ALERTS AND UPDATES

# Two-Year Statute of Limitations for Federal Securities Fraud Claims Begins to Run When a Reasonably Diligent Plaintiff Would Have Discovered the Violations

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In *Strategic Diversity, Inc. v. Alchemix Corp.*, an opinion marked for publication, the United States Court of Appeals for the Ninth Circuit held that for federal securities fraud claims, the statute of limitations begins to run when a reasonably diligent plaintiff would have *discovered* the underlying violations, and not from when a reasonably diligent plaintiff should have begun investigating the potential violations[1].

Federal law provides that a securities fraud claim "may be brought not later than the earlier of (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation."[2] In *Strategic Diversity*, the lawsuit had been filed within the five-year limitation period; the dispute was whether the May 2007 lawsuit was time-barred because it had been filed outside the two-year "discovery" limitation period.

The plaintiff had purchased $250,000 worth of defendant Alchemix's common stock in July 2002. The plaintiff had made that stock purchase after receiving from the defendant corporation's founder a June 2002 memorandum outlining a sizable, potential third-party investment in Alchemix. The plaintiff claimed that he did not actually discover the allegedly fraudulent misrepresentations and omissions that induced him to purchase the stock – that is, the facts underlying his cause of action – until at least December 2005, when he learned that the sizable third-party investment never materialized, the Alchemix board had resigned, and the defendant corporation's founder had been a defendant in a separate 2002 securities fraud action in state court.

The district court found that the June 2002 memorandum placed the plaintiff on "inquiry notice"—the moment in time when the plaintiff should have begun investigating possible claims. Consequently, the district court ruled that the statute of limitations began to run at the time of inquiry notice, that is, June 2002. Because the May 2007 lawsuit had not been filed within two

years of June 2002, the district court found the securities claims time-barred and granted summary judgment against the claims.

The Ninth Circuit vacated summary judgment and remanded the case so the district court could consider the impact of recent authority from the United States Supreme Court in *Merck & Co, Inc. v. Reynolds*.[3] In *Merck*, the Supreme Court held that, with respect to the federal statute of limitations, "'discovery' as used in [28 U.S.C. § 1658] encompasses not only those facts the plaintiff actually knew, but also those facts a reasonably diligent plaintiff would have known."[4] Accordingly, while the Ninth Circuit acknowledged the usefulness of the "inquiry notice" concept, the Ninth Circuit emphasized that under Supreme Court precedent, a defendant who claims a lawsuit is time-barred must demonstrate that a reasonably diligent plaintiff would have *discovered* the facts constituting the violation more than two years prior to the filing of the complaint. Relying upon the Supreme Court's decision in Merck, the Ninth Circuit held:

[T]he "discovery" of facts that put a plaintiff on "inquiry notice" does not automatically begin the running of the limitations period. Terms such as "inquiry notice" and "storm warnings" may be useful *to the extent that they identify a time when the facts would have prompted a reasonably diligent plaintiff to begin investigating*. . . . [T]he ultimate burden is on the defendant to demonstrate that a reasonably diligent plaintiff would have discovered the facts constituting the violation.[5]

The Ninth Circuit ruled further that, because the limitations period does not begin to run until discovery, it does not matter, for statute of limitations purposes, whether the actual plaintiff actually had "inquiry notice" or whether the actual plaintiff undertook a reasonably diligent investigation.[6] Thus, the Ninth Circuit remanded the action for the District Court to determine, in light of the *Merck* opinion, whether the defendant could demonstrate that a reasonably diligent plaintiff would have discovered the alleged violations more than two years prior to the May 2007 complaint.

### For Further Information

If you have any questions about this *Alert*, please contact Kelly D. Eckel, Matthew M. Ryan, any member of the Securities Litigation practice, or the attorney in the firm with whom you are regularly in contact.

**Notes**

1. *Strategic Diversity, Inc. v. Alchemix Corp.*, Nos. 10-15256, 10-16404 (9th Cir. Dec. 2, 2011).
2. 28 U.S.C. § 1658. Also at issue in *Strategic Diversity, Inc.* was the Arizona statute of limitations, which similarly provides that "no civil action shall be brought . . . unless brought within two years after discovery of the fraudulent practice on which the liability is based, or after the discovery should have been made by the exercise of reasonable diligence." Ariz. Rev. Stat. § 44-2004(b).
3. 130 S. Ct. 1784 (2010). The district court granted summary judgment in January 2010, and the Supreme Court issued its opinion in Merck in April 2010. The Ninth Circuit vacated summary judgment and remanded, citing its own precedent recognizing the prudence of remand in light of recent Supreme Court authority. *Strategic Diversity, Inc.*, slip op. at 11 (citing *Betz v. Trainer Wortham & Co., Inc.*, 610 F.3d 1169, 1171 (9th Cir. 2010)).
4. *Merck*, 130 S. Ct. at 1796.
5. *Strategic Diversity, Inc.*, slip op. at 10 (*Merck* quotations omitted, emphases in *Strategic Diversity, Inc.*).
6. *Id.*, slip op. at 11.