rule," which requires reasonable diligence on the part of the actual plaintiff. Furthermore, Congress was aware of other relevant judicial precedent when it enacted the statute of limitations in the Sarbanes-Oxley Act; construing the statute in light of that awareness shows Congress likely did not mean to foreclose the "inquiry notice" standards. Finally, the Court's concern with the practical implications of an earlier accrual point had already been addressed by Congress when it doubled the time allowed in the limitations period.

1. The Court Failed to Consider Fully the Meaning of "Discovery"

The Court did not fully consider the standard of inquiry notice when it initially analyzed the meaning of discovery. In the course of determining that the term "discovery" must include constructive discovery as well as actual discovery, the Court in *Merck* focused on a single interpretation of "discovery" to decide that the term included facts that "a reasonably diligent plaintiff would have known."[89] However, inquiry notice was never intended to be a substitution for the term discovery; instead, courts used

88. *Id.* at 1798.
89. *Id.* at 1796.

inquiry notice standards to determine when discovery occurred. As support for its definition of discovery, the Court stated that all the courts of appeals had held that discovery includes, in addition to actual discovery, facts that a "hypothetical reasonably diligent plaintiff would have discovered . . . ."[90] However, this summation ignores a critical aspect of the circuits' standard: the *exercise* of reasonable diligence.[91]

The term "discovery", as used in the context of statutes of limitations, does tend to refer to the "discovery rule",[92] but the "discovery rule" can also imply a duty to exercise reasonable diligence. Knowledge of sufficient facts to constitute storm warnings can create a duty to inquire. A total failure to conduct an inquiry, at least in some jurisdictions, can result in an imputation of knowledge of the fraud.[93] Therefore, "discovery" could also mean that due diligence is required, an interpretation which would not be inconsistent with the statutory language.

Furthermore, the very purpose of the two-year statute of limitations period is to give the plaintiff time to develop and substantiate the facts of the case to the point that a lawsuit can be filed. In *Merck*, the Court also suggests that the phrase "facts constituting the violation" includes the facts that make up the necessary elements of the claim.[94] Were that the case, then the statutory period would not begin to run until the plaintiff had the facts needed to sue. However, in enacting the Sarbanes-Oxley Act, Congress expressed clear concerns regarding the one-year statute of limitations provision for securities frauds in 15 U.S.C. § 78i(e).[95] Before the statutory period was extended in the SOA, courts had, in part, based their decisions to delay accrual on the fact that an earlier accrual point would often prevent plaintiffs from being able to substantiate their claims adequately.[96] Likewise, one of Congress' goals for the SOA was to deter securities frauds by ensuring plaintiffs had time to develop the facts of their cases.[97] If plaintiffs could not develop their cases enough to sue within one

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90. *Id.* at 1795.

91. *See* Kahn v. Kohlberg, Kravis, Roberts & Co., 970 F.2d 1030, 1042 (2d Cir. 1992) (holding that discovery occurs when plaintiff has "notice of the facts, which in the exercise of reasonable diligence, would have led to actual knowledge").

92. *Merck*, 130 S. Ct. at 1794.

93. 37 AM. JUR. 2D *Fraud and Deceit* § 350 (2010).

94. *See Merck*, 130 S. Ct. at 1796 (stating that scienter is a fact constituting the violation because it "'constitut[es]' an important and necessary element of a '§10b' violation").

95. *See* Tello v. Dean Witter Reynolds, Inc., 410 F.3d 1275, 1285-88 (11th Cir. 2005).

96. *See* Sterlin v. Biomune Systems, 154 F.3d 1191, 1202 (10th Cir. 1998).

97. *See, e.g.,* 148 CONG. REC. S6540-41 (daily ed. July 10, 2002) (statement of Sen. Harkin); 148 CONG. REC. S7420 (daily ed. July 26, 2002) (statement of Sen. Leahy).

year or if defendants were able to conceal the fraud for three years, then securities frauds would not be effectively deterred by private lawsuits. Congress addressed this problem by amending 28 U.S.C. § 1658 to provide for a two-year/five-year statute of limitations scheme for securities frauds, as compared to the former one-year/three-year scheme.[98] Because the congressional purpose behind the lengthening of the statute of limitations period was to give plaintiffs more time to develop the facts, the Court should not have rejected a duty to inquire based on the potential lack of sufficient facts needed to satisfy heightened pleading requirements for securities frauds.

2. Congress Implicitly Approved the Circuits' Usage of Inquiry Notice

When Congress enacted the SOA, it was presumptively aware of how the circuit courts were treating the very words it chose to use in the statute of limitations for private securities frauds. As the Court explained, Congress can be assumed to be aware of relevant judicial precedent whenever it designs its statutes.[99] Because both the "inquiry plus reasonable diligence" and "duty to inquire" standards existed prior to the enactment of the SOA and provided competing interpretations of the language in the limitations statute, they are certainly "relevant judicial precedent." Consequently, one can assume that Congress was aware of the use of the "inquiry plus reasonable diligence" and "duty to inquire" standards when it amended 28 U.S.C. § 1658.

Because Congress was aware of these precedents, Congress' choice to adopt the exact same language previously used for the statute of limitations for private securities frauds demonstrates that Congress most likely did not have a contrary understanding of the meaning of the language. Since Congress decided to retain the same language as that found in 15 U.S.C. § 78i(e) when it could have opted to be more explicit, it demonstrated approval for that language by not attempting to correct the courts' interpretations.[100] Even if Congress did not actually approve the interpretations, Congress' failure to clarify the meaning of "discovery" indicates that it is unlikely that Congress had an overarching sense of what

98. *Compare* 15 U.S.C. § 78i(e) (2006) (providing a limitations period of one year after discovery and three years after the violation), *with* 28 U.S.C. §1658(b) (2006) (providing for a limitations period of two years after discovery and five years after the violation).

99. *Merck*, 130 S. Ct. at 1795.

100. One example of a less ambiguous statute of limitations is that found in 15 U.S.C. § 77m, which uses the phrasing "after the discovery . . . or after such discovery should have been made by the exercise of reasonable diligence."

"discovery" should include and was willing to allow courts to decide the issue on their own. Therefore, the "duty to inquire" standard is not inconsistent with the language in the limitations statute.

B. An Alternative to the Merck Analysis—Which Standard Is Better?

Because the imputation of knowledge of fraud due to failure to inquire is not inconsistent with the phrase "after discovery of the facts constituting the violation,"[101] the Court should have more broadly considered the implications of its holding regarding the applicability of inquiry notice. Specifically, the Court should have considered whether the inquiry notice standard used by the Second and Third Circuits was more or less practicable than the Court's standard and chosen the standard that better aligns with policy concerns.

1. The Merck Standard Is Less Practicable than the Inquiry Notice Standard

Under the *Merck* standard, investors have a decreased incentive to investigate fraud, which will inhibit courts from being able to determine accurately what facts were available to the plaintiffs at what time. If the particular plaintiff fails to investigate when a reasonably diligent person would do so, the court will not know exactly what information an investigation could have uncovered. For example, an investor who suspects fraud could contact a company during the course of an investigation, potentially revealing more of the facts constituting the violation. But if no investigation is made at all, courts will not have a complete picture as to when particular information could have been made available and thus when the cause of action should be deemed to have accrued.

The Court's standard in *Merck* will allow investors who do not investigate to sue, which will lead to a decrease in the incentive to investigate, since investors can obtain a "free ride" into court. Investors who fail to investigate indications of securities fraud can still join in lawsuits with those who have been diligent, allowing them a potential benefit from the lawsuit without expending any effort for an investigation. More investors will decide to allow other investors to keep watch for fraud. Given the inherently high level of complexity involved with recognizing and detecting securities frauds, less investigation by investors will likely result in fewer frauds being discovered; as a result, private securities fraud actions like §10(b) will lose their deterrence value, since issuers will

101. 28 U.S.C. § 1658(b) (2006).

recognize when it becomes easier to get away with fraud and thus more investors will end up being defrauded.[102] Therefore, the Supreme Court should have included a duty to investigate, allowing for imputation of knowledge of the fraud if the plaintiff failed to conduct any investigation after being put on inquiry notice.

2. The Merck Standard Is Less Consistent with the Policies Underlying the Securities Laws

The standard announced in *Merck* is most consistent with the policy of ensuring that investors have sufficient time to sue. By delaying accrual until investors would actually be able to discover the basis of their claims, the Supreme Court decided not to fault investors for failing to investigate when the investigation might not have revealed sufficient information to plead securities fraud.[103] However, as previously discussed, the SOA already accounted for the need for giving investors extra time to develop their claims by extending the limitations period.[104] Furthermore, since the Court held that scienter is one of the "facts constituting the violation" which must be present before discovery can occur, the duty to investigate would not be triggered until "storm warnings" exist indicating scienter.

Another important policy to consider is that of preventing opportunism by defrauded investors. Opportunism is particularly problematic in securities fraud cases because there are two methods by which investors can potentially benefit from delaying their lawsuits. First, investors could delay in order to avoid the expenses and effort of suing when recovery is uncertain until another party has taken the risk and won. Second, investors could wait and see if the price of the stock that is the subject of the alleged fraud increases.[105] This ends up benefiting investors either way, allowing investors to hold off a lawsuit to benefit from capital gains if stock performance improves or sue for fraud if the stock price decreases.[106] Requiring investors to investigate potential fraud or risk losing their right to sue due to the statute of limitations will help reduce the risk of opportunism because investors will be forced to make their choice earlier between suing for fraud or retaining their stock.

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102. *See* Tello v. Dean Witter Reynolds, Inc., 494 F.3d 956, 968 (11th Cir. 2007).
103. *See Merck*, 130 S. Ct. at 1798.
104. *See* discussion *infra* Part IV.A.1.
105. *See* Tregenza v. Great Am. Commc'ns Co., 12 F.3d 717, 722 (7th Cir. 1993).
106. *See id.*

V. Conclusion

Analysis of the relevant policy concerns as well as a comparison of the practicality of the Court's standard and the previous inquiry notice standard show that the Supreme Court should not have done away with the "duty to inquire" standard for securities fraud accrual determinations. Contrary to the Court's holding, an inquiry notice standard can be read into the language of 28 U.S.C. § 1658 because the term "discovery" had developed through securities fraud case law to refer to inquiry notice and because "discovery" can be read to include a duty to inquire similar to that required by the discovery rule. A comparison of the impacts of the Court's standard to those of the "duty to inquire" standard shows that imputing knowledge due to a failure to investigate is more practical than the Court's standard. Furthermore, the Court's standard is less closely aligned with relevant policies related to securities laws and will be less effective than the "duty to inquire" standard at encouraging investigation.

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