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The Securities Fraud Victim's Dilemma: Why California Should Reject Inquiry Notice

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THE SECURITIES FRAUD VICTIM'S DILEMMA: WHY
CALIFORNIA SHOULD REJECT INQUIRY NOTICE

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“Plaintiff could not fairly have been charged with notice of facts which he could have learned only out of the mouths of the conspirators, who were successfully endeavoring to conceal them.”¹

I. INTRODUCTION

On September 23, 2013, California Senate Bill 538 became law, conforming the anti-fraud provision of California securities law to Rule 10b-5, the federal anti-fraud provision promulgated by the Securities and Exchange Commission (“SEC”).² If courts interpret the amended California law consistently with federal courts’ interpretations of the now virtually identical Rule 10b-5, securities fraud victims will face new, onerous “pleading hurdle[s].”³ Plaintiffs

1. *Sime v. Malouf*, 212 P.2d 946, 960-61 (Cal. Ct. App. 1949).

2. S.B. 538, 2013 Leg. Sess. (Cal. 2013), 2013 Cal. Stat. ch. 335. The bill “[e]nsures consistency with federal law by updating anti-fraud provisions in the Securities law.” S.B. 538 Bill Analysis, Assemb. Comm. on Banking and Fin. (June 10, 2013), http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0501-0550/sb_538_cfa_20130607_121212_asm_comm.html. As amended, section 25401 of the California Corporations Code reads:

It is unlawful for any person, in connection with the offer, sale, or purchase of a security, directly or indirectly, to do any of the following: (a) Employ a devise, scheme, or artifice to defraud. (b) Make an untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading. (c) Engage in an act, practice, or course of business that operates or would operate as a fraud or deceit upon another person.

CAL. CORP. CODE § 25401 (West 2014). Rule 10b-5 reads:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, with the purchase or sale of any security.

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2014).

3. Michael Mugmon et al., *United States: California Overhauls State Anti-Securities Fraud Statute*, MONDAQ (Oct. 4, 2013), <http://www.mondaq.com/>

suing under Rule 10b-5 would then need to plead and prove the judicially-imposed elements—scienter, reliance, and causation—which have never before been required under the anti-fraud provision of California securities law.⁴ For that reason, the time is ripe for courts to reject the particularly harsh statute of limitations governing California's anti-fraud provisions.

Even under the previous version of California's anti-fraud provision,⁵ which relieved plaintiffs of pleading these elements,⁶ the statute of limitations posed a dilemma for aggrieved investors. The statute of limitations for securities fraud under California law begins to run when the plaintiff discovers “the facts constituting the violation,”⁷ but courts can impute “discovery” to plaintiffs before they even realize they have been defrauded.⁸ This judicial practice can rob securities fraud victims of any chance of recovery and give a complete defense to defendants who succeed in concealing their fraud because

unitedstates/x/267150/Securities/California+Overhauls+AntiSecurities+Fraud+Statute.

4. Ethan Brown, *California Amends Its State Securities Fraud Provision*, ETHAN BROWN LAW (Oct. 7, 2013), <http://ethanbrownlawblog.com/california-amends-its-state-securities-fraud-provision/>.

5. Before it was amended by S.B. 538, *see supra* note 2, section 25401 of the California Corporations Code read:

It is unlawful for any person to offer or sell a security in this state or buy or offer to buy a security in this state by means of any written or oral communication which includes an untrue statement of material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

CAL. CORP. CODE § 25401 (West 2014).

6. *Bowden v. Robinson*, 136 Cal. Rptr. 871, 878 (Ct. App. 1977). Though a plaintiff need not plead reliance, causation, or intent, section 25401 is not a strict liability violation. A defendant is afforded a complete defense if he can: “(1) prove that he exercised reasonable care and did not know of the untruth or omission, (2) show that even if he had exercised reasonable care, he would not have known of the untruth or omission, and (3) show that the plaintiff knew the facts concerning the untruth or omission.” *Id.*

7. CAL. CORP. CODE § 25506(b) (West 2014) (requiring that actions be brought no later than “two years after the discovery by the plaintiff of the facts constituting the violation”).

8. *See* discussion *infra* Parts III.D, IV.D.1.

the limitations period may expire long before the would-be plaintiff has gathered enough facts to file a viable complaint.⁹

The rule that allows this unjust outcome is called “inquiry notice.”¹⁰ Inquiry notice imposes a duty of inquiry upon a victim of fraud, which arises as soon as facts are available to the victim suggestive of the possibility of fraud.¹¹ When circumstances arise which suggest to an investor of ordinary intelligence that he may have been defrauded,¹² and the investor “makes no inquiry,” knowledge of the fraud is imputed to the investor as of the date the duty arose.¹³ If the investor does investigate, the investor will be charged with knowledge of the fraud as of the date the investor, exercising reasonable diligence, would have discovered the fraud.¹⁴ Therefore, inquiry notice may trigger the limitations period before the investor actually knows he or she has been defrauded.¹⁵ Even where the investor suspects fraud and diligently investigates, the limitations period may expire before the investor can gather enough facts to draft a viable complaint because plaintiffs must meet heightened pleading standards for fraud.¹⁶

9. See discussion *infra* Part IV.D.

10. See *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 815 (Ct. App. 2006).

11. *Deveny*, 42 Cal. Rptr. 3d at 822 (“[O]nce placed on inquiry notice by storm warnings, an investor must perform a reasonable investigation into the possibility of fraud.”).

12. “Such circumstances are often [called] ‘storm warnings.’” *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350 (2d Cir. 1993) (quoting *Cook v. Avien, Inc.*, 573 F.2d 685, 697 (1st Cir. 1978)).

13. *Id.*; see, e.g., *Wright v. Bloom*, No. C 12-00746, 2012 U.S. Dist. LEXIS 170679 WHA, at *8-10 (N.D. Cal. Nov. 30, 2012) (dismissing complaint as four months too late because inquiry notice triggered the running of the limitations period when plaintiffs first became aware of fraudulent conduct).

14. *Deveny*, 42 Cal. Rptr. 3d at 822 (citing *Berry v. Valence Technology, Inc.* 175 F.3d 669, 704, 706 & n.9 (9th Cir. 1999)).

15. See, e.g., *Wright*, 2012 U.S. Dist. LEXIS 170679, at *9-10 (finding that under inquiry notice, limitations period began to run before plaintiffs even knew they had participated in a securities offering).

16. See *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC*, 70 Cal. Rptr. 3d 199, 210 (Ct. App. 2007) (“Fraud allegations must be pled with more detail than other causes of action. The facts constituting the fraud, including every element of the cause of action, must be alleged ‘factually and specifically.’” (quoting *Comm. on Children’s Television, Inc. v. General Foods Corp.*, 673 P.2d 660, 672 (Cal. 1983))).

Given the likelihood that courts will impose even more exacting pleading requirements on securities fraud victims suing under California's amended anti-fraud provisions, California should reject inquiry notice.¹⁷ Instead, the statute of limitations for securities fraud should accrue upon discovery of facts constituting each element of the violation. This would provide investors with time to investigate the fraud, gather facts supporting each element of their claim, and plead with the particularity required for a fraud claim. Not only is this interpretation of the statute of limitations consistent with the plain meaning of the text of the statute, it is also consistent with the apparent legislative intent.¹⁸

Part II of this note provides background on securities fraud and the purpose and policies behind statutes of limitations, particularly as statutes of limitations apply to private rights of action for securities fraud. Part III describes anti-fraud provisions in securities law including private rights of action under both California and federal securities law, as well as their respective statutes of limitations. This part highlights the inconsistencies between the purposes of private enforcement of securities laws, the policies purportedly served by statutes of limitations, and inquiry notice. Part IV recommends that California reject inquiry notice in favor of a discovery-based standard. The plain language of the statute of limitations supports a discovery-based standard, and the Supreme Court has rejected inquiry notice for securities fraud claims under nearly identical federal law.¹⁹ More importantly, inquiry notice unfairly rewards fraudsters for concealing

17. Whether courts will require plaintiffs to plead the judicially-imposed elements of Rule 10b-5 to sustain a claim under California state securities law remains to be seen. Former Commissioner of the Department of Corporations (now the Department of Business Oversight) Keith Bishop opined, "It will probably be a very long time until the courts will untangle the Gordian knot tied by the legislature when it enacted SB 538." Keith Bishop, *California Creates Complete Chaos By Rewriting Anti-Fraud Statute, But "We Are Against Fraud Aren't We?"*, CALIFORNIA CORP. L. BLOG (Sept. 24, 2013), <http://calcorporatelaw.com/2013/09/california-creates-complete-chaos-by-rewriting-anti-fraud-statute-but-we-are-against-fraud-arent-we/>. Even if the amendment does not create a higher pleading standard, inquiry notice should be rejected for reasons set forth in Part IV.D, *infra*.

18. See discussion *infra* Part IV.C-D.

19. *Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 653 (2010).

their schemes and undermines the purposes of private enforcement—detering of fraud and providing restitution for victims.

II. BACKGROUND

A. *Securities Fraud*

The term “security” includes “the commonly known documents traded for speculation or investment.”²⁰ But securities are more than just stocks and bonds. Securities also include “investment contracts,” a broad term encompassing a wide array of schemes through which individuals are led to invest money “in a common enterprise with profits to come solely from the efforts of others.”²¹ This flexible judicial definition of investment contract acknowledges the “countless and variable schemes” devised by innovative “promoters” to trick individuals into parting with money.²²

Indeed, securities fraud takes many forms. In California, spikes in oil prices have triggered increases in fraudulent oil-related investment offerings.²³ Another form of securities fraud in California is the “prime bank scheme,” in which investors are induced to pool their money with other investors’ money by the promise of high returns from offshore banks which normally limit their services to the super-rich.²⁴ Due to recent rule changes that the SEC has promulgated pursuant to the JOBS Act,²⁵ states, as the primary regulators of securities registration, will likely face a new wave of fraudulent schemes carried out under the pretense of a private placement exemption from registration.²⁶ The SEC recently lifted the 80-year

20. SEC v. W.J. Howey Co., 328 U.S. 293, 297 (1946).

21. *Id.* at 301.

22. *Id.* at 299.

23. STATE OF CAL. DEP’T. OF CORPORATIONS, LAW ENFORCEMENT GUIDE TO THE CORPORATE SECURITIES LAW (2006), available at http://www.dbo.ca.gov/Licensees/Corporate_Securities_Law/pdf/doc37.pdf.

24. *Id.*

25. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

26. See A. HEATH ABSHURE, N. AM. SEC. ADM’RS ASS’N, NASAA COMMENTS IN RESPONSE TO RELEASE NO. 33-9354 (FILE NO. S7-07-12), “ELIMINATING THE PROHIBITION AGAINST GENERAL SOLICITATION AND GENERAL ADVERTISING IN

ban on general solicitations for private securities offerings.²⁷ Fraudsters can now take advantage of this lift on consumer protection by marketing their schemes through social media and other forms of advertising to unsophisticated, inexperienced investors, which will certainly lead to an increase in securities fraud.²⁸

The anticipated increase in securities fraud warrants a re-examination of the state securities laws because “[s]ecurities fraud produces . . . social costs that may justify regulation.”²⁹ “First, fraud increases the cost of capital” because investors who “fear that issuers will defraud them . . . discount the price they are willing to pay for securities,” and may even shy away from securities markets altogether.³⁰ Second, securities fraud “upset[s] the efficient allocation of resources” because stock will not be valued correctly.³¹ It follows that an “effective deterrence regime . . . reduce[s] these social costs” by “bring[ing] skittish investors back” to securities markets and improving the allocation of resources.³²

Securities laws provide for private rights of action because private enforcement supplements enforcement efforts by regulatory bodies, allows aggrieved investors to recover money lost in fraudulent investment schemes, and helps ensure the integrity of the securities

RULE 506 AND RULE 144A” 2 (2012), *available at* <http://www.sec.gov/comments/s7-07-12/s70712-92.pdf>.

27. Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release No. 33-9415 (July 10, 2013), *available at* <http://www.sec.gov/rules/final/2013/33-9415.pdf>.

28. *Top Investor Threats*, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, <http://www.nasaa.org/3752/top-investor-threats/> (last visited Nov. 25, 2013).

29. Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2179 (2010).

30. *Id.* Rose explains how securities fraud increases the cost of capital, not only with respect to primary offerings, but also on the secondary market.

31. *Id.* “If fraud is rampant, investors may be unable to distinguish between good and bad firms and may therefore pay too little for securities of the former and too much for securities of the latter. As a result, ‘companies whose stock is overvalued may raise too much equity and overinvest. On the other hand, companies whose stock is undervalued may find it costly or impracticable to obtain sufficient capital from alternative sources, and thus underinvest.’” *Id.* (quoting Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 1010 (1992)).

32. *Id.* at 2180.

markets.³³ Courts have acknowledged the important role of “private litigation in enforcing ethical corporate behavior and obtaining restitution for harmed investors,”³⁴ and have recognized an implied private right of action under Rule 10b-5 for over forty years.³⁵ Between 1998 and 2003, private enforcers recovered nearly four times more in investor losses than the SEC.³⁶

B. Policies Served by Statutes of Limitations

A statute of limitations requires that claims be brought within a prescribed period of time after a cause of action arises and serves as a complete bar to claims that are not brought within that time limit.³⁷ The purpose of statutes of limitations is twofold: to encourage plaintiffs to bring suit before “evidence of meritorious claims . . . become[s] stale” and to provide certainty for potential defendants that after a certain period of time, they will not be sued.³⁸ Limitation periods, then, are premised on the theory that “at some point, the [interest in limiting stale claims and relieving potential defendants of uncertainty] prevails over the right of a plaintiff to bring its claim.”³⁹

In the context of securities fraud, additional considerations inform statutes of limitations. Corporate issuers of securities are often the defendants in securities fraud litigation,⁴⁰ and a company that is “distracted by the threat of litigation” is “less likely to devote

33. *Id.* at 2174; Michael J. Kaufman & John M. Wunderlich, *Toward a Just Measure of Repose: The Statute of Limitations for Securities Fraud*, 52 WM. & MARY L. REV. 1547, 1555 (2011).

34. Nishal Ray Ramphal, *The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States*, RAND CORP. 13 (2007). http://www.rand.org/content/dam/rand/pubs/rgs_dissertations/2007/RAND_RGSD24.pdf.

35. Elizabeth Cosenza, *Dura-tion: A New Paradigm for Construing the Statute of Limitations in Securities Fraud Class Actions*, 62 BAYLOR L. REV. 681, 691 n.49 (2010).

36. Ramphal, *supra* note 34, at 22.

37. 51 AM. JUR. 2D *Limitation of Actions* § 2 (2000).

38. Kaufman & Wunderlich, *supra* note 33, at 1551.

39. Cosenza, *supra* note 35, at 686.

40. Between 1998 and 2004, “84.2% of class action [securities fraud] defendants [were] public corporations.” Ramphal, *supra* note 34, at 2-4.

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resources to productive purposes.”⁴¹ Moreover, defending class action securities fraud lawsuits is “costly,” not only to the defendant corporation but also to the public.⁴² Even in the wake of the most recent financial crisis, more than half of all American adults have money invested in the stock market,⁴³ so securities fraud statutes of limitations must serve the additional interest of minimizing liability exposure for “large numbers of innocent [stockholders].”⁴⁴

On the other hand, the overall health of the economy depends, to a large extent, on the integrity of securities markets, which in turn depends on private enforcement to deter securities issuers from engaging in fraud.⁴⁵ When investors lose money because of the “failure of regulatory authorities to detect [corporate] wrongdoing,” the “overall willingness of the public to invest” decreases, which “hinders the formation of capital.”⁴⁶ This “lead[s] ultimately to lower levels of economic growth than could otherwise have been achieved.”⁴⁷ Thus, the cost of private enforcement of securities laws to corporate defendants and the public “must be measured against the deterrence of fraud and the increase in public confidence in the securities market that more robust private securities litigation . . . has fostered.”⁴⁸ Therefore, the role of private enforcement in the protection of investors, the efficiency of capital markets, and the

41. Kaufman & Wunderlich, *supra* note 33, at 1551.

42. Ramphal, *supra* note 34, at 5. Who ultimately bears the costs of securities litigation—the defendant corporation, its shareholders, or the public—is a “complex question.” *Id.* at 100-01.

43. Lydia Saad, *U.S. Stock Ownership Stays at Record Low*, GALLUP (May 8, 2013), www.gallup.com/poll/162353/stock-ownership-stays-record-low.aspx.

44. Cosenza, *supra* note 35, at 687.

45. See Ramphal, *supra* note 34, at 13.

46. Ramphal, *supra* note 34, at 1. Ramphal also notes:

[T]he link between private and public enforcement mechanisms has taken on added significance in recent years following the corporate scandals and bankruptcies at a host of leading companies, beginning with Enron in 2001. Regulatory authorities were roundly condemned for failing to detect the wrongdoing, and subsequently to obtain adequate investor restitution.

Id. at 9.

47. *Id.* at 1.

48. *Id.* at 5.

health of the economy should not be undervalued, nor should it be thwarted by an overly obstructive statute of limitations.

III. PRIVATE ENFORCEMENT FOR SECURITIES FRAUD

A. *Private Rights of Action Under Federal Securities Laws*

“Federal [securities] regulation . . . emerged as part of the aftermath of the market crash in 1929.”⁴⁹ The laws were “designed to provide investors with full disclosure of material information concerning [issuers of securities, and] to protect investors against fraud” and “manipulation of stock prices.”⁵⁰ The Securities Act of 1933 (“Securities Act”) requires that public securities offerings be registered and that investors be given a prospectus containing material information about the issuer and its offering.⁵¹ The Securities Exchange Act of 1934 (“Exchange Act”) requires periodic disclosure of material information.⁵² It also created the SEC and provided it “with an arsenal of flexible enforcement powers.”⁵³

Section 12(a)(2) of the Securities Act creates liability for those who make a material misrepresentation in connection with the sale of securities.⁵⁴

Liability under [this provision] attaches if . . . (1) the defendant made a false or misleading statement of material fact or failed to state a material fact necessary in order to make the statement not misleading; (2) the plaintiff did not know of the untruth or

49. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976). The stock market crash of 1929 led to the Great Depression, “the longest economic downturn in American history.” U.S. SENATE HISTORICAL OFFICE, SUBCOMMITTEE ON SENATE RESOLUTIONS 84 AND 239 (THE PECORA COMMITTEE), NOTABLE SENATE INVESTIGATIONS 1, available at www.senate.gov/artandhistory/history/common/investigations/pdf/Pecora_investigation_citations.pdf. In 1932, Senate Resolution 84 authorized the Committee on Banking and Currency to investigate stock market practices. *Id.* Congress “rel[ie]d heavily on the revelations” uncovered by the committee in drafting and passing the Securities Act of 1933 and the Securities Exchange Act of 1934. *Id.* at 3.

50. *Ernst & Ernst*, 425 U.S. at 195.

51. Securities Act of 1933, 15 U.S.C. §§ 77a-77i (2012).

52. Securities Exchange Act of 1934, 15 U.S.C. § 78o(d) (2012).

53. *Ernst & Ernst*, 425 U.S. at 195.

54. Securities Act of 1933, 15 U.S.C. § 77m (2012).

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omission; and (3) the defendant knew, or in the exercise of reasonable diligence could have known, of the untruth or omission.⁵⁵

Section 12(a)(2) differs from common law fraud in that reliance, causation, and scienter are not elements.⁵⁶

In 1942, the SEC promulgated Rule 10b-5 pursuant to the power conferred by § 10 of the Exchange Act.⁵⁷ Rule 10b-5 makes it unlawful for any person to make a material misrepresentation “in connection with the purchase or sale of a security.”⁵⁸ The rule was adopted “primarily [to] impos[e] . . . liability upon buyers of securities,” because the “scheme of civil liability in the Securities Act . . . applies only to an action [brought] by a buyer of securities against a seller.”⁵⁹ However, a “spokesman for its drafters” “described [it] rightly as a ‘catchall’ clause . . . ‘to deal with new manipulative (or cunning) devices.’”⁶⁰ Though Rule 10b-5 “does not . . . provide for an express civil remedy,” the courts have read into the rule an implied private right of action for victims of securities fraud.⁶¹ A plaintiff suing under Rule 10b-5 must prove elements that are similar to the elements of common law fraud: a false or misleading statement or omission of material information; reliance; causation; and scienter.⁶²

55. *Cook v. Avien, Inc.*, 573 F.2d 685, 693 (1st Cir. 1978) (citing *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977)).

56. *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061, 1068 (S.D.N.Y. 1995). “The primary difference between a § 12(2) action and a fraud action is that in the former plaintiffs need not show scienter, reliance or loss causation.” *Id.*

57. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975); *see also* SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2013).

58. *Blue Chip Stamps*, 421 U.S. at 729 (quoting SEC Rule 10b-5, 17 C.F.R. § 240.10b-5).

59. HAROLD MARSH, JR. & ROBERT H. VOLK, *PRACTICE UNDER THE CALIFORNIA CORPORATE SECURITIES LAW OF 1968*, at 442 (1969).

60. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976).

61. *Blue Chip Stamps*, 421 U.S. at 730.

62. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 376-77 (1991) (Kennedy, J., dissenting) (“Once federal jurisdiction is established, a § 10(b) plaintiff must prove elements that are similar to those in actions for common-law fraud. Each requires proof of a false or misleading statement or

B. Private Rights of Action Under California Securities Laws

California enacted its first comprehensive scheme of securities regulation in 1917.⁶³ It lacked any civil remedy, except that a security issued without a permit could be deemed “void,” entitling the purchaser to restitution.⁶⁴ The legislative scheme provided no remedy for a purchaser of securities in a transaction where the issuer was guilty of intentional fraud, so long as the issuer complied with the permit requirement.⁶⁵

The drafters of the Corporate Securities Law of 1968 were “concerned” with the lack of “adequate civil . . . remedies for defrauded investors.”⁶⁶ Thus, the drafters “modeled” the new “civil liability provisions” upon those found in the federal Securities and Exchange Acts.⁶⁷ Like § 12(a)(2) of the Securities Act, section 25401 of the California Corporations Code⁶⁸ prohibits material misrepresentation in connection with a security. Like Rule 10b-5 of the Exchange Act, section 25401 imposes liability upon both buyer and seller.⁶⁹ Unlike § 12(a)(2) of the Securities Act, only actual purchasers or sellers of the securities may be liable under section 25401.⁷⁰ Section 25504, however, extends liability to enumerated individuals who materially aid in the fraud, including officers, directors, and broker-dealers,⁷¹ and section 25504.1 extends liability

material omission, reliance thereon, damages caused by the wrongdoing, and scienter on the part of the defendant.” (citations omitted)).

63. MARSH & VOLK, *supra* note 59, at 4.

64. *Id.* at 15-16.

65. *See id.* at 16.

66. *Id.* at 46.

67. *Id.* at 436.

68. CAL. CORP. CODE § 25401 (West 2014). Hereinafter, all statutory references are to the California Corporations Code, unless otherwise noted.

69. MARSH & VOLK, *supra* note 59, at 447.

70. Apollo Capital Fund, LLC v. Roth Capital Partners, LLC, 70 Cal. Rptr. 3d 199, 221 (Ct. App. 2007) (holding that while a “seller” under § 12 of the Securities Act has been construed to include anyone who solicits the purchase or sale of a security, under section 25401 liability attaches only to the actual seller of the security).

71. Corporate Securities Law of 1968, CAL. CORP. CODE § 25504 (West 2014).

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to any person who aids in the violation with the intent to deceive.⁷² Thus, California's anti-fraud provisions do not perfectly mirror the federal laws, but the civil liability created under each scheme is similar. While section 25401 was originally modeled after § 12(a)(2) of the Securities Act, the California legislature has recently amended section 25401 so that it is now virtually identical to Rule 10b-5,⁷³ which was promulgated under the authority granted to the SEC by the Exchange Act.

*C. Statutes of Limitations for Private Rights of Action
Under Federal Law*

The statute of limitations for § 12(a)(2) of the Securities Act is governed by § 13 of the Securities Act, which requires that a plaintiff bring suit “within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence.”⁷⁴ The statute also provides an absolute three-year limit from the time of the violation.⁷⁵

Because the private right of action under Rule 10b-5 is a “judicial creation,” it has no express statute of limitations in the Exchange Act.⁷⁶ Before 1991, the circuit courts disagreed about the appropriate statute of limitations; for instance, some “borrowed . . . from the closest analogous state-law cause of action” while others looked to § 13 of the Securities Act.⁷⁷

The Supreme Court attempted to settle the disagreement in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*.⁷⁸ The Court reasoned that “the federal interests in predictability and judicial economy” favored the adoption of a uniform statute of limitations for actions brought under Rule 10b-5, and, therefore, looked to the

72. Corporate Securities Law of 1968, CAL. CORP. CODE § 25504.1 (West 2014).

73. *See supra* note 2.

74. Securities Act § 13, 15 U.S.C. § 77m (2012).

75. *Id.*

76. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358 (1991).

77. Kaufman & Wunderlich, *supra* note 33, at 1559-60.

78. *Lampf*, 501 U.S. at 352-64.

statutes of limitations in the Securities and Exchange Acts.⁷⁹ But the Court did not adopt the language of § 13 of the Securities Act; instead, it borrowed from § 9(e) of the Exchange Act. The Court held that a suit under 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.”⁸⁰ Thus, the new statute of limitations for Rule 10b-5 differed from the Securities Act statute of limitations in that the former did not, by its terms, require “reasonable diligence” on the part of the plaintiff.⁸¹ Despite this distinction, most circuits after *Lampf* imposed a duty of reasonable diligence on plaintiffs bringing suit under Rule 10b-5 by applying the inquiry notice rule.⁸²

The Tenth and Ninth Circuits recognized the distinction between inquiry notice—the point at which “there exists sufficient suspicion of fraud to cause a reasonable investor to investigate the matter further”⁸³—and the later point at which the plaintiff “in the exercise of reasonable diligence, should have discovered the facts underlying the alleged fraud.”⁸⁴ The Tenth Circuit noted that “inquiry notice alone may not be the determinative factor, at least when a reasonable investor could not reasonably have discovered the facts underlying the alleged fraud until some time after being placed on inquiry notice.”⁸⁵ The Ninth Circuit followed that rationale in adopting the Tenth Circuit’s inquiry-plus-reasonable-diligence-test, holding that “[o]nce a plaintiff has inquiry notice, we ask when the investor, in the exercise of reasonable diligence, should have discovered the facts constituting

79. *Id.* at 357-58.

80. *Id.* at 364.

81. Section 13 of the Securities Act provides that “[n]o 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 such discovery should have been made by the exercise of reasonable diligence” Securities Act § 13, 15 U.S.C. § 77m (2012) (emphasis added).

82. *Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 646 (2010) (“Subsequently, every Court of Appeals to decide the matter [post-*Lampf*] held that ‘discovery of the facts constituting the violation’ occurs not only once a plaintiff *actually* discovers the facts, but also when a hypothetical reasonably diligent plaintiff would have discovered them.”).

83. *Betz v. Trainer Wortham & Co., Inc.*, 486 F.3d 590, 596 (9th Cir. 2007).

84. *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1201 (10th Cir. 1998).

85. *Id.* at 1196.

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the alleged fraud. The answer to that second question tells us when the statute of limitations began to run.”⁸⁶

Other circuits' formulations of inquiry notice imposed a duty of reasonable diligence on plaintiffs, and some courts timed the limitations period from the date the duty of inquiry arose. The Sixth Circuit held that the statute of limitations was not triggered until a reasonably diligent plaintiff would have discovered facts constituting the violation, but that inquiry notice triggered a duty to investigate.⁸⁷ Similarly, the First Circuit held that the statute of limitations began to run not upon inquiry notice, but upon the later date at which the plaintiff, exercising reasonable diligence, would have discovered the fraud.⁸⁸ It employed a burden-shifting formulation of inquiry notice, whereby if the defendant met the “initial burden of establishing the existence of [storm] warnings,” the plaintiff then bore the burden of showing she “fulfilled her corresponding duty of making a reasonably diligent inquiry into the possibility of fraudulent activity.”⁸⁹ The Second Circuit's approach was to time the statute of limitations “two different ways, depending on whether the investor undertakes some inquiry.”⁹⁰ The Fourth and Eleventh Circuits held that the statute of limitations began to run when the plaintiff was put on inquiry notice, and that inquiry notice was triggered by evidence of the mere possibility of fraud.⁹¹ In summary, *Lampf* failed to create a uniform statute of limitations for Rule 10b-5.

86. *Betz*, 486 F.3d at 596.

87. *New Eng. Health Care Emps. Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003).

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

89. *Id.* at 9.

90. *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. However, if the investor makes some inquiry once the duty arises, we will impute knowledge of what an investor ‘in the exercise of reasonable diligence, should have discovered’ concerning the fraud, and in such cases the limitations period begins to run from the date such inquiry should have revealed the fraud.” (quoting *Rothman v. Gregor*, 220 F.3d 81, 98 (2d Cir. 2000))).

91. *E.g.*, *Glaser v. Enzo Biochem, Inc.*, 126 F. App'x. 593, 597 (4th Cir. 2005) (holding that the statute of limitations “begins to run when the plaintiff is put on inquiry notice of the facts constituting the alleged violation,” and that a “plaintiff's awareness of the possibility of fraud, not complete exposure of the fraud, triggers inquiry notice.”); *Theoharous v. Fong*, 256 F.3d 1219, 1228 (11th Cir. 2001)

In 2002, in the wake of numerous high-profile financial disasters such as Enron, Congress passed the Sarbanes-Oxley Act to strengthen investor protection.⁹² Section 804 of the Sarbanes-Oxley Act increased the statute of limitations for private actions brought pursuant to the anti-fraud provisions of federal securities laws to the earlier of five years after the act or omission, or two years after discovery of the facts constituting the action.⁹³ However, the amendment did not clarify which formulation of the inquiry notice standard was correct, nor did it address whether inquiry notice was the proper standard at all.⁹⁴

In 2010, the Supreme Court had the opportunity in *Merck & Co., Inc. v. Reynolds* to settle what “discovery of the facts constituting the violation” meant for the purposes of the statute of limitations for securities fraud.⁹⁵ Investors sued pharmaceutical company Merck & Co. for securities fraud under § 10(b) of the Exchange Act and Rule

(explaining that inquiry notice “is triggered by evidence of the *possibility* of fraud, not full exposition of the scam itself,” but ignoring *Sterlin*’s second step in holding that inquiry notice starts the statute of limitations (quoting *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1203 (10th Cir. 1998))), *abrogated by Merck & Co., Inc. v. Reynolds*, 559 U.S. 633 (2010); *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993) (“Inquiry notice is triggered by evidence of the possibility of fraud, not by complete exposure of the alleged scam.”).

92. See Cosenza, *supra* note 31, at 718 n.215.

93. Sarbanes-Oxley Act § 804, 28 U.S.C. § 1658(b) (2006) (“[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws . . . 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.”).

94. Compare, e.g., *Betz v. Trainer Wortham & Co.*, 519 F.3d 863, 871 (9th Cir. 2007) (“The existence of inquiry notice is only the first prong of the two-part notice-plus-reasonable-diligence test that we are today adopting, and the second stage of that inquiry, the question of whether the plaintiff exercised reasonable diligence in investigating the facts underlying the alleged fraud . . . necessarily entails an assessment of the plaintiff’s particular circumstances from the perspective of a reasonable investor.”), and *Shah v. Meeker*, 435 F.3d 244, 249 (2d Cir. 2006) (if the plaintiff investigates, limitations period begins at “date such inquiry should have revealed the fraud,” but if the plaintiff does not investigate, limitations period begins upon inquiry notice), with *New Eng. Health Care Emps. Pension Fund v. Ernst & Young, LLP*, 336 F.3d 495, 501 (6th Cir. 2003) (limitations period never begins before a reasonably diligent plaintiff, after being placed on inquiry notice, would have discovered facts constituting the violation).

95. *Merck & Co., Inc.*, 559 U.S. at 633.

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10b-5, alleging that the company knowingly misrepresented the heart-attack risks associated with its drug Vioxx.⁹⁶ The district court dismissed the case as time barred because the plaintiffs were aware of facts that alerted them to a “*possibility* that Merck had knowingly misrepresented material facts” two years and one month before the complaint was filed.⁹⁷ The district court found that those facts put the plaintiffs on “inquiry notice,” which they failed to dutifully investigate.⁹⁸ The district court ultimately held the statute of limitations began to run at that time and imputed knowledge of the “facts constituting the violation” as of the date that the plaintiffs should have been aware of the possibility of fraud.⁹⁹ On appeal, the Third Circuit reversed, finding that the events constituting “storm warnings” “did not suggest much by way of scienter,”¹⁰⁰ which is a fact constituting the violation.¹⁰¹

The Supreme Court granted the writ of certiorari to resolve the disagreements among the courts of appeals regarding the statute of limitations. The Supreme Court rejected inquiry notice as triggering the statute of limitations, defining inquiry notice as “the point where the facts would lead a reasonably diligent plaintiff to investigate further,” because “that point is not necessarily the point at which the plaintiff would already have discovered facts showing scienter or other ‘facts constituting the violation.’”¹⁰² The Court further noted, “[n]othing in the text suggests that the limitations period can sometimes begin *before* ‘discovery’ can take place.”¹⁰³

96. *Id.* at 637-38.

97. *Id.* at 643 (quoting *In re Merck & Co. Securities, Derivative & “ERISA” Litigation*, 483 F. Supp. 2d 407, 423 (D.N.J. 2007)).

98. *Id.* (“[P]laintiffs had failed to ‘show that they exercised reasonable due diligence but nevertheless were unable to discover their injuries . . .’” (quoting *In re Merck & Co.*, 483 F. Supp. 2d at 423)).

99. *Id.* at 642-43.

100. Scienter means “intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). However, certain forms of recklessness may be considered intentional conduct for purposes of imposing liability. *Id.* at 193 n.12.

101. *Merck & Co., Inc.*, 559 U.S. at 643 (citing *In re Merck & Co. Securities, Derivative & “ERISA” Litigation*, 543 F.3d 150, 172 (3d Cir. 2008)).

102. *Id.* at 651.

103. *Id.*

Thus, the Court made clear that the statute of limitations “begins to run [at the earlier of] once a plaintiff did discover or a reasonably diligent plaintiff would have” discovered enough facts to draft a viable complaint.¹⁰⁴ While the holding in *Merck* is limited to federal securities laws and is not binding authority with respect to California’s anti-fraud provisions, it should be instructive because the pertinent language of Corporations Code section 25506 is identical to the statute of limitations that the Supreme Court construed in *Merck*.¹⁰⁵

D. Statutes of Limitations for Private Rights of Action Under California Law

The statute of limitations for the anti-fraud provisions of California securities law mirrors the statute of limitations for Rule 10b-5. Until 2004, section 25506 provided that an action for securities fraud must be brought “before the expiration of four years after the act or transaction constituting the violation or the expiration of one year after the discovery by the plaintiff of the facts constituting the violation, whichever shall first expire.”¹⁰⁶ In 2004, the legislature amended the statute to extend the limitations period to the earlier of five years after the act or two years after discovery of the facts constituting the violation.¹⁰⁷ The bill’s author, Representative Correa, noted that the amendment was needed to “conform California’s statute of limitations for securities fraud actions to the federal statute of limitations as set by the Sarbanes-Oxley Act of 2002, so that state law is at least as protective of California investors as federal law.”¹⁰⁸

104. *Id.* at 653.

105. *See* discussion *infra* Part IV.C.

106. Corporate Securities Law of 1968, CAL. CORP. CODE § 25506 (West 2014).

107. A.B. 2167, ch. 575, § 3, 2004 Leg. Serv. (West) (codified as amended at CAL. CORP. CODE § 25506(b)); *see also Securities: Corporate Liability: Hearing on Assem. B. 2167 Before the Comm. on Banking and Fin.*, 2004 Leg., 2003-04 Reg. Sess. (Cal. 2004), available at http://leginfo.public.ca.gov/pub/03-04/bill/asm/ab_2151-2200/ab_2167_cfa_20040330_104037_asm_comm.html.

108. *Unlicensed Security Brokers: Hearing on Assem. B. 2166 Before the S. Judiciary Comm.*, 2004 Leg., 2003-04 Reg. Sess., at 4 (Cal. 2004) (comments of Rep. Correa), available at http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_2151-2200/ab_2167_cfa_20040623_121942_sen_comm.html.

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The language of the California statute of limitations is now identical to Rule 10b-5's statute of limitations and the clear legislative intent was to follow Rule 10b-5. But several California courts, unlike the Supreme Court, have embraced inquiry notice.¹⁰⁹ In *Deveny v. Entropin, Inc.*, the California Court of Appeal for the Fourth District held that inquiry notice is sufficient to begin the limitations period under section 25506.¹¹⁰

The facts of *Deveny* are similar to the facts of *Merck*, the case in which the Supreme Court rejected inquiry notice.¹¹¹ In *Deveny*, a group of investors sued pharmaceutical company Entropin, Inc. for securities fraud under California law, "alleging that [the company] fraudulently concealed . . . negative clinical data that revealed [its developmental drug] was ineffective."¹¹² From 1998 until September of 2002, Entropin's filings with the SEC and its press releases indicated that clinical trials showed that its developmental drug was effective.¹¹³ During this period, Entropin "sold shares of common stock and warrants to the public."¹¹⁴ "In September 2002, however, Entropin issued a press release stating that its clinical trials had been a failure" and that it was "abandoning the drug."¹¹⁵ Entropin's securities price "collapsed," and four months later investors filed a securities fraud class action, alleging they purchased Entropin's securities in reliance on its misrepresentations about the clinical trials.¹¹⁶

109. *Jackson v. Fisher*, 931 F. Supp. 2d 1049, 1063 (N.D. Cal. 2013); *Wright v. Bloom*, No. C 12-00746 WHA, 2012 U.S. Dist. LEXIS 170679, at *8 (N.D. Cal. Nov. 30, 2012); *Hardisty v. Moore*, No. 11cv1591 AJB (BLM), 2012 U.S. Dist. LEXIS 61465, at *13 (S.D. Cal. 2012); *Hernandez v. Vasquez*, B244533, 2013 Cal. App. Unpub. LEXIS 8074, at *20-23 (Nov. 7, 2013); *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807 (Ct. App. 2006).

110. *Id.* Though the case was decided in 2006, the alleged violations occurred before 2002. *Id.* at 811-12. Thus, the court did not address the 2004 amendment to Section 25506 (which applies only to violations occurring on or after January 1, 2005). CORP. CODE §25506.

111. *Deveny*, 42 Cal. Rptr. 3d at 810-12.

112. *Id.* at 812-13.

113. *Id.* at 811-12.

114. *Id.* at 811.

115. *Id.* at 812.

116. *Id.*

Entropin moved for summary judgment on the ground that the action was untimely.¹¹⁷ Entropin cited blood and urine data, which was available on its website more than a year before the plaintiffs filed their complaint, arguing that the data indicated that the developmental drug was ineffective.¹¹⁸ The trial court granted the motion for summary judgment, holding that the availability of the data on the website put the investors on inquiry notice beyond the statutory period, and the investors appealed.¹¹⁹

The California Court of Appeal for the Fourth District reversed the lower court's decision, but rejected the plaintiffs' argument that actual notice, rather than inquiry notice, was the correct standard.¹²⁰ The court held that inquiry notice is sufficient to trigger the running of the limitations period under section 25506,¹²¹ but reversed only because it found that the blood and urine data on the website could not, as a matter of law, establish inquiry notice.¹²²

The Supreme Court may have laid to rest the knotty concept of inquiry notice in *Merck*, but inquiry notice is alive and well in California, where *Deveny* is still cited as good law.¹²³ The result of this inconsistency is that California law is less protective of investors

117. *Id.*

118. *Id.* at 813.

119. *Id.* at 814-15.

120. *Id.* at 817.

121. *Id.*

122. *Id.* at 823-24.

123. *E.g.*, *Jackson v. Fisher*, 931 F. Supp. 2d 1049, 1063 (N.D. Cal. 2013) (motion to dismiss securities fraud claim under California law granted based on statute of limitations, with leave to amend, though plaintiff alleged that she discovered the fraud less than two years before the complaint was filed); *Wright v. Bloom*, No. C 12-00746 WHA, 2012 U.S. Dist. LEXIS 170679, at *8 (N.D. Cal. Nov. 30, 2012) ("Inquiry notice is triggered when a person becomes aware of financial, legal, or other information that suggests (to an investor of reasonable intelligence) that he or she had been defrauded."); *Hardisty v. Moore*, No. 11cv1591 AJB (BLM), 2012 U.S. Dist. LEXIS 61465, at *13 (S.D. Cal. 2012) ("The statute of limitations provided under Section 25506 is subject to the inquiry notice rule."); *Hernandez v. Vasquez*, B244533, 2013 Cal. App. Unpub. LEXIS 8074, at *20-23 (Nov. 7, 2013) (holding that inquiry notice is sufficient to trigger the statute of limitations, and that while inquiry notice is generally an issue of fact, it may be established as a matter of law where the "underlying facts are undisputed and subject to only one reasonable" interpretation).

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than federal law, which is directly contrary to the stated purpose of the 2004 amendment to section 25506.¹²⁴

IV. CALIFORNIA SHOULD REJECT INQUIRY NOTICE

The rationale supporting the Supreme Court's holding in *Merck* applies with equal force to Corporations Code section 25506, but *stare decisis* commands that California lower courts follow *Deveny*.¹²⁵ But precedent need not be respected when "adherence to it puts us on a course that is sure error."¹²⁶ Moreover, when a prior decision is not well reasoned and is unworkable, a court may overrule it.¹²⁷ *Deveny* was not well reasoned because it ignored the maxim that "a statute's plain meaning should be given priority in its construction."¹²⁸ Furthermore, *Deveny* contradicts the legislative intent of the 2004 amendment to section 25506.¹²⁹ Finally, the unjust consequences of inquiry notice make *Deveny*'s holding unworkable, especially in light of the recent amendment to section 25401, which imposes judicially-created elements on a securities fraud claim.¹³⁰

A. *Deveny Was Not Well Reasoned*

In *Deveny*, the court conspicuously ignored crucial distinctions in the statutory language of section 25506 and § 13 of the Securities Act. In holding that inquiry notice was sufficient to start the limitations period for securities fraud under California law, the court noted that

124. *See supra* note 108.

125. *Payne v. Tennessee*, 501 U.S. 808, 827 (1991) ("Stare decisis is the preferred course because it promotes the evenhanded, predictable, and consistent development of legal principles, fosters reliance on judicial decisions, and contributes to the actual and perceived integrity of the judicial process.").

126. *Citizens United v. Fed. Election Comm'n*, 558 U.S. 310, 362 (2010).

127. *Id.* at 362-63 (citing *Montejo v. Louisiana*, 556 U.S. 778, 779 (2009)); *see also Payne*, 501 U.S. at 827 ("[Despite the importance of stare decisis,] when governing decisions are unworkable or are badly reasoned" courts are not constrained to follow precedent.).

128. *W. Union Tel. Co. v. Fed. Commc'n Comm'n*, 665 F.2d 1126, 1137 (D.C. Cir. 1981). "[The maxim] is the cardinal rule of statutory interpretation." *Id.* at n.21.

129. *See discussion supra* Part IV.B.

130. *See discussion supra* Part IV.C-D.

federal courts had held the same, including in *Kramas v. Security Gas & Oil, Inc.*¹³¹ The court in *Kramas*, however, failed to offer any support for its proposition that inquiry notice triggers the limitations period under section 25506.¹³² The court simply stated that “[t]he limitations period under 15 U.S.C. § 77m [§ 13 of the Securities Act] does not begin to run until plaintiff discovers the facts constituting the violation or in the exercise of reasonable diligence should have discovered them,” and that “[t]he same principle applies . . . in view of the similarity in language, we think also under [section 25506 of the California Corporations Code].”¹³³ The fatal flaw in this logic is that the language of section 25506 is different from the language of § 13 of the Securities Act: section 25506 does not say “in the exercise of reasonable diligence.”¹³⁴ This distinction is critical because while § 13 of the Securities Act arguably incorporates inquiry notice by its terms, section 25506 certainly does not.¹³⁵ Thus, *Deveny* erroneously treated § 13 of the Securities Act and section 25506 the same.

The *Deveny* court declined to follow a prior California court of appeal decision in *Eisenbaum* that rejected inquiry notice under section 25507—the statute of limitations for actions alleging failure to qualify a securities transaction in California.¹³⁶ In *Eisenbaum*, the court held that the statute of limitations under section 25507 commences upon actual discovery of the facts underlying the elements of the violation, not upon inquiry notice.¹³⁷ The *Eisenbaum* court aimed its primary focus at the language of the statute, noting, “[b]y its plain language, the statute requires actual knowledge, not just ‘inquiry

131. *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 815 (Ct. App. 2006); *Kramas v Security Gas & Oil Inc.*, 672 F.2d 766, 770 (9th Cir. 1982).

132. *Kramas*, 672 F.2d 766.

133. *Id.* at 770.

134. Corporate Securities Law of 1968, CAL. CORP. CODE § 25506(b) (West 2014).

135. Some argue that the “reasonable diligence” language expresses a constructive discovery standard, not an inquiry notice standard, and in the absence of such language, the statute should be read as requiring actual discovery of the facts constituting the violation. See Cosenza, *supra* note 35, at 727-32.

136. *Deveny*, 42 Cal. Rptr. 3d at 810.

137. *Eisenbaum v. W. Energy Res., Inc.*, 267 Cal. Rptr. 5, 11-12 (Ct. App. 1990).

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notice.”¹³⁸ The court further supported its conclusion by contrasting the language of section 25507 with that of section 25506.1, which establishes the “statute of limitations for fraud liability imposed upon those who ‘expertise’ a prospectus.”¹³⁹ Under section 25506.1, the statute of limitations begins to run one year “after such discovery should have been made by the exercise of reasonable diligence.”¹⁴⁰ The court recognized “the significant and controlling distinction in the statutory language.”¹⁴¹

The *Deveny* court’s refusal to give the *Eisenbaum* decision any weight is difficult to reconcile given that the exact same “significant and controlling distinction in the statutory language”¹⁴² is present in section 25506.¹⁴³ The *Deveny* court distinguished *Eisenbaum* on the basis of the fiduciary relationship between the plaintiff and the defendant in *Eisenbaum*.¹⁴⁴ But the court in *Eisenbaum* said, “the lack of a fiduciary relationship . . . would not be decisive on the statute of limitations issue.”¹⁴⁵ Therefore, the rationale employed by the *Eisenbaum* court is equally persuasive as applied to section 25506, and the court in *Deveny* should have followed *Eisenbaum*.

138. *Id.*

139. *Id.* at 12.

140. *Id.* (citing Corporate Securities Law of 1968, CAL. CORP. CODE § 25506.1 (West 2014)).

141. *Id.*

142. *Id.*

143. Section 25507 says that actions must be “brought before the expiration of . . . one year after the discovery by the plaintiff of the facts constituting such violation.” Corporate Securities Law of 1968, CAL. CORP. CODE § 25507 (West 2014). Section 25506, subdivision b, says that actions must be “brought before the expiration of . . . two years after the discovery by the plaintiff of the facts constituting the violation.” Corporate Securities Law of 1968, CAL. CORP. CODE § 25506(b) (West 2014). Section 25506.1, on the other hand, says that actions must be “brought within one year after the discovery of the facts constituting the violation, or after such discovery should have been made by the exercise of reasonable diligence.” Corporate Securities Law of 1968, CAL. CORP. CODE § 25506.1 (West 2014) (emphasis added).

144. *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 816-17 (Ct. App. 2006).

145. *Eisenbaum*, 267 Cal. Rptr. at 11.

B. The Textualist Interpretation of Section 25506

Given that *Deveny* was not well-reasoned, it should be overruled and section 25506 should be interpreted without regard to *Deveny*'s holding. "The starting point in every case involving construction of a statute is the language itself."¹⁴⁶ "A basic canon of statutory construction is that words should be interpreted as taking their ordinary and plain meaning."¹⁴⁷ Section 25506 provides that an action for securities fraud must be brought "before the expiration of five years after the act or transaction constituting the violation or the expiration of two years after the discovery by the plaintiff of the facts constituting the violation, whichever shall first expire."¹⁴⁸ The ordinary and plain meaning of "facts constituting the violation" is facts corresponding to each element of the violation.¹⁴⁹ Inquiry notice—the point at which facts suggest wrongdoing and would lead a reasonably diligent investor to investigate further—is not necessarily the point at which the plaintiff would have already discovered the "facts constituting the violation."¹⁵⁰ Thus, inquiry notice is inconsistent with the plain meaning of the text of section 25506.

Another canon of statutory interpretation is that "words undefined in a statute are to be interpreted and applied according to their common-law meanings."¹⁵¹ At common law, "discovery" of a cause of action occurs not only when the plaintiff has actual knowledge of the facts underlying the claim, but also when the plaintiff has reason

146. *Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Daniel*, 439 U.S. 551, 558 (1979) (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring)).

147. *United States v. Scrimgeour*, 636 F.2d 1019, 1022 (5th Cir. Unit B Feb. 1981).

148. Corporate Securities Law of 1968, CAL. CORP. CODE § 25506(b) (West 2014).

149. *See Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 648 (2010) ("Scienter is assuredly a 'fact.' . . . And this 'fact' of scienter 'constitut[es]' an important and necessary element of a § 10(b) 'violation.'" (alteration in original)).

150. *Id.* at 651. For example, in *Wright v. Bloom*, the plaintiffs realized they had been defrauded several months before they even became aware that they had participated in a securities offering. *Wright v. Bloom*, No. C 12-00746 WHA, 2012 U.S. Dist. LEXIS 170679, at *8-9 (N.D. Cal. Nov. 30, 2012).

151. ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* 320 (2012).

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to suspect a factual basis for the action.¹⁵² The court in *Deveny* noted that section 338, subdivision (d), of the California Code of Civil Procedure, which requires that an action for common law fraud be asserted within three years of discovery of the facts constituting the fraud, states that the limitations period begins to run upon discovery of facts that would lead a reasonably prudent person to suspect fraud.¹⁵³ The court concluded that inquiry notice is consistent with the common law understanding of the term “discovery” in statutes of limitations.¹⁵⁴

But statutes are not interpreted in isolation.¹⁵⁵ Read in context, “discovery” here cannot implicate inquiry notice.¹⁵⁶ The presumption of consistent usage reveals that section 25506 does not require reasonable diligence on the part of the plaintiff.¹⁵⁷ When a statute contains a provision, the omission of that provision in another statute concerning the same subject matter cannot be ignored.¹⁵⁸ As the court noted in *Eisenbaum*, section 25506.1, which establishes the limitations period for fraud claims against those who “expertise” a prospectus, requires that claims be brought “within one year after the discovery of the facts constituting the violation, *or after such discovery should have been made by reasonable diligence.*”¹⁵⁹ The fact that section 25506 omits the “reasonable diligence” clause is significant, especially given that section 25506.1 immediately follows section

152. 43 CAL. JUR. 3D *Limitation of Actions* § 34 (2011).

153. *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 816 (Ct. App. 2006).

154. *Id.*

155. *Lungren v. Deukmejian*, 755 P.2d 299, 304 (Cal. 1988) (“The meaning of a statute may not be determined from a single word or sentence; the words must be construed in context, and provisions relating to the same subject matter must be harmonized to the extent possible.”).

156. *See Merck & Co., Inc.*, 559 U.S. at 656 (2010) (Scalia, J., concurring).

157. *See SCALIA & GARNER, supra* note 151, at 170-73.

158. *People v. Kuhn*, 31 Cal. Rptr. 253, 256 (Ct. App. 1963) (“Where a statute, with reference to one subject contains a given provision, the omission of such provision from a similar statute concerning a related subject is significant to show that a different intention existed.” (internal quotation marks omitted) (quoting *People ex rel. Paganini v. Town of Corte Madera*, 218 P.2d 810, 813 (Cal. Ct. App. 1950))).

159. Corporate Securities Law of 1968, CAL. CORP. CODE § 25506.1 (West 2014) (emphasis added).

25506.¹⁶⁰ Thus, properly interpreted, section 25506 requires the plaintiff to have discovered the facts constituting the violation before the limitations period begins to run.¹⁶¹

Moreover, the presumption against surplusage supports distinguishing sections 25506 and 25506.1.¹⁶² If the term “discovery” in section 25506 implicates inquiry notice, the phrase “or after discovery should have been made by reasonable diligence” in section 25506.1 is rendered meaningless.¹⁶³ Such an interpretation violates the rules that “significance should be given to every word and phrase of an act in pursuance of the legislative purpose,”¹⁶⁴ and that “[e]very] statute should be construed with reference to the whole system of law of which it is a part so that all may be harmonized and have effect.”¹⁶⁵

C. *The Intent-Based Interpretation of Section 25506*

The *Deveny* court emphasized the court’s focus on legislative intent when interpreting statutes.¹⁶⁶ A true interpreter, in seeking the

160. See SCALIA AND GARNER, *supra* note 151, at 173 (“[T]he more connection the cited statute has with the statute under consideration, the more plausible the argument becomes. If it was enacted at the same time, and dealt with the same subject, the argument could even be persuasive.”).

161. *Cf. Eisenbaum v. W. Energy Res., Inc.*, 267 Cal. Rptr. 5, 11 (Ct. App. 1990).

162. See *Jones v. City of Los Angeles*, 59 Cal. Rptr. 902, 904 (Ct. App. 1967) (“In statutory construction there is a presumption against surplusage and in favor of a meaning for all parts . . .”).

163. *Cf. Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 656 (2010) (Scalia, J., concurring) (noting that “discovery” in 15 U.S.C. § 77m “cannot mean constructive discovery, since that would render superfluous the phrase ‘or after such discovery should have been made by the exercise of reasonable diligence’”).

164. *Buchwald v. Superior Court of S.F.*, 62 Cal. Rptr. 364, 369 (Ct. App. 1967) (citing *Select Base Materials v. Board of Equalization*, 335 P.2d 672, 675-76 (Cal. 1959)).

165. *Rees v. Layton*, 86 Cal. Rptr. 268, 272 (Ct. App. 1970) (quoting *Stafford v. Realty Bond Service Corp.*, 249 P.2d 241, 245-56 (Cal. 1952)).

166. See *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 815-16 (Ct. App. 2006) (“Our function . . . is to ascertain the intent of the Legislature so as to effectuate the purpose of the law. . . . In general, the legislative purpose behind such statutes is to prevent plaintiffs from asserting stale claims. At the same time, public

legislative intent, would look only to the words of the statute to glean the legislative intent, because the legislature chose those words to carry out its purpose.¹⁶⁷ Courts and advocates often seek the legislative intent by looking beyond the words of the statute and considering the context in which it was enacted.¹⁶⁸ And in doing so here, the same conclusion is reached as the one reached in Part B, *supra*. Even if one were to seek the legislative intent by looking beyond the text and considering the context in which section 25506 was enacted, one would have to conclude that inquiry notice should be rejected.

Section 25506, as amended in 2004, is virtually identical to 28 U.S.C. § 1658(b).¹⁶⁹ “[W]here provisions in the federal and state laws are identical and similar in language federal interpretations are persuasive in determining how the state law is to be applied.”¹⁷⁰ Under this rationale, the Supreme Court’s rejection of inquiry notice in *Merck* should apply to section 25506. Even more persuasive, the California legislature intentionally copied the federal statute when it

policy favors the resolution of claims on the merits.” (quoting *Debro v. L.A. Raiders*, 112 Cal. Rptr. 2d 329, 335 (Ct. App. 2001))).

167. See *Huffman v. Western Nuclear, Inc.*, 486 U.S. 663, 672 (1988).

168. See, e.g., *United States v. Scrimgeour*, 636 F.2d 1019, 1023 (5th Cir. Unit B Feb. 1981) (“[C]onsideration of legislative history is proper in determination of the meaning of words used in statutes, even where the meaning of the words appears to be plain.”); *Hope v. Contractors’ State License Bd.*, 39 Cal. Rptr. 514, 518 (Ct. App. 1964) (noting that a court “may look to legislative committee reports as extrinsic aid in the interpretation of the legislative purpose in the enactment of a statute”); *Kelly v. Kane*, 94 P.2d 384, 386 (Cal. Ct. App. 1939) (“[A] statute should be construed in the light of the history of the times and the conditions which prompted its enactment.”).

169. Section 25506, as amended in 2004, allows actions to be brought “before the expiration of five years after the act or transaction constituting the violation or the expiration of two years after the discovery by the plaintiff of the facts constituting the violation, whichever shall first expire.” Corporate Securities Law of 1968, CAL. CORP. CODE § 25506(b) (West 2014). Under Sarbanes-Oxley, a private right of action for a claim of fraud under the federal securities laws “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.” Sarbanes-Oxley Act § 804, 28 U.S.C. § 1658(b).

170. *Coast Oyster Co. v. Perluss*, 32 Cal. Rptr. 740, 743 (Ct. App. 1963).

amended section 25506.¹⁷¹ The California Senate Judiciary Committee noted that under Sarbanes-Oxley, “a private right of action for claims of fraud, deceit, manipulation, or contrivance in contravention of a securities regulation may be brought not later than the earlier of two years after the discovery of the facts constituting the violation or five years after such violation.”¹⁷² The legislature’s stated purpose in amending section 25506 was to “conform California’s statute of limitations for securities fraud actions to the federal statute of limitations as set by the Sarbanes-Oxley Act of 2002, so that state law is at least as protective of California investors as federal law.”¹⁷³

On the surface, it seems strange that the legislature was concerned with conforming California’s securities fraud statute of limitations to the Exchange Act statute of limitations because section 25401 was modeled after the Securities Act, not the Exchange Act.¹⁷⁴ Perhaps the legislature believed that Sarbanes-Oxley’s extended statute of limitations applied to claims under both Acts.¹⁷⁵ It is also possible that the legislature recognized that while section 25401 mirrored § 12(a)(2) of the Securities Act, the statute of limitations set forth in section 25506 tracked the language of § 9(e) of the Exchange Act.¹⁷⁶

171. *Unlicensed Securities Brokers: Hearing on A.B. 2167 Before the S. Comm. on the Judiciary*, 2004 Leg., Reg. Sess. 3 (Cal. 2004), available at ftp://leginfo.public.ca.gov/pub/03-04/bill/asm/ab_2151-2200/ab_2167_cfa_20040623_121942_sen_comm.html.

172. *Id.* at 4.

173. *Id.* at 4.

174. *See supra* Part III.B.

175. This would not be an unreasonable assumption, because, although section 804 of the Sarbanes-Oxley Act specifically refers to the Exchange Act, (“a private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3(a)(47) of the Securities Exchange Act of 1934”), at least one court has held that the Supreme Court’s holding in *Merck*, which interpreted 28 U.S.C. § 1658(b), applies to § 13 of the Securities Act. *See Pension Trust Fund for Operat’g Eng’rs v. Mortg. Asset Securitization Transactions, Inc.*, 730 F.3d 263, 273 (3d Cir. 2013).

176. Subsection (e) of § 9 of the Exchange Act was redesignated as subsection (f) in 2010. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929X(b)(1), 124 Stat. 1376 (2010). It requires that actions for manipulation of security prices under § 9 of the Exchange Act be “brought within one year after the discovery of the facts constituting the violation.” Exchange Act § 9(f), 15 U.S.C. § 78i(f) (2010).

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Either way, the legislature made clear that its priority was to ensure that state law would be at least as protective of California investors as federal law.¹⁷⁷

Inquiry notice frustrates that purpose because it discourages investors from filing meritorious claims and prevents fraud suits from being decided on the merits.¹⁷⁸ It follows that rejecting inquiry notice in favor of a discovery-based standard will protect investors by encouraging plaintiffs to seek redress on behalf of themselves and similarly situated aggrieved investors. Therefore, because the California legislature intended to enhance investor protection when it amended the statute of limitations to conform to § 1658(b), the Supreme Court's rejection of inquiry notice for § 1658(b) should extend to California's statute of limitations.

D. Unjust Consequences of Inquiry Notice

The unjust consequences of inquiry notice provide another justification for overruling *Deveny*. First, inquiry notice unfairly rewards fraudsters who succeed in concealing their fraudulent schemes.¹⁷⁹ Second, inquiry notice deters securities fraud victims from seeking redress, which subverts the policies behind private enforcement of securities laws.¹⁸⁰ Third, the recent amendment of section 25401 will make it even more difficult for plaintiffs to plead securities fraud sufficiently, so a statute of limitations that allows plaintiffs enough time to gather facts is now more important than ever.¹⁸¹

177. *Unlicensed Securities Brokers: Hearing on A.B. 2167 Before the S. Comm. on the Judiciary, 2003-2004 Leg., Reg. Sess. 4 (Cal. 2004)*, available at ftp://leginfo.public.ca.gov/pub/03-04/bill/asm/ab_2151-2200/ab_2167_cfa_20040623_121942_sen_comm.html.

178. See discussion *infra* Part IV.D.2.

179. See discussion *infra* Part IV.D.1.

180. See discussion *infra* Part IV.D.2.

181. See discussion *infra* Part IV.D.3.

1. Inquiry Notice Unfairly Rewards Fraudsters

Inquiry notice increases the likelihood that securities fraud victims, by no fault of their own, will lose any chance of recovery.¹⁸² An example of how promoters can mask their fraud long enough to afford the absolute protection of inquiry notice is the use of “self-directed IRAs.”¹⁸³ This type of scam involves convincing investors to move assets into a self-directed IRA supposedly held by a custodian but which is actually created and owned by the fraudster.¹⁸⁴ This type of fraud is appealing to a scam artist because the “financial penalty for early withdrawal may cause investors to be more passive or to keep funds in a fraudulent scheme longer.”¹⁸⁵

Affinity fraud is another example of how fraudsters can employ cunning devices to prevent their victims from filing suit before the statute of limitations expires. Affinity fraud occurs when fraudsters exploit members of a particular group by professing to be a member of that same group.¹⁸⁶ Fraudsters market their schemes to group members who are more willing to “trust someone who is perceived to have a common interest, beliefs or background.”¹⁸⁷ Victims of affinity fraud are less likely to suspect that they have been defrauded because “[m]embers of the group often find it hard to believe that ‘one of their own’ could be scamming them.”¹⁸⁸ Inquiry notice, though, gives rise to a duty of inquiry “when the circumstances would suggest to an investor of ordinary intelligence the probability that she has been defrauded.”¹⁸⁹

These two examples illustrate that inquiry notice rewards fraudsters who use cunning methods to ensure that their victims will not take affirmative steps to discover the fraud. Victims of these types

182. See, e.g., *Wright v. Bloom*, *Wright v. Bloom*, No. C 12-00746, 2012 U.S. Dist. LEXIS 170679 WHA, at *8-10 (N.D. Cal. Nov. 30, 2012) 2012 U.S. Dist. LEXIS 170679, *10 (N.D. Cal. 2012) (dismissing securities fraud claim because plaintiffs were on inquiry notice more than two years before filing their claim).

183. *Top Investor Threats*, *supra* note 28.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 822 (Ct. App. 2006).

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of schemes are also victims of inquiry notice. When they eventually do discover the fraud, their inability to see the early warning signs of fraud (the “storm warnings”) bars their meritorious claims and eliminates their chance of recovery.

2. *Inquiry Notice Deters Securities Fraud Victims From Seeking Redress*

The Fourth Circuit stated that inquiry notice encourages plaintiffs to take “the actions necessary to bring the fraud to light” and gives a defendant the “security of knowing when legal action against him has been foreclosed.”¹⁹⁰ However, these justifications erroneously assume that aggrieved investors are not already sufficiently incentivized to promptly file suit.¹⁹¹ Courts have also suggested that inquiry notice is essential to prevent investors from taking unfair advantage of the protections of the securities laws by postponing action on an alleged fraud, pending the outcome of their investments.¹⁹² But the assumption that securities fraud victims who are aware of the fraud wait to file suit is misguided because “[i]t is more likely that plaintiffs [do] not know about the fraud, rather than that they [sit] on their hands with the information.”¹⁹³ Moreover, the strict pleading requirements for fraud “strongly discourage private plaintiffs from bringing marginal suits.”¹⁹⁴

190. *Brumbaugh v. Princeton Partners*, 985 F.2d 157, 162 (4th Cir. 1993).

191. Securities fraud plaintiffs are already highly motivated to investigate and file their claims as soon as possible for several reasons. *See Kaufman & Wunderlich, supra* note 33, at 1589-90 (noting several motivating factors, such as the presence of institutional investors as lead plaintiffs encouraging plaintiffs to investigate and file because these institutional investors often have sufficient resources to conduct their own pre-filing investigation; filing early correlates with a stronger likelihood of surviving a Rule 12(b)(6) motion to dismiss; and any delay comes at the cost of increased unavailability of evidence).

192. *See Brumbaugh*, 985 F.2d at 162 (“In sum, plaintiffs should not be able to coerce settlements simply because aging has improved an originally meritless claim”); *Tregenza v. Great American Commc’ns Co.*, 12 F.3d 717, 722 (7th Cir. 1993) (“These plaintiffs waited patiently to sue. If the stock rebounded from the cellar they would have investment profits, and if it stayed in the cellar they would have legal damages. Heads I win, tails you lose. This tactic is discouraged by the doctrine of inquiry notice.”).

193. *Kaufman & Wunderlich, supra* note 33, at 1594.

194. *Rose, supra* note 29, at 2220.

The uncertainty regarding whether the statute of limitations will bar a potential plaintiff's claim can prove costly because inquiry notice is generally an issue left to the finder of fact.¹⁹⁵ Even where a plaintiff has a strong case for fraud, the plaintiff must weigh the significant cost of pursuing litigation, starting from pre-discovery through trial, against the possibility that the plaintiff may lose at trial based on the statute of limitations. Thus, inquiry notice reduces a fraud victim's incentive to pursue redress and reduces the chance that cases will be decided on the merits of the claim.

The SEC recently implemented § 201(a) of the Jumpstart Our Business Startups Act by lifting the 80-year ban on general solicitation for private securities offerings.¹⁹⁶ Now, certain types of investment schemes can be advertised on billboards, through the Internet, and other media.¹⁹⁷ States are the primary regulator of private offerings,¹⁹⁸ and state regulators predict that lifting the ban on general solicitation will lead to more enforcement actions.¹⁹⁹ State regulators will not have the resources necessary to handle the sudden wave of fraud perpetrated through general solicitation, leaving aggrieved investors to rely on private actions to seek redress.²⁰⁰ The importance of private enforcement of the securities laws on the overall economy will become even more pronounced.²⁰¹ If fraudsters are not deterred by private enforcement, securities fraud will become more prevalent, and state regulators will become even more overwhelmed in their efforts to protect investors.²⁰² In light of the increased importance of

195. *Hernandez v. Vasquez*, No. B244533, 2013 Cal. App. Unpub. LEXIS 8074, at *22 (Ct. App. Nov. 7, 2013).

196. 17 C.F.R. pts. 230, 239, & 242 (2013).

197. *Id.*

198. *ABSHURE*, *supra* note 26, at 2-3.

199. *Id.* at 4.

200. Luis A. Aguilar, Commissioner, SEC, *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections*, Address at the North American Securities Administrators Association Annual NASAA/SEC 19(d) Conference (April 16, 2013), available at http://www.sec.gov/News/Speech/Detail/Speech/1365171515400#P55_10421.

201. *See discussion supra* Part II.

202. In his speech explaining why he voted against the proposal eliminating the prohibition on general solicitation, Commissioner Aguilar noted that "it is now more important than ever that defrauded investors have the ability to seek redress against those who participate in defrauding them." Aguilar, *supra* note 200. He

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private rights of action for securities fraud, California should reject inquiry notice because it discourages investors from filing meritorious securities fraud claims.

3. *California's Amended Securities Fraud Statute*

The recent remodeling of the anti-fraud provision of California securities law conforms it to SEC Rule 10b-5.²⁰³ If California courts interpret the amended law consistently with how federal courts have interpreted the now virtually identical Rule 10b-5, aggrieved investors will now face even more overwhelming pleading hurdles,²⁰⁴ because plaintiffs bringing suit under Rule 10b-5 must plead judicially imposed elements—scienter, reliance, and causation—which have never before been required under California securities law.²⁰⁵ The California legislature has asserted that the purpose of the amendment was “to ensure consistency with more comprehensive, federal anti-fraud statutes.”²⁰⁶ Thus, the legislative history evidences an intent to adopt Rule 10b-5, including the judicially-imposed elements.²⁰⁷

also stated that: “Private actions give fraud victims the ability to recover their losses. It is unrealistic to expect that state regulators or the SEC will have the resources to police all securities frauds or go after every fraudster. Investors should have the ability to protect themselves.” *Id.*

203. *See supra* note 2.

204. Mugmon et al., *supra* note 3. Defense attorneys will certainly advocate for a Rule 10b-5 pleading standard, and it is likely that courts will read the 10b-5 elements into the amended statutes given that “by amending an unambiguous statute the Legislature may be assumed to have intended to change the existing law.” *Gaumer v. County of Tehama*, 55 Cal. Rptr. 777, 778 (Ct. App. 1967) (citing *Cal. Motor Transp. Co. v. Pub. Utilit. Comm’n.*, 379 P.2d 324, 326-27 (Cal. 1963)); *see also Farmers Ins. Exch. v. Geyer*, 55 Cal. Rptr. 861, 867 (Ct. App. 1967) (“It is a settled principle of statutory construction that a material change in the phraseology of a legislative enactment is ordinarily viewed as showing an intention on the part of the Legislature to change the meaning of the statute.”).

205. *Brown, supra* note 4.

206. S.B. 538 Bill Analysis, Assemb. Comm. on Banking and Fin. (June 10, 2013), http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0501-0550/sb_538_cfa_20130607_121212_asm_comm.html.

207. Keith Paul Bishop, *Die Verwandlung: How the Legislature Likely Raised the Bar on Securities Fraud Actions*, CALIFORNIA CORPORATE AND SECURITIES LAW BLOG (Sept. 30, 2013), <http://calcorporatelaw.com/2013/09/die-verwandlung-how-the-legislature-likely-raised-the-bar-on-securities-fraud-actions/>.

In California, the “facts constituting the fraud . . . must be alleged factually and specifically.”²⁰⁸ Moreover, in securities fraud claims, the court accepts as true only “properly pleaded” material facts, not “contentions, deductions, or conclusions of fact or law.”²⁰⁹ But if, as *Deveny* holds, circumstances suggesting the mere possibility of fraud are sufficient to trigger the running of the limitations period,²¹⁰ a securities fraud victim could easily run out of time to file his claim before he can gather enough facts through pre-discovery investigation to draft a complaint that meets the heightened pleading standard. After all, “[c]oncoction is inherent in most securities fraud cases,”²¹¹ and “extensive and corrupt schemes may not be discovered within” the limitations period.²¹¹

The requirement of scienter itself creates a “pleading trap” for plaintiffs.²¹² Scienter is likely more difficult to discover than the other elements of fraud.²¹³ Uncovering evidence of a defendant’s mental state in a pre-discovery investigation is a formidable task.²¹⁴ Plaintiffs may only point to facts suggestive of scienter that are available within

208. *Apollo Capital Fund, LLC v. Roth Capital Partners, LLC*, 70 Cal. Rptr. 3d 199, 210 (Ct. App. 2007) (internal quotation marks omitted) (quoting *Comm. on Children’s Telev., Inc. v. Gen. Foods Corp.*, 673 P.2d 660, 672 (Cal. 1983)).

209. *Moss v. Kroner*, 129 Cal. Rptr. 3d 220, 225 (Ct. App. 2011) (internal quotation marks omitted) (quoting *Blank v. Kirwan*, 703 P.2d 58, 61 (Cal. 1985)).

210. *Deveny v. Entropin, Inc.*, 42 Cal. Rptr. 3d 807, 817 (Ct. App. 2006) (“Inquiry notice is sufficient to trigger the running of the limitations period . . .”). “Inquiry notice arises in a securities action when circumstances suggest to an investor of ordinary intelligence the possibility that he has been defrauded.” *Id.* at 821.

211. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 377 (1991) (Kennedy, J., dissenting) (arguing against the three-year statute of repose).

212. For further discussion of this dilemma facing plaintiffs even after *Merck’s* rejection of inquiry notice, see Kaufman & Wunderlich, *supra* note 33, at 1581-86.

213. *Merck & Co., Inc. v. Reynolds*, 559 U.S. 633, 657-58 (2010) (Scalia, J., concurring) (“Determining when the plaintiff should have uncovered an untrue assertion in a registration statement or prospectus is much simpler than assessing when a plaintiff should have learned that the defendant deliberately misled him using a deceptive device . . .”).

214. Kaufman & Wunderlich, *supra* note 33, at 1578-79.

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the two-year window, or their action may be dismissed based on the statute of limitations.²¹⁵

Another reason California should reject inquiry notice is that with the reworking of the anti-fraud provision, the justification for a shortened statute of limitations is gone. The legislature created a statute of limitations for securities fraud shorter than that available under common law fraud because the anti-fraud provisions of the Corporate Securities Law of 1968 relieved victims of establishing some of the elements of common law fraud.²¹⁶ But the judicially-imposed elements of Rule 10b-5 closely resemble the elements of common law fraud.²¹⁷ Keeping the truncated inquiry notice statute of limitations, while still requiring plaintiffs to essentially plead common law fraud, would frustrate the purpose of the anti-fraud provisions of the securities laws. Congress has recognized that:

[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.²¹⁸

Inquiry notice, though, prevents defrauded investors from bringing meritorious suits.²¹⁹

One could argue that because California's anti-fraud provision was originally modeled after § 12(a)(2) of the Securities Act, the Supreme Court's rejection of inquiry notice for the Exchange Act's statute of limitations has no bearing on section 25506, notwithstanding the recent amendment to section 25401. However, whether inquiry notice is sufficient to start the limitations period for actions brought under the Securities Act has been called into question since *Merck*. The Third Circuit recently rejected inquiry notice in favor of a

215. *Id.* at 1581-86.

216. *Bowden v. Robinson*, 136 Cal. Rptr. 871, 879 (Ct. App. 1977).

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

218. H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *available at* <http://www.gpo.gov/fdsys/pkg/CRPT-104hrpt369/pdf/CRPT-104hrpt369.pdf>.

219. *See* discussion *supra* Part IV.D.2.

discovery-based standard for securities fraud claims brought under the Securities Act, holding that *Merck's* rejection of inquiry notice is not limited to the Exchange Act.²²⁰ The court's well-reasoned opinion rests on four grounds. First, both the Exchange Act's statute of limitations (28 U.S.C. § 1658(b)) and the Securities Act's statute of limitations (§ 13) "incorporate the word 'discovery' which . . . [is] a term of art representing the discovery rule."²²¹ Second, while the latter statute references "'the exercise of due diligence' . . . [n]either statute includes any language suggesting that the limitations period begins to run before discovery."²²² Third, the court noted that the Supreme Court has treated both statutes of limitations as "interchangeable."²²³

Finally, the Third Circuit critically analyzed the purpose of the limitations period, and concluded that inquiry notice is inconsistent with that purpose.²²⁴ "[I]t is logical to link the statute of limitations standard with the pleading standard; the purpose of statutes of limitations is to prevent stale claims, but claims cannot be stale until they have accrued, and claims cannot accrue until they can be adequately pled."²²⁵ The court thus concluded that a plaintiff cannot be "deemed" to have "discovered" facts constituting the violation for the purposes of beginning the limitations period "until a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint . . . with sufficient detail and particularity to survive a 12(b)(6) motion to dismiss."²²⁶

Like federal securities fraud claims, securities fraud claims under California law must meet heightened pleading standards.²²⁷

220. *Pension Trust Fund for Operat'g Eng'rs v. Mortg. Asset Securitization Transactions, Inc.*, 730 F.3d 263, 273 (3d Cir. 2013).

221. *Id.*

222. *Id.*

223. *Id.*

224. *Id.* at 275.

225. *Id.*

226. *Id.* (ellipsis in original) (quoting *City of Pontiac Gen. Empl. Ret. Sys. V. MBIA, Inc.*, 637 F.d 169, 175 (2d Cir. 2011)).

227. *Olenicoff v. UBS AG*, No. SACV 08-1029 AG (RNBx), 2009 U.S. Dist. LEXIS 14056, at *18 (C.D. Cal. Feb. 24, 2009) (claim for securities fraud under California Corporations Code sections 25401 and 25501 dismissed because plaintiffs failed "to meet the heightened pleading requirements of Rule 9(b).").

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Moreover, the importance of private actions under the federal securities laws applies with equal force to state securities laws.²²⁸ Therefore, the policies articulated by the Third Circuit which support extending *Merck's* holding to claims under both the Securities and Exchange Acts also support extending *Merck's* holding to the securities fraud claims under California law, even if the judicially-imposed elements of Rule 10b-5 are not grafted onto section 25401.

V. CONCLUSION

The purpose of a statute of limitations is to prevent stale claims from being brought, but under inquiry notice, a claim may be deemed “stale” before it even accrues. This is both illogical and unfair. The inquiry notice standard has no place in section 25506 because the imposition of a duty of inquiry conflicts with the text of the statute. Inquiry notice made its way into California securities law during the befuddling era before a discreet statute of limitations applied to causes of action under Rule 10b-5. Its unquestioned reign continues only because courts have not critically analyzed the California court of appeal's holding in *Deveny*.

Private enforcement plays a crucial role in the deterrence-based scheme of securities regulation. But the policies underlying the rights of aggrieved investors to bring private actions against perpetrators of securities fraud are frustrated by a limitations period that may expire before the investors can adequately plead each element of securities fraud. In light of the California legislature's reformation of the anti-fraud provision, which will likely require plaintiffs to plead and prove reliance, causation, and scienter, it is more crucial than ever that California reject inquiry notice.

*Shauna C. Güner**

228. See H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), available at <http://www.gpo.gov/fdsys/pkg/CRPT-104hrpt369/pdf/CRPT-104hrpt369.pdf>.

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