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# THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT: HAS CONGRESS SUPPLIED A LIMITATIONS PERIOD APPROPRIATE FOR USE IN PRIVATE 10b-5 ACTIONS?

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Because civil actions brought pursuant to section 10(b) of the Securities Exchange Act of 1934 (1934 Act)<sup>1</sup> and rule 10b-5<sup>2</sup> promulgated thereunder are judicially implied,<sup>3</sup> there is no federal statute of limitations that is expressly applicable to such actions. Courts traditionally have adopted limitations periods for 10b-5 actions from state law,<sup>4</sup> but that practice has given rise to a host of collateral issues that have consumed undue amounts of judicial energy and resulted in protracted litigation unrelated to the merits of the actions.

For a number of reasons, adoption of state limitations periods for federal causes of action has resulted in uncertainty, unpredictability, and a

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1. 48 Stat. 891, 15 U.S.C. § 78j(b) (1988).

2. 17 C.F.R. § 240.10b-5 (1990).

3. The first published opinion recognizing an implied cause of action under rule 10b-5 was in *Kardon v. Nat'l Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). In the 44 years since that decision, an implied right of action under rule 10b-5 has become firmly entrenched. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under section 10(b)."). Federal courts also have recognized implied rights of action under §§ 14(a) and (e) of the Securities Exchange Act of 1934. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (section 14(a)); *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513 (11th Cir. 1985) (section 14(e)). The circuit courts are split on the issue of whether an implied right of action should exist under § 17(a) of the Securities Act of 1933. Compare *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808 (9th Cir. 1981) (recognizing action); *Kirshner v. United States*, 603 F.2d 234 (2d Cir. 1978) (same), *cert. denied*, 442 U.S. 909 (1979) with *Landry v. All Am. Assurance Co.*, 688 F.2d 381 (5th Cir. 1982) (no implied right of action exists under § 17(a)); *Gunter v. Hutcheson*, 674 F.2d 862 (11th Cir. 1982) (same), *cert. denied*, 459 U.S. 826; *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152 (8th Cir. 1977) (same), *cert. denied*, 434 U.S. 1086 (1978). Although this article primarily concerns section 10(b) and rule 10b-5, its analysis is applicable in large part to these other implied rights of action. Cf. *Suslick v. Rothschild Sec. Corp.*, 741 F.2d 1000, 1004 (7th Cir. 1984) (treating § 17(a) and rule 10b-5 claims similarly); *Baron v. Allied Artists Pictures Corp.*, 717 F.2d 105, 108-09 (3d Cir. 1983) (action under § 14(a) and rule 14a-9; court applied statute of limitations analysis of rule 10b-5 cases).

4. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384 n.18 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 n.29 (1976).

lack of uniformity. Looking to a forum state's limitations period often entails application of the forum state's choice of law principles<sup>5</sup> and borrowing statutes<sup>6</sup> to determine if the forum would apply its own statutes of limitation or those of some other state. Once the court decides what state's limitations periods apply, it must choose from among that state's statutes to find the period that applies to state law actions that are "most closely analogous" to the 10b-5 claim being asserted, a subjective process that frequently leads to confusing and unpredictable results.<sup>7</sup> Having decided on a given period, the court then must decide whether to look to state or federal law to determine when the applicable period begins to run,<sup>8</sup> and what, if any, tolling rules might interrupt the running of the statute.<sup>9</sup> The problems are compounded in complex, nationwide litigation and in multi-district transfer cases.<sup>10</sup>

This uncertainty has important consequences to both plaintiffs and defendants. As the Supreme Court recently recognized,

[p]laintiffs may be denied their just remedy if they delay in filing their claims, having wrongly postulated that the courts would apply a longer statute. Defendants cannot calculate their contingent liabilities, not knowing with confidence when their delicts lie in repose.<sup>11</sup>

Aside from the delay, inefficiency, and practical difficulties attendant to the application of state limitations periods, this practice will always suffer from the inherent problems associated with the use of different limitations

5. Conflict of laws problems have not been extensively litigated in the context of rule 10b-5 actions. However, § 142 of the RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1971) provides that the limitations period that normally would be applied by the forum is applicable even if the action would be barred under the law of another appropriate forum, unless the action in the other forum would have been barred by a statute that barred the right and not merely the remedy. This principle, combined with the far-reaching venue provisions of the 1934 Act, lends itself to forum shopping. See H. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* § 25.02, at 660 (1988-89 ed.)

6. See *Arnell v. Ramsey*, 550 F.2d 774, 779-80 (2d Cir. 1977); *Jones Found. v. Soros Fund Management, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,588 (S.D.N.Y. 1983); *Hill v. Equitable Trust Co.*, 562 F. Supp. 1324 (D. Del. 1983). See also *infra* notes 70-72 and accompanying text.

7. In *Roberts v. Magnetic Metals Co.*, 611 F.2d 450 (3d Cir. 1979), for example, each of the three judges on the panel had a different opinion as to what limitations period was applicable. One judge held that the forum state's limitations period for common-law fraud applied. A dissenting judge opined that the state's blue sky limitations period should apply. The concurring judge stated that in "ordinary circumstances" he would have applied the blue sky limitations period, but because the blue sky statute did not provide a remedy for defrauded sellers (as was the situation before the court), he felt compelled to adopt the limitations period from the fraud statute.

8. See *infra* notes 60-69 and accompanying text.

9. *Id.*

10. See *infra* notes 56-59 and accompanying text.

11. *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 150 (1987) (quoting *Wilson v. Garcia*, 471 U.S. 261, 275 n. 34 (1985)).

periods by various courts for a single federal cause of action. As long as state limitations periods are used, litigants' rights under a federal law inevitably will vary according to their state of residence or the forum in which they choose, or are forced, to litigate. Plaintiffs will be encouraged to utilize the 1934 Act's nationwide service of process and liberal venue provisions to forum shop, and defendants will be unable to enjoy the protection from claims that statutes of limitations are designed to provide.

Most courts and commentators that have discussed the policy questions associated with the application of state limitations periods to 10b-5 actions have harshly criticized the practice<sup>12</sup> and have suggested a number of alternatives.<sup>13</sup> However, years of precedent and differences of opinion about

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12. See, e.g., *In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131; *Norris v. Wirtz*, 818 F.2d 1329, 1332 (7th Cir. 1987), *cert. denied*, 484 U.S. 943; *McNeal v. Paine, Webber, Jackson & Curtis, Inc.*, 598 F.2d 888 (5th Cir. 1979); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1164-75 (1983); Bloomenthal, *The Statute of Limitations and Rule 10b-5: A Study in Judicial Lassitude*, 60 *COLO. L. REV.* 235 (1989); *Report of the Task Force on Statutes of Limitations for Implied Actions*, 41 *BUS. LAW.* 645 (1986) [hereinafter *Task Force Report*]; Schulman, *Statutes of Limitation in 10b-5 Actions: Complication Added to Confusion*, 13 *WAYNE L. REV.* 635 (1967); Comment, *Statutes of Limitations in 10b-5 Actions: A Proposal for Congressional Legislation*, 24 *SYRACUSE L. REV.* 1154 (1973) [hereinafter *Legislation Comment*].

Courts and commentators have lambasted the lack of uniformity engendered by adopting local limitations rules for federal legislation. The traditional approach of adopting state limitations rules has been described as a "tottering parapet of a ramshackle edifice," *Norris*, 818 F.2d at 1332, and the resulting lack of uniformity and certainty has been categorized as chaotic and an untold waste of time "in search of an answer to the wrong question." Bloomenthal, *supra*, at 236.

An American Bar Association Task Force stated that application of local limitations periods to rule 10b-5 claims

has disserved not only the federal courts but litigants, the bar, and the investment community. As the current chaotic state of the law demonstrates, no state law is readily applicable to the federal rights sought to be enforced. Furthermore, deference to state law is not warranted because federal, not state, interests are involved in the federal courts' creation and application of the implied private right of action under section 10 and Rule 10b-5.

*Task Force Report, supra*, at 656. See also L. Loss, *supra*, at 1168-69; Blume & George, *Limitations and the Federal Courts*, 49 *MICH. L. REV.* 937 (1951); Note, *Statutes of Limitations in Federal Civil Rights Litigation*, 1976 *ARIZ. L.J.* 97; Note, *Federal Borrowing of Arkansas Statutes of Limitations in Enforcement of the Reconstruction Civil Rights Statutes*, 31 *ARK. L. REV.* 692 (1978); Note, *A Limitation on Actions for Deprivation of Federal Rights*, 68 *COLUM. L. REV.* 68 (1968); Note, *Federal Statutes Without Limitations Provisions*, 53 *COLUM. L. REV.* 68 (1953); Note, *Rules of Decision in Nondiversity Suits*, 69 *YALE L.J.* 1428 (1960); Note, *Disparities in Time Limitations on Federal Causes of Action*, 49 *YALE L.J.* 738 (1940).

13. Some commentators have urged adoption of the limitations periods applicable to the express negligence or strict liability-based civil liability sections of the 1933 and 1934 Acts. See, e.g., L. Loss, *supra* note 12, at 898-900; Bloomenthal, *supra* note 12, at 235. Such limitations periods generally allow a claim to be filed within one year of discovery (or in some cases, constructive discovery), but no more than three years after the "sale," "violation," or "accrual" of the cause of action. The Third Circuit in *In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131, recently adopted its own form of this one year/three year rule for all 10b-5 actions. As discussed herein, the Third Circuit's new

the best alternative to the traditional rule have prevented the lower courts from adopting a uniform approach, and the Supreme Court has repeatedly refused to squarely address the issue.<sup>14</sup>

The central inquiry in determining what limitations period governs a federal implied remedy necessarily revolves around congressional intent and, to some extent, public policy. However, with respect to rule 10b-5 actions, divining congressional "intent" from legislation predating the recognition of a private right of action under rule 10b-5 is a dubious exercise at best, and decisions based on "public policy" invite result-oriented logic that produces a variety of results. Fortunately, recent federal legislation amending the 1934 Act contains a clear expression of congressional intent and offers a previously unavailable alternative to the status quo that better serves the goals of the 1934 Act and at the same time bars stale claims and promotes uniformity and certainty.<sup>15</sup> The Supreme Court now should adopt the recently enacted five year limitations period of section 20A of the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)<sup>16</sup> for the implied causes of action under section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 promulgated thereunder.

This article discusses the development of the "traditional rule" of adopting state limitations periods, the Supreme Court's willingness in certain circumstances to forsake that rule, and the alternative presented by ITSFEA.

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rule conflicts with Supreme Court precedent and the policies behind rule 10b-5.

Other commentators have urged new legislation including a statute of limitations modeled on New York's limitations period, allowing the lesser of two years from constructive discovery or six years from sale. See 5C A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5, § 235.02 (rev. ed. 1990); *Legislation Comment*, *supra* note 12, at 1168-71. Still others have proposed using the one year/five year limitations period contained in § 1727(b) of the Federal Securities Code prepared by the American Law Institute. See Block & Barton, *Statute of Limitations in Private Actions Under Section 10(b)—A Proposal for Achieving Uniformity*, 7 SEC. REG. L.J. 374 (1980); Comment, *Statutes of Limitations for Rule 10b-5*, 39 WASH. & LEE L. REV. 1021, 1168-71 (1982).

This article advocates the adoption of the five year limitations period found in the recently enacted Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"), Pub. L. No. 100-704, 102 Stat. 4677 (1988), which pertains to 10b-5 actions relating to insider trading. The SEC also has recommended the use of ITSFEA's limitations period for 10b-5 actions and a few courts have considered, but not adopted, that approach. See *infra* notes 231-241 and accompanying text.

14. Not only has the Supreme Court in several instances refused to review divergent circuit court decisions adopting various state rules, see, e.g., *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976), *cert. denied*, 429 U.S. 1074 (1977) (adopting state rule for fraud claims); *Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977) (adopting state rule for blue sky claims), it denied certiorari of the Third Circuit's recent decision to abandon that traditional rule in favor of a uniform federal limitations period. See *Data Access*, 843 F.2d 1537; Bloomenthal, *supra* note 12, at 235-37, nn.2, 4, 8, 10.

15. Pub. L. No. 100-704, § 5, 102 Stat. 4681 (adding section 20A(a), to be codified at 15 U.S.C. § 78t-1(a)).

16. *Id.*

THE TRADITIONAL METHOD<sup>17</sup>: ADOPTION OF THE FORUM STATE'S MOST  
CLOSELY ANALOGOUS LIMITATIONS PERIOD AND THE PROBLEMS INHERENT IN  
THAT METHOD

The practice of adopting state statutes of limitation by federal courts for federal causes of action can be traced to a line of old decisions construing the Rules of Decisions Act.<sup>18</sup> The first Supreme Court decision to discuss the applicability of the Rules of Decisions Act to a limitations issue was *M'Cluny v. Silliman*.<sup>19</sup> In *M'Cluny* a purchaser of land sued the federal land office registrar, alleging that the federal official wrongfully had refused to enter a tendered land purchase application. The purchaser had waited thirteen years, however, to bring his suit.<sup>20</sup> The trial court dismissed the case as being outside the forum state's limitations period, and the purchaser appealed his way to the Supreme Court, arguing that "no statute of limitations of the state . . . is pleadable . . . in the circuit court of the United States . . . where the plaintiff's rights accrued to him under a law of congress."<sup>21</sup> The Court simply assumed without any analysis that the Rules of Decisions Act required that a state limitations period apply, probably because the plaintiff never suggested a viable alternative. The plaintiff's argument that it would be repugnant for a state limitations period to apply to a federal right overlooked the fact that once a state limitations period is *adopted* by the federal court, it becomes *federal* law.<sup>22</sup> Although the plaintiff also argued that the lack of uniformity resulting from adopting state limitations periods should preclude the adoption of state limitations periods,<sup>23</sup> the Court rejected that argument by never addressing it.

The Supreme Court in *Campbell v. Haverhill*<sup>24</sup> again assumed, without question, that the Rules of Decisions Act mandated application of the state statute of limitations when there was no express federal limitations period. The Court in *Campbell*, however, tacked on an exception that would apply whenever the state's limitation period would discriminate against a federal right, stating:

In such case it might be plausibly argued that it could never have been intended by Congress that [the Rules of Decisions Act] should apply to statutes passed in manifest hostility to Federal rights or jurisdiction, but only to such as were uniform in their operation

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17. For ease of reference in this article, the method of adopting the forum state's most closely analogous statute of limitations shall sometimes be referred to as the "traditional rule."

18. 28 U.S.C. § 1652 (1988).

19. 28 U.S. (3 Pet.) 270 (1830).

20. *M'Cluny v. Silliman*, 28 U.S. (3 Pet.) 270, 275-76 (1830).

21. *Id.* at 270.

22. See *Special Project, Time Bars in Specialized Federal Common Law: Federal Rights of Action and State Statutes of Limitation*, 65 CORNELL L. REV. 1011, 1028-29 (1980) [hereinafter *Special Project*].

23. *M'Cluny*, 28 U.S. (3 Pet.) at 278.

24. 155 U.S. 610 (1895).

upon state and Federal rights and upon state and Federal courts.<sup>25</sup>

Again, however, the Court never considered the primary issue of whether the right of action was created by state or federal law, and it never sought to determine Congress' intent. Instead it only considered the nonissue of whether the court's jurisdiction was exclusive or concurrent.<sup>26</sup> Although by the time of these decisions the Court had established its ability to make federal common law,<sup>27</sup> the Court doubted its ability to fashion its own limitations period.<sup>28</sup>

The Supreme Court's view of the applicability of the Rules of Decisions Act to adoption of a limitations period for federal causes of action took a turn in *Holmberg v. Armbrecht*.<sup>29</sup> *Holmberg* involved an action brought under the Federal Farm Loan Act.<sup>30</sup> Because the action was in equity, the defendants pleaded laches as a defense and argued that the forum's most analogous statute of limitations should be the guidepost to determine whether laches should be employed. En route to a rejection of that defense, the Court paused to note in dictum that "[a]s to actions at law, the silence of Congress has been interpreted to mean that it is federal policy to adopt the local law of limitation."<sup>31</sup>

*Holmberg* is a confused opinion. As authority for its dictum that state statutes of limitation apply to actions at law in the absence of an express federal limitation period, the Court cited three cases interpreting the Rules of Decisions Act to mandate the application of state statutes of limitation.<sup>32</sup> *Holmberg*, however, did not cite the Rules of Decisions Act. Ironically, although *Holmberg* usually is cited as mandating adoption of state limitations periods, the Court in *Holmberg* declined to do so.<sup>33</sup> Indeed, the

25. *Campbell v. Haverhill*, 155 U.S. 610, 615 (1895).

26. See *Special Project*, *supra* note 22, at 1031-34.

27. See, e.g., *Swift v. Tyson*, 41 U.S. (16 Pet.) 1, 18-19 (1842); Schofield, *Swift v. Tyson, Uniformity of Judge-Made State Law in State and Federal Courts*, 4 ILL. L. REV. 533, 536 (1910) ("No judge in England or in the United States ever did need to be told . . . that he has the power to make law.").

28. See generally *Special Project*, *supra* note 22, at 1034.

29. 327 U.S. 392 (1946).

30. 39 Stat. 374 (1916) (repealed by Pub. L. No. 92-181, Title V, § 5.26(a), 85 Stat. 624 (1971), 12 U.S.C. § 812 (1988)).

31. *Holmberg v. Armbrecht*, 327 U.S. 392, 395 (1946) (citing *Campbell v. Haverhill*, 155 U.S. 610 (1895)); *Rawlings v. Ray*, 312 U.S. 96 (1941); *Chattanooga Foundry & Pipe Works v. City of Atlanta*, 203 U.S. 390 (1906).

32. *Holmberg*, 327 U.S. at 395 (citing *Campbell*, 155 U.S. 610; *Chattanooga Foundry*, 203 U.S. 390; *Rawlings*, 312 U.S. 96).

The Rules of Decision Act, 28 U.S.C. § 1652 (1988), states:

The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply.

*Id.* The *Special Project*, *supra* note 22, contains a thorough history and criticism of the Supreme Court's decisions preceding *Holmberg*.

33. See Bloomenthal, *supra* note 12, at 237-38.

Supreme Court recently cited *Holmberg* as support for the notion that it "has not hesitated to turn away from state law."<sup>34</sup> Although some courts have continued to argue that the Rules of Decision Act mandates adoption of state limitations periods to "fill in the gap" of a non-existent federal limitations period,<sup>35</sup> commentators have suggested that such a notion should have been dispelled by *Holmberg*.<sup>36</sup> If congressional intent can be ascertained through legislative history, presumptions, or otherwise, the Rules of Decisions Act is inapplicable because Congress is deemed to have spoken.

Ever since the issue of what limitations period, if any,<sup>37</sup> applies to private<sup>38</sup> rule 10b-5 actions was first presented to a district court in *Osborne v. Mallory*,<sup>39</sup> and to a court of appeal in *Fischman v. Raytheon Manufacturing Co.*,<sup>40</sup> federal courts uniformly have relied on *Holmberg* when adopting the forum state's most analogous limitations period. Until only recently, all twelve circuit courts applied the forum state's limitations periods in 10b-5 actions,<sup>41</sup> and the Supreme Court seems to have endorsed that

34. *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 148 (1987) (quoting *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 171-72 (1983)).

35. The majority opinion in *Malley-Duff*, 483 U.S. at 143, gave short shrift to this argument. *See also id.* at 161 n.1 (Scalia, J., concurring in judgment).

36. *See Special Project*, *supra* note 22, at 1041 (1980).

A careful reading of *Holmberg* reveals that the Court did not *mandate* adoption of local law; instead, the Court *allowed* such adoption:

The implied absorption of State statutes of limitation within the interstices of the federal enactments is a phase of fashioning remedial details where Congress has not spoken but left matters for judicial determination within the general framework of familiar legal principles.

327 U.S. at 395 (citing *Board of Comm'rs v. United States*, 308 U.S. 343, 349-52 (1939)).

37. It might be argued that, because courts have presumed from congressional silence an intent to permit a cause of action under rule 10b-5, we should also presume from the fact that no limitations period was created that Congress did not want there to be a limitations period. However, as would be expected, the prospect of an implied right of action unlimited by any time constraints has not been gleefully accepted by the courts. *See Moviecolor, Ltd. v. Eastman Kodak Co.*, 288 F.2d 80, 83 (2d Cir. 1961) (Friendly, J.) ("Congress could not have intended an unlimited period for enforcement" of federal rights with no express federal limitations period). In *Adams v. Woods*, 6 U.S. (2 Cranch) 336, 342 (1805), Chief Justice Marshall cautioned that having no statute of limitations would be "utterly repugnant to the genius of our laws." *Cf. Malley-Duff*, 483 U.S. at 166 (Scalia, J., concurring) (arguing in the context of a RICO case that because Congress did not create a limitations period for the RICO civil right of action, if no state analogy is apparent, there should be no limitations period).

38. Apparently, there is no limitations period on actions brought by the SEC. *See SEC v. Continental Advisers*, Fed. Sec. L. Rep. (CCH) ¶ 96,489, at 93,819 (D.D.C. 1978) (citing *United States v. Summerlin*, 310 U.S. 414, 416 (1940)).

39. 86 F. Supp. 869 (S.D.N.Y. 1949).

40. 188 F.2d 783 (2d Cir. 1951).

41. *See, e.g.*, *Corwin v. Marney, Orton Inv.*, 843 F.2d 194 (5th Cir. 1988), *cert. denied*, 109 S. Ct. 305; *Suslick v. Rothschild Sec. Corp.*, 741 F.2d 1000 (7th Cir. 1984); *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434 (9th Cir. 1984); *Kennedy v. Tallant*, 710 F.2d 711 (11th Cir. 1983); *Armstrong v. McAlpin*, 699 F.2d 79 (2d Cir. 1983); *Herm v. Stafford*, 663 F.2d 669 (6th Cir. 1981); *Wachovia Bank & Trust Co. v. Nat'l Student Mktg.*



approach.<sup>42</sup> Hence, regardless of whether *Holmberg* did, or did not, mandate this traditional rule in 10b-5 cases, the rule exists.

Although courts in the past have agreed that the forum state's "most closely analogous" limitations period should be applied in private 10b-5 actions, there has been no consensus on which state statute is "most closely analogous." For example, the Eighth and Eleventh Circuits apply the forum's limitations period for state blue sky<sup>43</sup> claims, noting that the purpose of state securities statutes is identical to that of the 1934 Act.<sup>44</sup> Other circuits, such as the Second, Ninth, and Tenth Circuits,<sup>45</sup> apply the forum state's limitations period for fraud. The First Circuit, on the other hand, has adopted the forum state's limitation period for personal injury actions.<sup>46</sup> The Fifth and Sixth Circuits (and the Third Circuit prior to its recent decision in *In re Data Access Systems Securities Litigation*)<sup>47</sup> have mixed decisions, sometimes adopting the forum's blue sky limitations period and

Corp., 650 F.2d 342 (D.C. Cir. 1980), *cert. denied*, 452 U.S. 954 (1981); *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) (recently overruled by *In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131); *Buder v. Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 690 (8th Cir. 1981); *O'Hara v. Kovens*, 625 F.2d 15 (4th Cir. 1980), *cert. denied*, 449 U.S. 1124 (1981); *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978); *de Haas v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1971).

42. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384 n.18 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 210 n.29 (1976).

43. State securities laws generally are referred to as "blue sky" laws. The term apparently originated in a 1916 article:

A definition of "Blue Sky Law" is necessary. The State of Kansas, most wonderfully prolific and rich in farming products, has a large proportion of agriculturists not versed in ordinary business methods. The State was the hunting ground of promoters of fraudulent enterprises; in fact their frauds became so barefaced that it was stated that they would sell building lots in the blue sky in fee simple. Metonymically they became known as blue sky merchants, and the legislation intended to prevent their frauds was called Blue Sky Law.

Muluey, *Blue Sky Law*, 36 CAN. L. TIMES 37 (1916). See 12 J. LONG, *BLUE SKY LAW* 1-2 n. 5 (1989 rev. ed.); L. LOSS & D. COWETT, *BLUE SKY LAW* 7 (1958). The Supreme Court, not long after publication of the Muluey article, used the term in describing "speculative schemes which have no more basis than so many feet of blue sky." *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917).

44. *Friedlander v. Troutman, Sanders, Lockerman & Ashmore*, 788 F.2d 1500, 1509 (11th Cir. 1986); *Buder v. Merrill Lynch, Pierce, Fenner & Smith*, 644 F.2d 690 (8th Cir. 1981); *Vanderboom v. Sexton*, 422 F.2d 1233 (8th Cir. 1970), *cert. denied*, 400 U.S. 852.

45. *Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434 (9th Cir. 1984); *Armstrong v. McAlpin*, 699 F.2d 79 (2d Cir. 1983); *Loveridge v. Dreagoux*, 678 F.2d 870 (10th Cir. 1982); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687 (10th Cir. 1981), *cert. denied*, 454 U.S. 895; *Briskin v. Ernst & Ernst*, 589 F.2d 1363 (9th Cir. 1978); *de Haas v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970); *Fratt v. Robinson*, 203 F.2d 627 (9th Cir. 1953); *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951).

46. *Cook v. Avien, Inc.*, 573 F.2d 685 (1st Cir. 1978); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965), *cert. denied*, 382 U.S. 879.

47. 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131.

sometimes adopting another limitations period, depending upon how the particular claim is characterized.<sup>48</sup>

Questions of application are found not only among the circuits but within them as well. Although there are decisions on the books establishing 10b-5 limitations periods for the great majority of the fifty states, many of those cases were determined on an ad hoc basis, and subsequent modifications to the state limitations periods adopted in those cases and the state statutes to which they apply may cast some doubt on their continued applicability.<sup>49</sup>

As long as limitations periods for rule 10b-5 claims are drawn from analogous state periods, plaintiffs can never know with any degree of certainty what deadlines they face in filing a claim, and potential defendants will never be free from the fear of a lawsuit.<sup>50</sup> Statutes of limitation are designed to protect defendants from stale claims by terminating contingent liabilities at specific points in time while at the same time providing a potential plaintiff a reasonable time in which to bring suit.<sup>51</sup> To achieve that purpose, limitation periods must be predictable. Neither plaintiffs nor defendants are well served by a statute of limitations if it is difficult to determine the length of the limitations period, the point at which the limitations period should start to run, or when it is tolled, since litigation will be necessary to determine whether the statute has run. To obtain a clearly ascertainable cutoff in the securities fraud context, it is necessary to

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48. Compare *Herm v. Stafford*, 663 F.2d 669 (6th Cir. 1981) (applying blue sky law); *Carothers v. Rice*, 633 F.2d 7 (6th Cir. 1980) *cert. denied*, 450 U.S. 988 (1981); *O'Connell v. Economic Research Analysts*, 499 F.2d 994 (5th Cir. 1974), *cert. denied*, 419 U.S. 1122 (1975) with *Marx v. Centran Corp.*, 747 F.2d 1536 (6th Cir. 1984) (applying fraud limitations period); *Breen v. Centex Corp.*, 695 F.2d 907 (5th Cir. 1983); *Azalea Meats, Inc. v. Muscat*, 386 F.2d 5 (5th Cir. 1967); *Charney v. Thomas*, 372 F.2d 97 (6th Cir. 1967). See also *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Biggans v. Bache Halsey Stuart Shields, Inc.*, 638 F.2d 605 (3d Cir. 1980); *Roberts v. Magnetic Metals Co.*, 611 F.2d 450 (3d Cir. 1979).

49. See, e.g., *Hoff Research & Dev. Laboratories, Inc. v. Philippine Nat'l Bank*, 426 F.2d 1023 (2d Cir. 1970); see also *Herm v. Stafford*, 663 F.2d 669, 680-81 (6th Cir. 1981) (quoting *McNeal v. Paine, Webber, Jackson & Curtis*, 598 F.2d 888, 893 n.9 (5th Cir. 1979)) (noting that "it is undeniably untidy to insist that the statute of limitations applicable to a federal cause of action vary from time to time dependent upon changes in local law . . . [T]hat circumstance, however, is an unavoidable side effect of the basic rule of requiring application of state statutes of limitation.").

50. See *Newman v. Freeman*, 262 F. Supp. 106, 112 (E.D. Pa. 1966) ("It is rudimentary that the purpose of a Statute of Limitations is to . . . give potential defendants a fixed point in time when they will no longer have to fear a lawsuit.").

51. See *Allen v. United States*, 542 F.2d 176, 179 (3d Cir. 1976) (statutes of limitation "serve to strike a balance between the need for certainty and predictability in legal relationships and the role of the courts in resolving private disputes."); *Gates Rubber Co. v. U.S.M. Corp.*, 508 F.2d 603, 611 (7th Cir. 1975) ("[T]he interest in certainty and finality in the administration of our affairs, especially in commercial transactions, makes it desirable to terminate contingent liabilities at specific points in time."); *Developments in the Law—Statutes of Limitation*, 63 HARV. L. REV. 1177, 1185 (1950) ("There comes a time when [the defendant] ought to be secure in his reasonable expectation that the slate has been wiped clean of ancient obligations").

achieve uniformity among the districts because the interstate character of securities transactions, coupled with the 1934 Act's nationwide jurisdiction and venue provisions, exposes potential defendants to the possibility of actions in any number of states. Potential defendants cannot rest assured that they cannot be sued successfully merely because the limitations period in their state has expired. Rather, they must look to the limitations period of every state touched by their transactions.

As the law now stands, statutes of limitation in 10b-5 actions do not, and cannot, provide the desired fairness, predictability, or uniformity.<sup>52</sup> Plaintiffs in some states are given inordinately long periods in which to sue, while in other jurisdictions their claims are cut off quickly. Whereas a Tennessee court would apply a ten year limitation period borrowed from that state's laws,<sup>53</sup> a defrauded plaintiff suing in Maryland federal court has but one year to seek redress.<sup>54</sup> Utilizing the state blue sky period, as is done in the Eighth and Eleventh Circuits, provides some predictability but not uniformity, because blue sky statutes across the nation contain widely varying limitations periods.<sup>55</sup>

The practical problems associated with the application of state limitation periods to 10b-5 claims are enormous. If a case is transferred from one district to another, issues arise as to which state's statute to apply.<sup>56</sup> The difficulties created by this lack of uniformity among states become particularly acute in multidistrict cases, which often arise as a natural result of the national and international scope of the securities markets. Hence, an even thornier problem is presented if two (or more) class actions are transferred to one court by the Judicial Panel on Multidistrict Litigation.<sup>57</sup>

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52. The Third Circuit's decision in *Roberts v. Magnetic Metals Co.*, 611 F.2d 450 (3rd Cir. 1979), exemplifies the anomalies of this claim-by-claim approach. The plaintiff in *Roberts* was an allegedly defrauded seller who did not sell his stock in a tender offer because certain facts were not disclosed to him. In prior cases the Third Circuit had adopted the forum's statute of limitations for civil actions under the state securities act. Had that limitations period been adopted in *Roberts* the plaintiff would have had two years to file suit. However, because the forum's blue sky statute did not permit a cause of action by a defrauded seller, the court instead adopted the forum's six-year limitations period for common law fraud, thus providing defrauded sellers three times as long to file a lawsuit as defrauded buyers.

53. *Denny v. Performance Sys., Inc.*, [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,387, at 91,981 (M.D. Tenn. 1971).

54. *O'Hara v. Kovens*, 625 F.2d 15 (4th Cir. 1980), *cert. denied*, 449 U.S. 1124 (1981).

55. See *Task Force Report*, *supra* note 12, at Appendix B.

56. It is generally held that if an action is transferred for the convenience of the parties, the statute of limitations of the transferor jurisdiction governs. 28 U.S.C. § 1404(a) (1988). See *Loughan v. Firestone Tire & Rubber Co.*, 624 F.2d 726 (5th Cir. 1980); *Schreiber v. Allis-Chambers Corp.*, 611 F.2d 790 (10th Cir. 1979) (applying limitations period of transferor court). If, however, the transfer results from a lack of venue or personal jurisdiction, the laws of the transferee state govern (presumably including its choice of law principles which could result in the application of still another state's statute). See *Sargent v. Genesco, Inc.*, 492 F.2d 750, 758-59 (5th Cir. 1974); *In re Clinton Oil Co. Sec. Litig.*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,015, at 91,567 (D. Kan. 1978); 28 U.S.C. § 1406(a) (1988).

57. See 28 U.S.C. § 1407 (1988).

The transferee court presiding over a consolidated case first must figure out how the circuit court in which each transferor district court sits would approach the issue, and it then must use that approach to determine which limitations period of the transferor state the transferor court would deem to be most appropriate.<sup>58</sup> If the transferor state has a borrowing statute, the complexity of the issue grows exponentially.<sup>59</sup>

In addition to the lack of uniformity and predictability in applying states' limitation periods, the rules governing when the chosen period begins to run and when, if ever, it is tolled vary among the courts. Most courts have ruled that federal law determines when the statute of limitations begins to run in a 10b-5 case.<sup>60</sup> Those courts have applied the federal equitable tolling doctrine<sup>61</sup> in holding that the limitations period begins to run when the plaintiff knew, or through the exercise of reasonable diligence should have known, of the fraud.<sup>62</sup> Some courts, however, have not applied the federal tolling doctrine.<sup>63</sup>

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58. See, e.g., *Clinton Oil*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,015.

59. See *infra* notes 70-72 and accompanying text.

60. See, e.g., *Durham v. Business Management Assoc.*, 847 F.2d 1505, 1508 (11th Cir. 1988) ("while state law governs the limitations period applicable to a section 10(b) action, federal law governs when the limitations period begins to run."); *Semegen v. Weidner*, 780 F.2d 727, 733 (9th Cir. 1985); *Suslick v. Rothschild*, 741 F.2d 1000, 1004 (7th Cir. 1984); *Kennedy v. Tallant*, 710 F.2d 711, 716 (11th Cir. 1983); *Summer v. Land & Leisure, Inc.*, 664 F.2d 965, 968 (5th Cir. 1981); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687, 691-92 (10th Cir. 1981), *cert. denied*, 454 U.S. 895; *ITT v. Cornfeld*, 619 F.2d 909, 929 (2d Cir. 1980); *Gaudin v. KDI Corp.*, 576 F.2d 708, 712 (6th Cir. 1978); *Cook v. Avien, Inc.*, 573 F.2d 685, 694 (1st Cir. 1978); *Vanderboom v. Sexton*, 422 F.2d 1233, 1240 (8th Cir. 1970), *cert. denied*, 400 U.S. 852.

61. The Supreme Court in *Bailey v. Glover*, 88 U.S. 342, 349-50 (1874), described this doctrine as follows:

[W]hen there has been no negligence or laches on the part of a plaintiff in coming to the knowledge of the fraud which is the foundation of the suit, and when the fraud has been concealed, or is of such character as to conceal itself, the statute does not begin to run until the fraud is discovered by, or becomes known to, the party suing . . . .

*Id.*

62. See, e.g., *Mosesian v. Peat, Marwick, Mitchell & Co.*, 727 F.2d 873, 877 (9th Cir. 1984), *cert. denied*, 469 U.S. 932; *Kennedy v. Tallant*, 710 F.2d 711, 716 (11th Cir. 1983); *Armstrong v. McAlpin*, 699 F.2d 79, 87 (2d Cir. 1983); *Breen v. Centex Corp.*, 695 F.2d 907, 911 (5th Cir. 1983); *Trecker v. Scag*, 679 F.2d 703, 706 & n.7 (7th Cir. 1982); *Herm v. Stafford*, 663 F.2d 669, 682 (6th Cir. 1981); *Ohio v. Peterson, Lowry, Rall, Barber & Ross*, 651 F.2d 687, 691-92 (10th Cir. 1981), *cert. denied*, 454 U.S. 895; *Wachovia Bank & Trust Co., N.A. v. Nat'l Student Mktg. Corp.*, 650 F.2d 342, 349 (D.C. Cir. 1980), *cert. denied sub nom.*, *Peat, Marwick, Mitchell & Co. v. Wachovia Bank & Trust Co.*, 452 U.S. 954 (1981); *Buder v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 644 F.2d 690, 692 (8th Cir. 1981); *Cook v. Avien, Inc.*, 573 F.2d 685, 694-95 (1st Cir. 1978); *Johns Hopkins Univ. v. Hutton*, 488 F.2d 912, 917 (4th Cir. 1973) (actual discovery or should have discovered with reasonable diligence), *cert. denied*, 416 U.S. 916 (1974); *Janigan v. Taylor*, 344 F.2d 781, 784 (1st Cir. 1965), *cert. denied*, 382 U.S. 879.

63. See *Logan v. Ledford*, 699 F. Supp. 141, 144-45 (M.D. Tenn. 1988); *Zigel v. Garcia*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 92,455-56 (D. Md. 1988); *Shelter Mutual*

Anomalous results sometimes occur when federal tolling rules are applied. Most blue sky statutes have adopted a version of the limitations period found in the Uniform Securities Act, which provides a limitations period running from the date of the contract of sale.<sup>64</sup> Application of the federal tolling period to these statutes of limitation results in longer limitation periods than are available under the supposedly analogous state statutes. For example, although the blue sky limitations period for Arkansas is five years from the contract of sale, for a rule 10b-5 action borrowing that limitations period the limitations period is five years from the time the investor discovered the fraud, and the federal equitable tolling doctrine places no absolute cap on the period.<sup>65</sup> If the Arkansas legislature had intended its limitations period to be used in conjunction with a tolling rule, it may well have chosen a shorter period.

Application of the federal tolling doctrine does reduce some of the inconsistencies between various states' limitation periods by creating a uniform starting point for the chosen limitation periods. However, uncertainty still is engendered because the federal tolling doctrine is not applied uniformly by the various circuit courts. The Tenth Circuit, for example, holds that the determination of when the plaintiff reasonably should have been put on notice of the fraud is a *subjective* determination, affected by each individual plaintiff's sophistication and knowledge.<sup>66</sup> The Second, Sixth, and Seventh Circuits, on the other hand, apply an objective standard that requires the plaintiff only to exercise the degree of diligence that a reasonable person would have used under the circumstances.<sup>67</sup> Some courts hold that when a defendant actively conceals his fraud, the plaintiff is relieved of any duty to discover it.<sup>68</sup> Others require the plaintiff to exercise due diligence to discover a fraud practiced upon him even if the defendant is actively

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Ins. Co. v. Public Water Supply Dist. No. 7, 569 F. Supp. 310, 321-22 (E.D. Mo. 1983). These district court decisions rely generally upon two civil rights cases decided by the Supreme Court, Board of Regents v. Tomanio, 446 U.S. 478 (1980), and Wilson v. Garcia, 471 U.S. 261 (1985). Those two cases, however, are not analogous to 10b-5 litigation in this context because the express language of 42 U.S.C. § 1988 (1988) (with which those cases dealt) seems to require by its terms that state tolling rules be adopted in civil rights actions. See Ohio v. Peterson, Lowry, Rall, Barber & Ross, 651 F.2d 687, 691 (10th Cir. 1981), *cert. denied*, 454 U.S. 895.

64. Uniform Securities Act § 410(e) (1957).

65. Pinney v. Edward D. Jones & Co., Inc., 718 F. Supp. 1419, 1421-22 (W.D. Ark. 1989).

66. See Ohio v. Peterson, Lowry, Rall, Barber & Ross, 472 F. Supp. 402, 408 (D. Colo. 1979), *aff'd*, 651 F.2d 687 (10th Cir. 1981), *cert. denied*, 454 U.S. 895.

67. See, e.g., Armstrong v. McAlpin, 699 F.2d 79, 88 (2d Cir. 1983); Campbell v. Upjohn Co., 676 F.2d 1122, 1126-27 (6th Cir. 1982); Morgan v. Koch, 419 F.2d 993, 997-98 (7th Cir. 1969).

68. See, e.g., Currie v. Cayman Resources Corp., 835 F.2d 780 (11th Cir. 1988); Suslick v. Rothschild Sec. Corp., 741 F.2d 1000, 1004 (7th Cir. 1984); Robertson v. Seidman & Seidman, 609 F.2d 583, 593 (2d Cir. 1979); Tomera v. Galt, 511 F.2d 504, 509-10 (7th Cir. 1975).

concealing the fraud.<sup>69</sup> Nonetheless, although the federal tolling rule is not treated uniformly by all circuits, it certainly promotes more uniformity than adoption of fifty states' tolling rules.

Problems also arise when the forum state has a statute by which it borrows the limitations period of another state. The anomalies produced by such borrowing statutes are illustrated by the case of *Berry Petroleum Co. v. Adams and Peck*.<sup>70</sup> Although the Second Circuit uniformly adopts the forum state's limitations period for fraud actions, the forum in *Berry Petroleum* had a statute directing that the limitations period of the state in which the action accrued be applied. Because the action accrued in Texas, the Second Circuit was forced to determine what approach the Fifth Circuit would use in adopting a limitations period. The Second Circuit then chose Texas' blue sky limitations period because it thought the Fifth Circuit would do so. However, subsequent Fifth Circuit decisions have adopted the fraud limitations period for rule 10b-5 actions in Texas.<sup>71</sup>

Similarly, in *Robertson v. Seidman & Seidman*,<sup>72</sup> the forum state had a borrowing statute that directed the Second Circuit to apply Alaska's limitations period. Again, the Second Circuit faced the difficult question of which limitations period would be applied in a state outside of its jurisdiction, and the Second Circuit chose Alaska's blue sky period. If the law of a state in the Second Circuit had applied, the court would have applied a fraud limitations period.

Although the unfairness to litigants inherent in the inconsistencies created by some states having longer or shorter limitations periods than others for the same federal claim may not rise to the level of a denial of due process,<sup>73</sup> such wide discrepancies in state limitation periods, coupled with the nationwide service of process and venue provisions of the 1934 Act,<sup>74</sup> create a

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69. See, e.g., *Campbell*, 676 F.2d at 1128; *Ohio v. Peterson*, Lowry, Rall, Barber & Ross, 651 F.2d 687, 694-95 (10th Cir. 1981), cert. denied, 454 U.S. 895.

70. 518 F.2d 402 (2d Cir. 1975).

71. See, e.g., *Breen v. Centex Corp.*, 695 F.2d 907 (5th Cir. 1983).

72. 609 F.2d 583 (2d Cir. 1979).

73. See *UAW v. Hoosier Cardinal Corp.*, 383 U.S. 696, 701-05, 703 n.4 (1966) ("[T]he lack of uniformity in limitations provisions [under §301 of the Labor Management Relations Act of 1947] is unlikely to have a substantial effect upon the private definition or effectuation of 'substantive' or 'primary' rights."); cf. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 729 (1979) (value of uniformity with respect to priority of liens rules is insufficient to "override intricate state laws of general applicability on which private creditors base their daily commercial transactions.").

74. Section 27 of the 1934 Act states that a civil cause of action may be brought in any [district in which any act or transaction constituting the violation occurred], or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

15 U.S.C. § 78aa (1988).

Section 27 of the 1934 Act is "intended to grant a potential plaintiff a liberal choice in selecting his forum, and gives teeth to the enforcement of the law." 5C A. Jacobs, *supra* note 13, § 287; see also *Leroy v. Great W. United Corp.*, 443 U.S. 173, 188 (1979) (White, J., dissenting); *SEC v. Elec. Warehouse, Inc.*, 689 F. Supp. 53 (D. Conn. 1988); *Ritter v.*

substantial incentive for forum shopping.<sup>75</sup> Such forum shopping “virtually guarante[es] . . . complex and expensive litigation over what should be a straightforward matter,”<sup>76</sup> unfairly burdens the courts of states with more liberalized limitations periods, and adds undue expense to both plaintiffs and defendants who may be dragged to far away states to litigate their disputes.

Fortunately, recent Supreme Court decisions in nonsecurities cases suggest that it is appropriate to revisit the question of the applicability of the “traditional” *Holmberg* rule to rule 10b-5 actions.

#### THE SUPREME COURT’S CHANGING VIEW: DEVOLUTION OF THE TRADITIONAL RULE

##### A. Supreme Court Precedent Regarding the Appropriate Limitations Period for Rule 10b-5 Claims

Although the Supreme Court has never squarely addressed the issue of what, if any, statute of limitations should be applied to rule 10b-5 actions, two of its seminal 10b-5 decisions, *Ernst & Ernst v. Hochfelder*<sup>77</sup> and *Herman & MacLean v. Huddleston*,<sup>78</sup> are premised on the applicability of *Holmberg*. In *Hochfelder*, the Supreme Court stated in a footnote:

Since no statute of limitations is provided for civil actions under § 10(b), the law of limitations of the forum state is followed as in other cases of judicially implied remedies. See *Holmberg v. Armbrecht*, 327 U.S. 392, 395 (1946). Although it is not always certain which state statute of limitations should be followed, such statutes of limitations usually are longer than the period provided under § 13 [of the Securities Act of 1933].<sup>79</sup>

Not only did the Court in *Hochfelder* recognize the applicability of the traditional *Holmberg* rule to 10b-5 actions, but that conclusion formed a part of the basis for its ultimate ruling that scienter is an element of the cause of action. The Supreme Court reasoned that Congress enacted particularly short statutes of limitation for the express civil liability provisions

Zuspan, 451 F. Supp. 926 (E.D. Mich. 1978); *Carpenter v. Hall*, 352 F. Supp. 806, 809-10 (S.D. Tex. 1972) (stating that § 27 provides “teeth for enforcement” of federal securities laws.). The policy further is to provide a forum for suits involving multistate frauds no matter how many states defendants are citizens of or may do business in. *Carpenter*, 352 F. Supp. at 809.

75. See Schulman, *supra* note 12, at 648.

76. *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 154 (1987) (quoting *Report of the Ad Hoc Civil RICO Task Force of the ABA Section of Corporation, Banking and Business Law* 391 [hereinafter *ABA Report*] (1985)).

77. 425 U.S. 151 (1976).

78. 459 U.S. 375 (1983).

79. *Ernst & Ernst v. Hochfelder*, 425 U.S. 151, 210 n.10 (1976).

of the 1933<sup>80</sup> and 1934<sup>81</sup> securities acts because those causes of action generally do not require proof of scienter; most are either strict liability or negligence-based statutes rather than fraud causes of action. The Court held that it would be appropriate to impose a scienter requirement in rule 10b-5 actions<sup>82</sup> because the state statutes of limitation applied to 10b-5 actions generally are longer than the rules applicable to the express causes of action in the federal securities acts.<sup>83</sup> Hence, not only has the Supreme Court stated (albeit in a footnote) that the forum state's most analogous limitations period applies in a rule 10b-5 case, the Court's decision in the case rested in part on that assumption.

In *Huddleston* the Supreme Court similarly stated,

[C]ourts [in rule 10b-5 actions] look to the most analogous statute of limitations of the forum state, which is usually longer than the period provided for Section 11 actions.<sup>84</sup>

The Court again relied on the fact that rule 10b-5 limitations periods adopted from the forum states generally are longer than the periods for express civil liabilities under the Securities Act of 1933 (1933 Act) in concluding that rule 10b-5 actions and the express civil liability sections of the 1933 Act are not mutually exclusive. The Court reasoned that because the elements of a rule 10b-5 claim impose a significantly greater burden on the plaintiff than the express civil liability sections, and because the limitations period for rule 10b-5 actions accordingly is longer than for such express provisions, plaintiffs should be permitted to join claims for violation of rule 10b-5 with claims for violations of the 1933 Act.

Thus, twice the Supreme Court has stated that courts should look to the most analogous state limitations period in rule 10b-5 cases. Although neither case turned on the question of the applicability of *Holmberg*, both cases shaped the law of federal securities actions based on the assumption that the limitation period for 10b-5 claims is longer than the one year period contained in the 1933 and 1934 Acts.

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80. See section 13 of the Securities Act of 1933, 15 U.S.C. § 77m (1988).

81. See section 9(e) of the 1934 Act, 15 U.S.C. § 78i(e) (1988); section 16(b), 15 U.S.C. § 78p(b) (1988); section 18(c), 15 U.S.C. § 78r(c) (1988); section 29(b), 15 U.S.C. § 78cc(b) (1988).

82. *Hochfelder*, 425 U.S. at 209-11.

83. *Hochfelder*, 425 U.S. at 210 n.10; *Herman & MacLean v. Huddleston*, 459 U.S. 375, 384 n.18 (1983). As discussed *infra* at notes 138-51 and accompanying text, there are important distinctions in the language used in the various limitations periods applicable to the express civil liability sections of the 1933 and 1934 Acts. Although most of those limitations periods use a one year from discovery rule with some form of three year cap, there are variations in the language used to define "discovery," and in the starting point for the maximum three year period. For ease of reference, all of these express limitations are sometimes referred to in this article as being the one year/three year rule.

84. *Huddleston*, 459 U.S. at 384 n.18.



*B. The Supreme Court's Recent Departure from the Traditional Rule*

Prior to *Holmberg*, courts construed the Rules of Decisions Act as mandating the application of state limitations periods. Subsequent to *Holmberg*, courts generally applied state statutes of limitation, although the rationale supporting the application of state law has been less clear. In a series of cases since the *Hochfelder* and *Huddleston* decisions, the Court further has modified its views regarding the methodology of supplying a limitations period to implied causes of action, but the Court has not yet applied its new method to a rule 10b-5 cause of action.

The Court began its departure from the traditional rule in *DelCostello v. International Brotherhood of Teamsters*.<sup>85</sup> *DelCostello* involved an action on a collective bargaining agreement and allegations that a union breached its duty of fair representation in grievance procedures. In determining what statute of limitations to apply, the Court considered state statutes of limitation for actions to set aside arbitration decisions, state legal malpractice statutes of limitation and the federal statutory limitations period for violations of the National Labor Relations Act.<sup>86</sup>

The Court first stated the general rule of *Holmberg* that where Congress has not provided a statute of limitations, the court should look to state law. After noting that it had always permitted an exception to the traditional rule,<sup>87</sup> the Court in *DelCostello* subtly expanded its view of the circumstances that would justify that exception. Prior to *DelCostello*, the Court rejected state limitations periods in favor of an analogous *federal* limitations period only if the state statute of limitations was "inconsistent" with the federal policies involved.<sup>88</sup> For example, in *Occidental Life Insurance Co. v. EEOC*<sup>89</sup> the EEOC brought a civil action against Occidental Life Insurance alleging violations of the Civil Rights Act of 1964.<sup>90</sup> The EEOC's preliminary investigation of the case, however, had taken three years, and the district court dismissed the case on the basis of the most closely analogous state limitations period, which was one year. The Supreme Court reversed, stating:

[T]he one-year statute of limitations applied by the District Court in this case could under some circumstances *directly conflict* with the timetable for administrative action expressly established in the 1972 Act.

But even in cases involving no inevitable and *direct conflict* with

85. 462 U.S. 151 (1983).

86. Section 10(b) of the National Labor Relations Act, 29 U.S.C. § 160(b) (1988).

87. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 161-62 (citing *Occidental Life Ins. Co. v. EEOC*, 432 U.S. 355 (1977)) (reasoning that adoption of state limitations periods for EEOC enforcement actions under Title VII of Civil Rights Act of 1964 would undermine effective enforcement of Act by placing too onerous burden on agency).

88. *See Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 162 (1987) (Scalia, J., concurring in judgment).

89. 432 U.S. 355 (1977).

90. 42 U.S.C. § 2000e-17 (1976).

the express time periods provided in the Act, absorption of state limitations periods would be inconsistent with the congressional intent underlying the enactment of the 1972 amendments.<sup>91</sup>

The Court in *Occidental* further observed that because “[s]tate legislatures do not devise their limitations periods with national interests in mind,” federal courts should refuse to adopt state limitations rules that would “frustrate or interfere with the implementation of national policies.”<sup>92</sup> Due to the EEOC’s heavy case load and duty to investigate allegations prior to instituting suit, the “vagaries of diverse state limitations statutes”<sup>93</sup> would create an inestimable burden on the EEOC’s efforts to penalize civil rights violations.

The Court’s long-held view that state limitations periods should not be adopted for federal claims if they are inconsistent with, or discriminate against, federal policies would seem to be mandated by the supremacy clause.<sup>94</sup> In *Delcostello*, however, the Court went beyond the requirements of the supremacy clause and allowed an exception to the traditional rule if a federal limitations statute was “more closely analogous” and “more appropriate”<sup>95</sup> than state law alternatives; the Court no longer insisted that the state limitations period be “inconsistent” with the federal policies at stake.<sup>96</sup>

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91. *Occidental Life Ins. Co. v. EEOC*, 432 U.S. 355, 368-69 (1977) (emphasis added); see also *Campbell v. Haverhill*, 155 U.S. 610, 615 (1895) (allowing exception to adoption of state rules for “statutes . . . discriminating against causes of action enforceable only in the federal courts.”) (emphasis added). See generally *Special Project*, *supra* note 22, at 1045-55.

92. *Occidental*, 432 U.S. at 367.

93. *Id.* at 371.

94. U.S. CONST., art. VI, cl. 2. For example, at the time of passage of § 16(b) of the Fair Labor Standards Act, the applicable limitations period borrowed from Alabama state law was either three or six years, depending upon the nature of the employment agreement. But after passage of the Act, Alabama carved out an exception for federal FLSA claims and created for such federal claims a one year limitations period. The Fifth Circuit in *Caldwell v. Alabama Dry Dock & Shipbuilding Co.*, 161 F.2d 83 (5th Cir. 1947), held that the new one year limitations period was too short and discriminated against federal claims, thereby violating the supremacy clause. *Id.* at 85-86; see also, e.g., *Republic Pictures Corp. v. Kappler*, 151 F.2d 543, 546-47 (8th Cir. 1945), *aff’d per curiam*, 327 U.S. 757 (1946).

95. Although these two phrases seem redundant, the Court treats them as separate requirements. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. at 171-72.

96. The Court in *DelCostello* concluded that neither the malpractice statute nor the statute of limitations for actions to vacate arbitration awards was analogous to the actions before it alleging violations of a collective bargaining agreement and breaches of a union’s duty of fair dealing. The Court was concerned that the extremely short time allowed to challenge an arbitration award (30 days in one statute and 90 days in another) could not fairly be applied to a union member challenging the representation given him by his representatives. 462 U.S. at 166. On the other hand, with respect to claims against the union, the three year bar for legal malpractice actions also is not appropriate because of the lack of an analogy. Federal law favors a “relatively rapid final resolution of labor disputes,” a problem not necessarily present when a party to a commercial arbitration sues his lawyer. *Id.* at 168.

Section 10(b) of the National Labor Relations Act, which establishes a six month limitations period, was analogous to the case before the Court, because the NLRA had been designed by

*DelCostello* thus contrasts sharply with the Court's prior decisions permitting courts to abandon state limitation periods *only* when all the state's statutes conflict or are inconsistent with the federal cause of action. Moreover, although paying heed to the Rules of Decisions Act, the Court in fact implicitly rejected its prior decisions relying upon the Rules of Decision Act, referring to the traditional rule as just "a sort of fallback rule of thumb . . . that, absent *some sound reason* to do otherwise, Congress would likely intend that the courts follow their previous practice of borrowing state provisions."<sup>97</sup>

The Court continued its devolution of the traditional rule in *Wilson v. Garcia*.<sup>98</sup> In *Wilson* the Court faced the issue of what limitations period applies to implied causes of action under 42 U.S.C. section 1983, which like rule 10b-5, provides an implied remedy for a broad variety of wrongs. As in rule 10b-5 cases, courts in section 1983 cases traditionally have adopted the state's most closely analogous limitation period.<sup>99</sup> The determination of which of the state's limitations periods should apply generally had been made on a claim-by-claim basis, which would entail a fact-intensive procedure of comparing and analogizing the civil rights claims made to similar violations of state law.<sup>100</sup>

The Court was concerned, however, with the uncertainty and inefficiency of this procedure, which often resulted in application of a different statute of limitations depending upon how the claim was pleaded.<sup>101</sup> Accordingly, the Court held that the determination of which state limitations period to apply should be made on a statute-by-statute basis rather than on a claim-by-claim basis.<sup>102</sup> In other words, in determining which state limitations period to apply, the court should find one limitations period that served the purposes of section 1983, and that limitations period would be applied to all causes of action brought pursuant to section 1983, regardless of how each claim might be characterized.

Although the Supreme Court recognized that efforts to choose the most analogous state limitations period "inevitably breed[] uncertainty and time-consuming litigation,"<sup>103</sup> and that "Congress intended the identification of the appropriate statute of limitations to be an uncomplicated task for

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Congress to accommodate a similar balance of interests between employers, employees, and employee representatives. In fact, "[t]he NLRB has consistently held that all breaches of a union's duty of fair representation are in fact unfair labor practices" under its statutory authority. *Id.* at 170. *DelCostello*, by itself, arguably is a case involving a direct conflict between the available state limitations periods and the federal interests at stake, regardless of what the Court said. The Court, however, has not given such a restrictive view to the decision. See *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 146-47 (1987).

97. *Malley-Duff*, 483 U.S. at 160 n.12 (emphasis added).

98. 471 U.S. 261 (1985).

99. *Wilson v. Garcia*, 471 U.S. 261, 266-67 (1985).

100. *Id.* at 272.

101. *Id.* at 272-75.

102. *Id.* at 275.

103. *Id.* at 272.

judges, lawyers and litigants,"<sup>104</sup> it might be argued that *Garcia* lends further support to the traditional rule. The Court in *Garcia* did not look to federal law to achieve uniformity, but instead was satisfied to avoid much of the collateral litigation connected with choosing a state limitations period by choosing one period on a statute-by-statute basis at the expense of uniformity among states. But because of the the special circumstances of the civil rights acts at issue in that case, the Court may have been required to adopt a state limitations period.<sup>105</sup>

Not long after the *Wilson* decision, the Court in *Agency Holding Corp. v. Malley-Duff & Associates*<sup>106</sup> addressed concerns similar to those involved in the context of rule 10b-5 actions, and moved toward a complete rejection of prior standards. Although the Court in *Malley-Duff* recognized that it had "generally concluded that Congress intended that the courts apply the most closely analogous statute of limitations under state law,"<sup>107</sup> it considerably broadened the scope of available alternatives to include "a timeliness rule drawn from elsewhere in *federal law*,"<sup>108</sup> and held that the goal of uniformity could, by itself, be a sufficient reason to justify a departure from the traditional rule in some circumstances so as to allow adoption of an analogous federal limitations period.

*Malley-Duff* involved the question of what limitations period should apply to civil actions brought pursuant to the Racketeer Influenced and Corrupt Organizations Act (RICO),<sup>109</sup> which includes an express provision for civil liability, but does not contain a limitations period. The Court in *Malley-Duff* again subtly modified its approach to the issue and stated a new formula to follow in approaching the problem. The Court in *Malley-Duff* explained that

[a]lthough it has been suggested that federal courts always should apply the state statute of limitations most analogous to each indi-

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104. *Id.* at 275.

105. 42 U.S.C. § 1988 (1982 & Supp. 1987) states:

The jurisdiction in civil and criminal matters conferred on the district courts by the provisions of this Title . . . for the protection of all persons in the United States in their civil rights, and for their vindication, shall be exercised and enforced in conformity with the laws of the United States, so far as such laws are suitable to carry the same into effect; but in all cases where they are not adapted to the object, or are deficient in the provisions necessary to furnish suitable remedies and punish offenses against law, *the common law, as modified and changed by the constitution and statutes of the State wherein the court having jurisdiction of such civil or criminal cause is held, so far as the same is not inconsistent with the Constitution and laws of the United States, shall be extended to and govern the said courts in the trial and disposition of the cause.* . . .

*Id.* (emphasis added).

106. 483 U.S. 143 (1987).

107. *Agency Holding Corp. v. Malley-Duff & Associates*, 483 U.S. 143, 146 (1987) (quoting *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 158-59).

108. *Id.* at 147 (quoting *DelCostello*, 462 U.S. at 159 n.13) (emphasis added).

109. 18 U.S.C. § 1964 (1988).

vidual case whenever a federal statute is silent on the proper limitations period, a clear majority of the Court [in *DelCostello*] rejected such a single path.<sup>110</sup>

The Court then described its two-step approach in terms again only subtly different from those employed in *DelCostello*, but with very different implications.

The initial inquiry was "whether all claims arising out of the federal statute 'should be characterized in the same way, or whether they should be evaluated differently depending upon the varying factual circumstances and legal theories presented in each individual case.'"<sup>111</sup> That is, should the determination of what limitations period is to be used be made on a claim-by-claim basis, or on a statute-by-statute basis? As did the Supreme Court in *Wilson* with respect to civil rights claims, and the Eleventh Circuit in *Friedlander v. Troutman, Sanders, Lockerman & Ashmore*<sup>112</sup> with respect to rule 10b-5 actions, the Court in *Malley-Duff* ruled that a statute-by-statute determination was appropriate for RICO claims. It is in the next step of the inquiry that the *Malley-Duff* decision departs from prior practice.

The second step of the Court's approach required a court to determine whether to use a federal or a state limitations period.<sup>113</sup> The Court in *Malley-Duff* mentioned the "longstanding practice of borrowing state law and the congressional awareness of this practice,"<sup>114</sup> but asserted that "in some circumstances the Court has found it more appropriate to borrow limitation periods found in other federal, rather than state, statutes."<sup>115</sup>

After noting that federal courts have been inconsistent in their approaches to selecting a limitations period for RICO actions, which caused the current state of the law to be "confused, inconsistent, and unpredictable,"<sup>116</sup> the Court determined that uniformity was such an overwhelming necessity in RICO actions that the Court would look to federal law for a limitations period.<sup>117</sup> The Court then began its quest for a federal limitations period and seized upon the four year statute of the Clayton Act.<sup>118</sup> In a departure from prior cases, the Court did not adopt a uniform state law analogy, as in *Wilson*,<sup>119</sup> nor did it find a federal limitations period that

110. *Malley-Duff*, 483 U.S. at 146 (citations omitted)(emphasis added).

111. *Id.* at 147 (quoting *Wilson*, 471 U.S. at 268).

112. 788 F.2d 1500 (11th Cir. 1986).

113. *Malley-Duff*, 483 U.S. at 147.

114. *Id.*

115. *Id.* at 147-48.

116. *Id.* at 148 (quoting *ABA Report*, *supra* note 76, at 391).

117. *Id.* at 148-50.

118. Clayton Act, ch. 323, § 7, 38 Stat. 730, 731 (1914) (codified as amended at 15 U.S.C. § 15 (1988)).

119. The Court also took note of the fact that an action under § 1983, unlike RICO or 10b-5, "most commonly involves a dispute wholly within one State," *Malley-Duff*, 483 U.S. at 154, and it recognized that the "atrocities" that led Congress to enact 42 U.S.C. § 1983 "plainly sounded in tort." *Id.* at 152 (quoting *Wilson v. Garcia*, 471 U.S. 261, 277).

arguably was *directly* applicable to the cause of action being asserted, as in *DelCostello*,<sup>120</sup> nor did it find that *all* potential state limitations periods were inimical to the policies of RICO. Instead, the Court found it sufficient that “a uniform statute of limitations is necessary to avoid intolerable ‘uncertainty and time-consuming litigation.’”<sup>121</sup> Further, the Court chose a uniform federal, rather than state, statute, *not* because the available state alternatives were *inconsistent* with federal policies, but only because the federal limitations period in the Clayton Act “offers a far closer analogy to RICO.”<sup>122</sup> According to the Court, the practical problems involved made the Clayton Act limitation period “significantly more appropriate” than any state law alternative.<sup>123</sup>

### C. Application of the Recent Supreme Court Decisions to Implied Actions Under the Securities Exchange Act of 1934

Courts have been slow in 10b-5 cases to accept the Supreme Court’s invitation to revisit the propriety of their use of the traditional rule. In *Friedlander v. Troutman, Sanders, Lockerman*,<sup>124</sup> the Eleventh Circuit attempted to add some level of certainty to the process without departing from the precedent of the *Hochfelder* and *Huddleston* footnotes.<sup>125</sup> The court adopted the analysis of the *Wilson* decision and abandoned its prior ad hoc approach in favor of a strict rule favoring adoption of the forum state’s blue sky limitations period regardless of the precise nature of the claim asserted. Although the Eleventh Circuit’s approach, modeled on *Wilson*, lends some certainty to the issue in that circuit by removing the initial inquiry of which state limitations period is most analogous, it does not add uniformity because state blue sky limitation periods across the nation are not uniform. *Friedlander* was decided prior to the Court’s decision in *Malley-Duff*, but the Eleventh Circuit has since reaffirmed its *Friedlander* decision in a panel decision and refused to reconsider its holdings en banc.<sup>126</sup>

The Third Circuit in *In re Data Access Systems Securities Litigation*<sup>127</sup> had the benefit of the *Malley-Duff* decision, but in its haste<sup>128</sup> to adopt a

120. See *Malley-Duff*, 483 U.S. at 167-68 n.4 (Scalia, J., dissenting).

121. *Id.* at 150 (quoting *Wilson*, 471 U.S. at 272).

122. *Id.* at 150.

123. *Id.* at 153.

124. 788 F.2d 1500 (11th Cir. 1986).

125. See *supra* note 42 and accompanying text.

126. *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567, 1570 (11th Cir. 1990), *reh’g denied*, 904 F.2d 712.

127. 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131.

128. The Third Circuit was so anxious to abandon *Holmberg* that it used the recent Supreme Court decisions more as a pretext than as a rationale. The district court certified to the Third Circuit the following question:

For the statute of limitations found in the New Jersey law to apply to plaintiffs’ security claims herein, need plaintiffs’ claims state a viable cause of action under

uniform limitations period, it ignored the Supreme Court's holdings and analysis in *Hochfelder* and *Huddleston*. Prior to *Data Access*, the Third Circuit had criticized the lack of uniformity inherent in the traditional rule in light of the fact that the securities laws were enacted "to fill a void in the common law and to create remedies that would be uniform throughout our nation's commercial universe."<sup>129</sup> The Third Circuit properly recognized that the national scope of securities markets made a uniform statute of limitations not just a tool for judicial efficiency, but a virtual necessity.<sup>130</sup> As was the case in the RICO statute that was the subject of *Mally-Duff*, given the interstate nexus requirement of the 1934 Act which is a jurisdictional prerequisite to a 10b-5 action, the multistate nature of claims under section 10(b) virtually guarantees that "the statute of limitations of several States could govern any given . . . claim"<sup>131</sup> and that the borrowing of state law will result in "complex and expensive litigation over what should be a straightforward matter."<sup>132</sup> The Third Circuit, in *Data Access* therefore concluded:

The necessity for uniform federal remedies . . . would seem to demand recourse to a uniform federal statute of limitations. A broker in New York, an issuer in Delaware, a purchaser in San Francisco, an accountant in New Jersey, and a lawyer in Pennsyl-

said blue sky law?

*Id.* at 1539.

The Third Circuit apparently had wanted to make such a change for some time, and did so in the *Data Access* case even though neither party to the appeal suggested it. In *Roberts v. Magnetic Metals Co.*, 611 F.2d 450, 454 (3d Cir. 1979), for example, the court lamented the fact that it was required to look for an analogous state, rather than federal, limitations period, stating:

Much can be said, perhaps, for a different rule in a different context directing a federal court to statutes of limitations governing analogous federal causes of action. But the rule has been otherwise for many years, and an inferior federal court is not free to change it.

*Id.* Chief Judge Seitz in dissent in *Roberts* further stated,

Thus the policy question is how long a plaintiff should have to file suit once he knows or should know of the wrongful conduct. After the plaintiff has notice, there is a strong federal interest in requiring him to file suit quickly. . . . Were I writing on a clean slate, I would be inclined to adopt that approach [of adopting an analogous federal provision]. The Supreme Court, however, has rarely deviated from the normal rule of looking to state statutes.

*Id.* at 462-63 (Seitz, J., dissenting).

129. *Data Access*, 843 F.2d at 1548-49.

130. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 245-46 (1988); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975). In a typical tender offer involving a public company, for example, virtually all of the transactions in securities will occur in interstate commerce and will involve persons residing all across the country. The same is true of many new issues of securities, whether they involve stocks, bonds, notes, or investment contracts in earthworm farms. See *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979) (investments in earthworm farms solicited by newsletter).

131. *Malley-Duff*, 483 U.S. at 153.

132. *Id.* at 154 (quoting *ABA Report*, *supra* note 76, at 392).

vania should be subject to the same statute of limitations for actions based on section 10(b) or Rule 10b-5. . . . [U]niformity is not to be found in the diverse body of state tort limitations . . . [or in] the plethora of state blue sky laws.<sup>133</sup>

The Third Circuit then did what it apparently had wanted to do for so long: it legislated by judicial fiat a new federal statute of limitations for 10b-5 actions modeled on assorted express civil liability provisions of both the 1933 and 1934 Acts, all of which vary from rule 10b-5 in significant respects. The Third Circuit's limitations period runs one year from constructive discovery of the violation, but no more than three years from the violation, a limitations period with no counterpart in either the 1933 or 1934 Acts. The Third Circuit's self-made limitations period is neither more closely analogous to the policies of rule 10b-5 nor more appropriate than state rules for use in 10b-5 actions. The Third Circuit's attempt to overcome the uniformity hurdle was only partially successful. In this case, partial success was tantamount to complete failure, for the decision resulted in less uniformity and less certainty.

#### 1. The Lack of An Analogy Between the Third Circuit's Rule and 10b-5

The Third Circuit's decision to adopt a version of the various one year/three year limitations periods of the 1933 and 1934 Acts is at odds with the Supreme Court's opinion that 10b-5 limitation periods should be longer than those found in the 1933 and 1934 Acts. In its head-long rush to abandon *Holmberg*, the Third Circuit completely ignored the Supreme Court's language in *Ernst & Ernst v. Hochfelder*<sup>134</sup> and *Herman & MacLean v. Huddleston*<sup>135</sup> when it stated that the Supreme Court "has yet to rule on" the question of what statute of limitation applies to rule 10b-5 actions.<sup>136</sup> More importantly, the court in *Data Access* also disregarded the fact that the Supreme Court's decisions in both *Hochfelder* and *Huddleston* were premised, in part, on the assumption that the limitations period in 10b-5 actions is distinct from the express limitations periods of the 1933 and 1934 Acts, and in particular, that it is longer than the period prescribed in *Data Access*. That assumption was integral to the Court's decision in *Hochfelder* to impose a scienter requirement on rule 10b-5 actions and to its decision in *Huddleston* that such express civil liability sections and rule 10b-5 claims were not mutually exclusive. Clearly, it is inappropriate to divorce the Supreme Court's holdings from their supporting rationales in this manner.

The Third Circuit's new rule also fails to supply a "closer analogy" than state law because it is not an "analogy" at all—it is a new rule created by the court. The Third Circuit purported to adopt the "general one-year-

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133. 843 F.2d at 1549.

134. 425 U.S. 185 (1976).

135. 459 U.S. 375 (1983).

136. *Data Access*, 843 F.2d at 1539.



after-discovery and three-years-after-violation schema"<sup>137</sup> of the 1933 and 1934 Acts; however, close examination of the various express limitations periods in those Acts reveals that no two are identical.

Section 13 of the 1933 Act<sup>138</sup> provides the limitation periods for actions brought under Securities Act sections 11<sup>139</sup> and 12.<sup>140</sup> For actions under section 11, the limitations period is one year from discovery of the true facts, or after discovery should have been made by the exercise of reasonable diligence, but no more than three years after the security was bona fide offered to the public.<sup>141</sup> The limitations period for section 12(1) actions is one year after the "violation," but no more than three years after the security was bona fide offered to the public. The limitations period for section 12(2) actions is one year from discovery of the true facts, or after discovery should have been made by the exercise of reasonable diligence, but no more than three years after the "sale."

The 1934 Act contains statutes of limitation for the express civil causes of action under sections 9,<sup>142</sup> 16,<sup>143</sup> 18,<sup>144</sup> and 29.<sup>145</sup> The limitations period for actions brought under section 9(e) is one year from discovery of the facts constituting the cause of action, but no more than three years after "violation" of the section. A claim under section 16(b) is in the nature of a derivative action on behalf of the issuer, and the outside limit on commencing an action is two years after the insider realized a "short-swing" profit. The limitations period for violations of section 18(c) is one year from discovery of the facts constituting the cause of action, but no more than three years after the "cause of action accrued."<sup>146</sup> The limitation period for a right of rescission under section 29 is one year after discovery

137. *Id.* at 1546.

138. 15 U.S.C. § 77m (1988).

139. 15 U.S.C. § 77k (1988). Section 11 governs civil liabilities for false registration statements.

140. 15 U.S.C. § 77l (1988). Section 12(1) creates a right of action for violations of the registration and prospectus delivery requirements of the 1933 Act, and section 12(2) prohibits the making of misstatements or omissions in a prospectus or oral presentation regarding the sale of securities.

141. There is some difference of opinion of whether the three year period runs from the date the securities were *first* offered to the public, or *last* offered to the public. Compare *Zola v. Gordon*, 685 F. Supp. 354, 360 (S.D.N.Y. 1988) with *In re Bestline Prod. Sec. and Antitrust Litig.*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,070, at 97,751 (S.D. Fla. 1975).

142. 15 U.S.C. § 78i(e) (1988). Section 9(e) prohibits manipulation of securities prices. It is a limited right of action generally available only against brokers or dealers who deal directly with investors.

143. 15 U.S.C. § 78p(b) (1988). Section 16 requires certain listed insiders to report their securities transactions to the SEC and prohibits short swing profits by such insiders.

144. 15 U.S.C. § 78r(a) (1988). Section 18(a) imposes liability for misleading statements in any application, report, or document filed with the SEC.

145. 15 U.S.C. § 78cc(b) (1988). Section 29 deems void any contract made in violation of the 1934 Act and provides a right of rescission of such contracts in certain circumstances.

146. Section 18(c), 15 U.S.C. § 78r(c) (1988).

that the purchase or sale of the security involved a violation of the Act, but no more than three years after the "violation."

The Third Circuit was deceived by the similarities among all these limitation periods and overlooked their significant differences. Only the limitation periods in the 1933 Act begin running from the time "discovery should have been made by the exercise of reasonable diligence. . . ." <sup>147</sup> Presumably, the one year from discovery rules in the 1934 Act start to run not when the plaintiff should reasonably have been placed on inquiry, but only after the plaintiff has *actual notice of facts* that make up the violation. Because the Third Circuit never recognized this distinction, it purported to adopt both types of rules and never clarified whether it would impose a reasonable diligence standard on plaintiffs.

In addition, the three year outside limits of some of the express periods begin to run from the date of "sale," <sup>148</sup> whereas others run from the date of the "violation" <sup>149</sup> or from the "accrual of the claim." <sup>150</sup> The Third Circuit undertook no analysis of these distinctions and simply adopted the rules using the "violation" as the starting point. In 10b-5 litigation, however, the time of the "violation" need not equate with the time of the "sale." For example, in actively traded securities, a corporation may issue a press release containing materially false and misleading representations as to its financial condition. A month or more later, an investor may buy shares of that corporation's stock in reliance on the previously issued press release. Arguably, the "violation" occurred at the time the press release was issued, but the "sale" did not occur for another month, and the investor's cause of action could not have "accrued" until he purchased the stock. <sup>151</sup> The Third Circuit made no effort to clarify which of these various periods it was adopting, nor did it state why it chose a three year period running from the violation rather than the sale.

The differing limitations periods of the 1933 and 1934 Acts also do not furnish a "*closer analogy*" <sup>152</sup> than blue sky laws to implied causes of action under section 10(b) and rule 10b-5 because the blue sky civil liability provisions are modeled on and are practically identical to section 12 of the 1933 Act, but materially different from 10b-5. The federal limitations periods cannot constitute a *closer analogy* than the identical state periods because the underlying causes of action are basically the same.

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147. 15 U.S.C. § 77m (1988).

148. See, e.g., § 13 of the 1933 Act, establishing a limitations period for violations of § 12(2).

149. See, e.g., § 29(b) of the 1934 Act, U.S.C. § 78cc(b) (1988).

150. See § 18(c) of the 1934 Act, 15 U.S.C. § 78r(c) (1988). No guidance is given on whether a cause of action under § 18(c) accrues at the time of the misleading report, or upon actual discovery, or constructive discovery. *But see* *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 526-27 (S.D.N.Y. 1977) (holding that cause of action under § 18(c) "accrues" at time of sale).

151. See *Jacobson*, 445 F. Supp. at 526-27 (holding language in § 18(c) mandates that three year limitations period runs from time of sale).

152. *Malley-Duff*, 483 U.S. at 150.

## 2. The Third Circuit's New Rule is Not "More Appropriate" for 10b-5 Actions

Real world practicalities do not make the Third Circuit's limitations rule "more appropriate" for use in 10b-5 actions than state rules. The usual reason that the Supreme Court has given for rejecting a state limitation period in favor of an analogous federal period is that the state limitation period is too short to achieve the federal policies at stake. For example, in choosing a uniform federal limitations period for civil RICO claims, the Court in *Malley-Duff* stated:

[A]pplication of a uniform federal limitations period avoids the possibility of the application of unduly short state statutes of limitations that would thwart the legislative purpose of creating an effective remedy.<sup>153</sup>

The Third Circuit did the reverse of what the Supreme Court did in *Malley-Duff* and *DelCostello*; it rejected longer state limitations periods in favor of a short federal statute. The one year/three year limitation period created in *Data Access* is too short to effectuate the goals and policies of rule 10b-5.<sup>154</sup> As has been recognized by at least two circuit courts of appeals, the "policies of the federal securities laws are best served by a longer, not a shorter, statute of limitations."<sup>155</sup> The Supreme Court has recognized a "congressional policy embodied in the 1934 Act" of "facilitating rule 10b-5 litigation."<sup>156</sup> Because regulatory agencies are overwhelmed by the amount of corruption in the nation's financial markets, private actions under rule 10b-5 are necessary to aid the SEC's enforcement of the law<sup>157</sup> and such

153. *Malley-Duff*, 483 U.S. at 154; see also, e.g., *DelCostello*, 462 U.S. at 166 ("We conclude that state limitations periods for vacating arbitration awards fail to provide an aggrieved employee with a satisfactory opportunity to vindicate his rights under § 301 and the fair representation doctrine."). See generally *Special Project*, *supra* note 22, at 1045-46.

154. See generally *Legislation Comment*, *supra* note 12 (criticizing adoption of one year/three year limitations period for express civil liability provisions as too short to effectuate policies of rule 10b-5).

155. *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 409 (2d Cir. 1975); *United California Bank v. Salik*, 481 F.2d 1012, 1015 (9th Cir. 1973), *cert. denied*, 414 U.S. 1004.

156. *Basic, Inc. v. Levinson*, 485 U.S. 224, 245 (1988); see also *Pinter v. Dahl*, 486 U.S. 622, 633 (1988) (recognizing "the congressional policy favoring private suits as an important mode of enforcing federal securities statutes").

157. See *Inundated Agency, Busy SEC Must Let Many Cases, Filings Go Uninvestigated*, *Wall St. J.*, Dec. 16, 1985, at 1:

'The SEC is horribly overmatched by the bad guys in the marketplace,' declares Royce Griffin, the president of the North American Securities Administrators Association, a group of state regulators . . .

But concerns about the SEC's workload are growing. A recent report by an American Bar Association task force says the enforcement staff may be too small 'for the commission to effectively discharge its statutory responsibilities.' . . .

Chairman Shad points out that the SEC isn't the sole defense against false or misleading financial statements. If anything is seriously amiss, he contends, 'you

private enforcement is facilitated by longer statutes of limitation.

The short limitations periods in the 1933 and 1934 Acts should be viewed in the context of the lessened burden on the plaintiff in those statutes to establish a cause of action. Sections 11 and 12 of the 1933 Act and section 18 of the 1934 Act are in the nature of strict liability claims. Unlike 10b-5 actions, none of those express remedies requires proof of scienter, reliance, or causation.<sup>158</sup> Those express causes of action place the burden on the defendant to establish a "good faith" defense<sup>159</sup> and the class of potential defendants is more narrowly defined than in 10b-5 actions.<sup>160</sup> Similarly, a violation of section 16(b) of the 1934 Act requires no intent, causation, or reliance, and because potential defendants must report their securities trades to the SEC,<sup>161</sup> discovery of violations usually is a straightforward matter. In contrast, section 10(b) requires proof of some form of scienter,<sup>162</sup>

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can be sure the private bar will be in there with class-action suits.'

*Id.* In testimony before the House Energy and Commerce Committee on July 11, 1988, SEC Chairman Ruder stated the "private rights of action have traditionally served as an important supplement to the Commission's enforcement of the federal securities laws." H. R. REP. NO. 910, 100th Cong., 2d Sess. 26, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6063 [hereinafter HOUSE REPORT].

Even if the budgetary and political restraints on the SEC's active enforcement were lifted, it has no statutory authority to recover complete damages for defrauded investors. *See Dolgow v. Anderson*, 43 F.R.D. 472, 483-84 (E.D.N.Y. 1968).

158. *See, e.g., Currie v. Cayman Resources Corp.*, 835 F.2d 780, 782 (11th Cir. 1988); *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680, 695-97 (5th Cir. 1971); L. LOSS, *FUNDAMENTALS OF SECURITIES LITIGATION* 889-90 (2d ed. 1988). One express cause of action in the 1934 Act, § 9, does appear on its face to require a showing of scienter and causation. Section 9 applies to persons who effect securities transactions, brokers and salesmen. However, the section applies only to a limited class of claims and defendants. *See generally* 5 A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5*, § 3.02[c] (rev. ed. 1990).

159. *See, e.g., §§ 11(b), 12(2) of the 1933 Act and § 18 of the 1934 Act.*

160. The universe of potential § 11 defendants is statutorily limited to persons who sign the registration statement, directors of the issuer at the time the registration statement was filed, underwriters, and "experts," who prepared or certified any part of the registration statement or any report used in connection with the registration. Liability for violations of § 12 of the 1933 Act is limited to "sellers" of the security at issue. *See Pinter v. Dahl*, 486 U.S. 622, 641-47 (1988). Section 18 of the 1934 Act applies only to persons who make (or cause to be made) false filings with the SEC, and § 9(e) concerns only brokers or dealers dealing directly with investors. Rule 10b-5, however, is read expansively, and in addition to covering a much broader range of activities (such as churning and insider trading), it applies to a wider range of potential defendants. Unlike the express civil liability sections, liability under rule 10b-5 can be predicated upon "aiding and abetting," conspiracy, and sometimes agency. *See generally* 5A A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5*, § 40 (rev. ed. 1990).

161. Section 16(a) and (b); 15 U.S.C. § 78p(a) & (b) (1988).

162. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976). According to the weight of authority, recklessness satisfies the scienter requirement. *See, e.g., Nelson v. Serwold*, 576 F.2d 1332, 1336-38 (9th Cir. 1978), *cert. denied*, 439 U.S. 970:

Although the Supreme Court left undecided the question whether recklessness is sufficient to support liability under Rule 10b-5, distinguished jurists have long

reliance,<sup>163</sup> and causation.<sup>164</sup> As the Supreme Court recognized in *Hochfelder* and *Huddleston*, while defendants may be entitled to protection for negligence or strict liability claims<sup>165</sup> after one or three years, it is appropriate to impose a longer period of contingent liability on defendants accused of conduct involving a more culpable mental state, as rule 10b-5 requires.

A person engaged in intentional wrongdoing is in a position to cover up his wrongdoing until the statute runs. In the garden variety "Ponzi scheme,"<sup>166</sup> the malfessor will induce the victim to invest with promises of high returns.<sup>167</sup> The malfessor will create the appearance of generating the promised return through a return of capital received from the original and subsequent investors and misdescribed as profits. Because of the malfessor's ostensible success, victims will invest additional money and will spread the

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considered it so. And since *Ernst & Ernst*, courts have continued to assess Rule 10b-5 liability for reckless behavior.

*Id.* at 1337.

163. See, e.g., *Sharp v. Coopers & Lybrand*, 649 F.2d 175, 186 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); *Wood v. Combustion Eng'g, Inc.*, 643 F.2d 339, 345 n.13 (5th Cir. 1981).

164. See, e.g., *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978); *Titan Group, Inc. v. Faggen*, 513 F.2d 234, 239 (2d Cir. 1975), *cert. denied*, 423 U.S. 840. The element of causation in 10b-5 actions has been described as "a metaphysical concept and its meaning may differ in different contexts and the linkage between causation and result necessary to satisfy the legal concept is not always susceptible of direct proof or mathematical determination." *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 98 (E.D.N.Y. 1969), *aff'd*, 478 F.2d 1281 (2d Cir. 1973).

165. Such as the express private rights of action under the 1933 and 1934 Acts.

166. See *Cunningham v. Brown*, 265 U.S. 1 (1924). In December of 1919, Charles Ponzi, began spreading the false tale that he was engaged in buying international postal coupons in foreign countries and selling them in other countries with a 100% profit, an opportunity allegedly made possible by the excessive differences in the rates of exchange following World War I. He was willing, he said, to give others the opportunity to share this profit with him.

By a written promise to pay each investor \$150 in 90 days for every \$100 loaned, he induced thousands to lend money to him. He stimulated their avidity by paying his 90-day notes in full at the end of 45 days, and by circulating the notice that he would pay any unmatured note presented in less than 45 days at 100% of the loan. He began with \$150 of capital and within eight months he took in \$9,582,000, for which he issued his notes for \$14,374,000. In reality, however, he made no investments of any kind. All of the money used to repay investors came from loans by other investors.

167. Ponzi schemes proliferate across the country, defrauding thousands of investors out of millions of dollars annually. See, e.g., *Thousands Reportedly Hit by Ponzi Schemes—Investors Bilked Out of More Than \$750 Million*, L.A. Times, June 9, 1985, Part V, at 8, col. 1 ("The nation's state securities administrators say they have found a pattern of 30 major known or suspected Ponzi schemes in which tens of thousands of Americans were bilked out of more than \$750 million over the past three years. The North American Securities Administrators Assn. and the Council of Better Business Bureaus said the schemes, based in 14 states, appear to have defrauded investors in all 50 states."); Akst, *How Barry Minkow Fooled the Auditors*, FORBES, Oct. 2, 1989, at 126 (discussing ZZZZ Best Company Ponzi scheme in which Barry Minkow created \$200 million house of cards); Stern & Giltenan, "Norma, Would I Do Anything to Hurt You?", FORBES, June 13, 1988, at 112 (regarding alleged Ponzi schemes of Florida developer).

tale of the malfessor's successes, thereby inducing future victims to provide additional funds for perpetuating the fraud. So long as investors receive their promised return they do not suspect any wrongdoing; to the contrary, they are happy with the "investment." In the classic Ponzi scheme, the malfessor pockets all of the invested funds not used to create the phoney return.<sup>168</sup> With the benefit of a short statute of limitations that begins to run from the date of the violation, or even sale of the security, the malfessor can insulate himself from liability simply by paying the phoney return until the statute expires.

Numerous variations of the scheme exist. For example, the malfessor can make the scheme more sophisticated (and more difficult to detect) by funneling a portion of the investments into actual business operations which create a phoney return by using investor funds to cover losses. This latter type of scheme can be virtually undetectable for an extended period of time because the investor, upon inquiry, can observe an actual, operating business. Without a scrupulous auditor, however, the investor cannot know whether, or to what extent, that business is operating successfully.

A similar situation often occurs in connection with defaulted municipal bond issues, an area of rule 10b-5 securities fraud that may well involve more damages to investors on a national level than any other.<sup>169</sup> Construction

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168. "Ponzi Schemes," and the endless variations on such schemes, are typical scenarios giving rise to 10b-5 claims. *See, e.g.*, Board of Trade v. SEC, 883 F.2d 525 (7th Cir. 1989); Williams v. California First Bank, 859 F.2d 664 (9th Cir. 1988); First Interstate Bank v. Chapman & Cutler, 837 F.2d 775 (7th Cir. 1988); Bosco v. Serhant, 836 F.2d 271 (7th Cir. 1987); SEC v. American Bd. of Trade, Inc., 830 F.2d 431 (2d Cir. 1987); *In re Dennis Greenman Sec. Litig.*, 829 F.2d 1539 (11th Cir. 1987); United States v. Brewer, 807 F.2d 895 (11th Cir. 1987); Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp., 801 F.2d 13 (2d Cir. 1986); Commodity Futures Trading Comm'n v. Chilcott Portfolio Management, Inc., 713 F.2d 1477 (10th Cir. 1983); United States v. Slocum, 695 F.2d 650 (2d Cir. 1982); United States v. Brainard, 690 F.2d 1117 (4th Cir. 1982); Sharp v. Coopers & Lybrand, 649 F.2d 175 (3d Cir. 1981); Rosenberg v. Collins, 624 F.2d 659 (5th Cir. 1980); United States v. Farris, 614 F.2d 634 (9th Cir. 1979); Carpenter v. Harris, Upham & Co., Inc., 594 F.2d 388 (4th Cir. 1979); United States v. Cook, 573 F.2d 281 (5th Cir. 1978); SEC v. Kasser, 548 F.2d 109 (3d Cir. 1977); SEC v. First Sec. Co., 507 F.2d 417 (7th Cir. 1974); United States v. Tellier, 255 F.2d 441 (2d Cir. 1958).

169. As of September 1988, investors held \$720 billion of municipal debt. Securities Exchange Act Release No. 26100, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,326, at 89,443 (Sept. 22, 1988). Household, rather than institutional, investors account for more than a third of municipal debt holdings. *Id.* The SEC, citing the Bond Investors' Association, has estimated that over 300 municipal issuers have defaulted on over \$5 billion in bond indebtedness. *Id.* at 89,446 n.29. During the eleven year period from 1972 through 1983, there were at least 118 defaults, including 82 defaults on private purpose conduit bond issues. *Report of the Securities and Exchange Commission on the Regulation of Municipal Securities*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,325 n. 57 (Sept. 22, 1988). That figure probably is conservative. *See* J. Rediker, *Duties, Responsibilities, Roles and Civil Liability of Counsel, Issuers, Underwriters and Indenture Trustees in Bond Default Situations*, at 11 (presented at the Practicing Law Institute seminar on The Problems of Indenture Trustees and Bondholders 1990: Defaulted Bonds and Bankruptcy, Jan. 1990).

A particularly graphic illustration of the enormity of the problem of fraudulently issued

or acquisition of many facilities has been financed by industrial development bonds, which often are viewed by the average investor as being "safe" investments because they are a species of "municipal" bonds. In reality, such revenue bonds can be more risky than many common stocks because industrial development revenue bonds are not general obligations of any governmental body.<sup>170</sup> The principal and interest on such bonds generally is paid only from the revenue of the financed project, and in a large number of issues which have defaulted in the last decade, there was little viable security for the bondholders other than a mortgage on a facility that was either shut down or operating at a loss. When the proceeds of bond issues are used to finance the construction or renovation of a project, it is common to set up "reserve funds," typically lasting eighteen months or sometimes even longer, to make interest payments during the construction period while the project is unable to generate its own income. Defrauded investors are unlikely to discover that there was any problem at all, much less deliberate fraud, until a scheduled coupon interest payment is missed. Thus, for bond issues with interest payable semiannually (which is customary), the first scheduled interest coupon to go unpaid, if the promoters do not put any money into the till to stave off a default, would be the fourth semiannual payment, due 24 months after closing of the bond issue. If some funds are available from other sources, such as a guarantor, the default might not

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municipal bonds is presented by the recent troubles of the Washington Public Power Supply System bonds, the so-called "WPPSS bonds." In the largest municipal bond default, WPPSS was unable to pay the principal and interest on \$2.25 billion of bonds sold to investors to finance construction of nuclear power facilities. As a part of the financing, certain Washington utilities agreed to finance more than 68% of the costs of the projects, even though those utilities would not own the power plants. Although there were indications that those utilities' agreements might not be binding, bond counsel and others issued unqualified opinions on their legality. After raising the \$2.25 billion estimated to be necessary to build the nuclear reactors, the Washington Supreme Court held that the utilities' agreements were illegal and not binding. See *Chemical Bank v. Public Util. Dist. No. 1*, 471 U.S. 1075 (1985); *Chemical Bank v. Washington Pub. Power Supply Sys.*, 99 Wash.2d 772, 666 P.2d 329 (Wash. 1983), *aff'd on reh'g*, 102 Wash.2d 874, 691 P.2d 524 (Wash. 1984), *cert. denied sub nom.*, *Haberman v. Chemical Bank*, 471 U.S. 1065 (1985). Accordingly, the bondholders were left without the primary security for their investments. See generally *Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,327. The WPPSS case is a prime example not only of the extent of municipal bond fraud in the nation, but also the complexities involved that prevent early detection of fraud.

170. See Securities Exchange Act Release No. 26100, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,326, at 89,443:

Today, however, municipal issues include a greater proportion of revenue bonds that are not backed by the full faith and credit of a governmental entity and which, in many cases, may pose greater credit risks to investors.

*Id.* Although general obligation bonds normally pose fewer risks than revenue bonds because they are backed by the good faith and credit of the governmental issuer, some such issuers' credit is not worth very much. For example, general obligation bonds issued by small, special purpose districts have sometimes defaulted and been the subject of SEC enforcement actions. See *id.* at 89,448 n.41.

occur until three or four years have elapsed. Even after the occurrence of a default, it is generally weeks or months later before the investor learns his coupons have "bounced" and he receives notice of the default.

Moreover, the initial notices of default from a bond indenture trustee do not necessarily put the purchaser on notice that fraud, or anything other than an unforeseen post-closing economic downturn, occurred. Bondholders usually must wait some period of time after the notice of default to learn whether the project will stay open, close, be sold at foreclosure, or be refinanced, and in general, whether they will have a loss on their investment. As a result, more than three years often pass after the date of closing a tax-exempt revenue bond issue before any notice of possible fraud arises.

Thus, in the proliferating area of municipal bond defaults, at least two factors, bondholder reliance on indenture trustees and capitalized interest reserve funds, make a one year/three year limitations rule wholly unworkable and unjust. The use of such reserve funds for "capitalized interest" permits a situation to exist in which the project financed by the bonds may never have been feasible, or it might not even be built or put into operation due to a fraudulent misuse of the bond proceeds, but because there are sufficient reserves from the offering proceeds and perhaps other short-term sources of funds to pay the bondholders' regular interest installments for at least two years, if not more, the bondholders will likely never have a reason to know of the fraud underlying the issuance of their bonds until after the one year/three year statute of limitations has expired. Even after the bondholders learn of a missed interest payment, they may be lulled into inaction by the indenture trustee's efforts to refinance the project, effect a workout, or foreclose on the project and avoid or reduce the bondholders' losses, accompanied by notices listing what is being done on their behalf but containing no hint that any fraud occurred.

An unscrupulous promoter could further obscure his fraud by utilizing a debt service reserve fund in a Ponzi scheme. For example, suppose that a promoter orchestrates the issuance of a series of revenue bond issues with capitalized interest provisions. If the revenues of the projects financed with the bond proceeds are commingled for the purpose of forestalling defaults, many years could pass before investors would have any hint that anything was wrong.<sup>171</sup>

Although Congress did not anticipate in 1934 that section 10(b) would be used as a private cause of action, the legislative history of the 1934 Act nonetheless indicates that the short one year/three year limitations period was deemed appropriate for the express remedies only in view of the comparatively light burdens placed on a plaintiff to establish a cause of

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171. The September 26, 1989, issue of *The Bond Buyer* describes a case in which a developer organized a not-for-profit corporation which was used in connection with \$82 million of revenue bonds sold in twenty-one separate issues over a five year period. Investors alleged that commingled funds from the projects had been used to keep prior projects afloat. So long as the promoter was able to keep doing new deals, bondholders from earlier projects continued to receive payments.



action. In response to criticism that it was "manifestly unfair . . . to limit any damaged party to one year or two years or three years in the bringing of a suit, because it may sometimes take four or five years to discover that a fraud has been committed,"<sup>172</sup> Senator Austin<sup>173</sup> stated:

I inquire of the Senator from Kentucky whether he does not recognize another exceptional circumstance in that the burden of proof is shifted around on the question of knowledge or willfulness in a misrepresentation. The committee have put the burden on the defendant, so that in this case the plaintiff does not have to spend any time going out and seeking his evidence. All he has to prove is the fact of misrepresentation.<sup>174</sup>

Because of these distinctions in the elements of a cause of action between both blue sky laws and the express remedies of the 1933 and 1934 Acts and rule 10b-5, there are innumerable claims that may be asserted under rule 10b-5 that might or might not be allowed under those express remedies. With some exceptions, the express federal remedies and blue sky laws generally do not provide a cause of action to defrauded sellers; they do not afford a cause of action for churning or violations of the "know thy customer" and suitability rules; they do not permit a cause of action directly against broker-dealers or investment advisers who are not "sellers," and there generally is no "aiding and abetting" liability under the blue sky laws or the express rights of action under the 1933 and 1934 Acts.<sup>175</sup> In addition, states that require proof of reliance to support a claim for damages generally have not recognized the "fraud on the market,"<sup>176</sup> or "fraud

172. 78 CONG. REC. 8201 (1934) (Statement of Senator Barkley).

173. Apparently addressing section 12(2) of the Securities Act.

174. 78 CONG. REC. 8201 (1936). Some commentators have suggested that the legislative history of the 1933 and 1934 Acts regarding the applicable statute of limitations for the express civil liability provisions supports the view that Congress "would have imposed a similar policy of repose on an implied action based upon violation of section 10(b) and the rules adopted thereunder." Bloomenthal, *supra* note 12, at 258-62. That contention, however, overlooks Senator Austin's statement. Moreover, it is impossible to determine from the 1934 legislative history what limitation period Congress would have chosen for a 10b-5 action, because it never considered that there might *be* such an implied right of action.

175. See *Woods v. Barnett Bank*, 765 F.2d 1004, 1009 (11th Cir. 1985).

[A] person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party has general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation.

*Id.* (quoting *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975)). Although the Supreme Court has refused to consider the availability of aiding and abetting liability in 10b-5 actions, see, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), the circuit courts agree both that it exists, and that the above-listed elements are appropriate. *Woods*, 765 F.2d at 1009 n.8.

176. The "fraud on the market" doctrine is a method of proving reliance by all investors in a class action context. See generally *Basic, Inc. v. Levinson*, 485 U.S. 224 (1990).

creates the market"<sup>177</sup> doctrines available to establish reliance in rule 10b-5 claims; nor have they generally recognized the *Affiliated Ute Citizens v. United States*<sup>178</sup> or *Mills v. Electric Auto-Lite Co.*<sup>179</sup> presumptions of reliance.<sup>180</sup>

The few cases that have been filed under the express rights of action compared to the large number of 10b-5 actions filed every year highlights this difference in their statutes of limitation. Because of the inordinately short limitation periods for the express provisions, most plaintiffs have been unable to obtain a remedy under such provisions and instead have filed suit only under rule 10b-5, often also depending upon equitable tolling to make their action timely.<sup>181</sup> Such results conflict with the federal policy of encouraging private litigation of rule 10b-5 disputes as an aid to enforcement. It also illustrates the reality that truly duped investors tend to stay duped for a long time, and therefore need more than one or three years to

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177. The "fraud creates the market," or "fraud on the undeveloped market" doctrine is a variation on the doctrine as discussed in *Basic*, 485 U.S. 224, and is used to establish classwide reliance in cases involving new issues of securities or securities for which there is no open and developed market. See, e.g., *Ross v. Bank South*, 885 F.2d 723 (11th Cir. 1989); *T.J. Raney & Sons, Inc. v. Ft. Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983), cert. denied, 465 U.S. 1026 (1984); *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc), cert. denied, 459 U.S. 1102 (1983); *Arthur Young & Co. v. United States Dist. Ct.*, 549 F.2d 686 (9th Cir. 1977), cert. denied, 434 U.S. 829; *Ockerman v. May Zima & Co.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,088, at 91,090 (M.D. Tenn. 1988); *Jackson v. First Fed. Sav.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,123 (E.D. Ark. 1988); *Anderson v. Bank of the South, N.A.*, 118 F.R.D. 147 (M.D. Fla. 1987); *Goldwater v. Alston & Bird*, 664 F. Supp. 403 (S.D. Ill. 1986); *Masri v. Wakefield*, 106 F.R.D. 322, 324-25 (D. Colo. 1984); *Gibb v. Delta Drilling Co.*, 104 F.R.D. 59, 67-69 (N.D. Tex. 1984); *Greenwald v. Integrated Energy, Inc.*, 102 F.R.D. 65, 69-71 (S.D. Tex. 1984); *Rose v. Arkansas Valley Envtl. & Util. Auth.*, 562 F.Supp. 1180 (W.D. Mo. 1983); *Frankel v. Wyllie & Thornhill, Inc.*, 537 F. Supp. 730 (W.D. Va. 1982); *Shores v. Arkansas Valley Envtl. & Util. Auth.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶97,345 (N.D. Ala. 1980).

178. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The Court in *Affiliated Ute* held that it is appropriate to presume investors' reliance when their 10b-5 claims are premised primarily on nondisclosures of material fact. See also, e.g., *Competitive Assocs. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 814 (2d Cir. 1975); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972), cert. denied, 409 U.S. 874; *Clark v. Cameron-Brown Co.*, 72 F.R.D. 48, 58-59 (M.D.N.C. 1976); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,377 (S.D.N.Y. 1975).

179. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970). In *Mills* the Court held that in a tender offer class action reliance could be presumed upon a showing of materiality where the alleged misrepresentations are contained in standardized written misrepresentations. See also, e.g., *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 170 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972), cert. denied, 409 U.S. 874; *Sharp v. Coopers & Lybrand*, 70 F.R.D. 544, 547 (E.D. Pa. 1976), aff'd, 649 F.2d 175 (3d Cir. 1981), cert. denied, 455 U.S. 938 (1982); *Schnorbach v. Fuqua*, 70 F.R.D. 424 (S.D. Ga. 1975); *Dorfman v. First Boston Corp.*, 62 F.R.D. 466, 476-77 (E.D. Pa. 1974).

180. The list of distinctions between rule 10b-5 and the express causes of action of both federal and state securities laws is endless, and is beyond the scope of this article.

181. *Legislation Comment*, supra note 12, at 1166.

comprehend that they are victims, and to go through the processes of investigation and preparation incidental to filing a lawsuit.

Finally, the force of arguments that some amalgamation of the one year/three year periods should govern implied actions has been diminished by congressional silence for the forty-four years since a 10b-5 cause of action was first implied. By the time the Third Circuit in *Data Access* decided that Congress intended forty-four years ago that some version of the one year/three year limitations rule apply to implied actions, all twelve circuits and the Supreme Court already had rejected that approach in favor of adoption of state limitations periods.<sup>182</sup> Congress has legislated against the backdrop of those decisions and, as of the date *Data Access* was decided, had remained silent. Accordingly, in light of the longstanding practice of borrowing state law, it generally should have been assumed "that Congress intends by its silence that [the courts] borrow state law."<sup>183</sup> If Congress had been dissatisfied with the courts' use over the last forty-four years of state limitations periods, it easily could have made the one year/three year period applicable to the implied causes of action. It did not.

Ironically, the Third Circuit's effort to promote uniformity has resulted in even less uniformity and less certainty. Although many courts have welcomed the idea of adopting a uniform federal statute of limitations for rule 10b-5 actions, thus avoiding the inevitable litigation over collateral issues, most, including the Sixth, Ninth, and Eleventh Circuits, have not followed the course taken by the Third Circuit in *In re Data Access*.<sup>184</sup> The Supreme Court for many years has declined the opportunity to attack the problem head on.<sup>185</sup> As a result, rather than promoting uniformity and

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182. See *supra* note 41 and accompanying text (discussing traditional rule adopted by federal courts to apply forum state's limitations period in 10b-5 actions).

183. *Agency Holding Corp. v. Malley-Duff & Assocs., Inc.*, 483 U.S. 143, 147 (1986).

184. See, e.g., *Nesbit v. McNeil*, 896 F.2d 380, 384 (9th Cir. 1990); *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567, 1570 (11th Cir. 1990); *Roney & Co. v. Goren*, 875 F.2d 1218 (6th Cir. 1989); *Durham v. Business Management Assocs.*, 847 F.2d 1505 (11th Cir. 1988); *Pinney v. Edward D. Jones & Co., Inc.*, 718 F. Supp. 1419, 1421 (W.D. Ark. 1989); *In re Atl. Fin. Management, Inc. Sec. Litig.*, 718 F. Supp. 1003, 1009-10 (D. Mass. 1989); *Ecodyne Corp. v. Guthrie N. Am., Inc.*, 716 F. Supp. 1132 (N.D. Ill. 1989) (citing *Suslick v. Rothschild Corp.*, 741 F.2d 1000, 1004 (7th Cir. 1984)); *Huang v. Sentinel Gov't Sec.*, 709 F. Supp. 1290, 1301 n.10 (S.D.N.Y. 1989); *McInnis v. Merrill Lynch, Pierce, Fenner & Smith*, 706 F. Supp. 1355, 1357 n.5 (M.D. Tenn. 1989); *Eickhorst v. American Completion and Dev. Corp.*, 706 F. Supp. 1087 (S.D.N.Y. 1989); *Metropolitan Sec. v. Occidental Petroleum*, 705 F. Supp. 134, 138 (S.D.N.Y. 1989); *In re Professional Fin. Management, Ltd.*, 703 F. Supp. 1388, 1392-93 (D. Minn. 1989); *Schoch v. Dade City Retirement Hous.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,341 (M.D. Fla. 1989); *Marchese v. Nelson*, 700 F. Supp. 522, 524 (D. Utah 1988); *Walker v. Aetna Life Ins. Co.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,955 (E.D. Ill. 1988).

185. The Supreme Court has refused to review the circuits' divergent views of what, if any, statute of limitations should be applied to rule 10b-5 actions. For example, in 1976, the Sixth Circuit applied the forum state's general fraud limitations period, and the Supreme Court denied certiorari. *Nickels v. Koehler Management Corp.*, 541 F.2d 611 (6th Cir. 1976),

certainly, *Data Access* has created new uncertainties as litigants are forced to relitigate what may already have been settled issues in their circuit, and unless the Sixth, Ninth, and Eleventh Circuits do an about-face, a split will remain. Only the Supreme Court can obviate the problem, for if the courts of appeals initiate their own efforts to change the method of borrowing a limitations period for 10b-5 actions that has been used for over forty years, only more confusion and less certainty will result. If district courts try to change the law, there will be a lack of uniformity not only among the circuits, but within them as well.

#### THE INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988

Despite the advantages of a uniform limitations period for 10b-5 actions, *Data Access* has not been followed by most courts because it failed to apply a federal statute which "clearly provides a *closer analogy*" than available state alternatives; nor is its creation of the one year/three year rule "more appropriate" than the period set out in state law. Those requirements may be satisfied, however, by a statute of limitations added to the 1934 Act after the *Data Access* decision by the Insider Trading and Securities Fraud Enforcement Act of 1988.<sup>186</sup> Section 5 of ITSFEA amended the 1934 Act by adding section 20A, a limitations period that expressly is applicable to certain actions brought under the auspices of rule 10b-5.<sup>187</sup> Section 20A of the 1934 Act provides "a federal statute of limitations actually designed to accommodate a balance of interests very similar to that at stake here—a statute that is, in fact, an analogy [to 10b-5] more apt than any of the suggested state-law parallels"<sup>188</sup> because it is consistent with the Supreme Court's pronouncements in *Hochfelder* and *Huddleston*.

Congress enacted ITSFEA in November of 1988 to "augment enforcement of the securities laws, particularly in the area of insider trading. . . ."<sup>189</sup> ITSFEA provides: (1) civil penalties against persons who trade securities while in possession of material, non-public information or who communicate

*cert. denied*, 429 U.S. 1074 (1977). The next year, the Fifth Circuit adopted the forum state's blue sky limitations period, and the Court again refused review. *Nortek, Inc. v. Alexander Grant & Co.*, 532 F.2d 1013 (5th Cir. 1976), *cert. denied*, 429 U.S. 1042 (1977). Most recently, the Court refused to review the *Data Access* opinion, in which the Third Circuit, relying upon the recent line of Supreme Court cases, held that the Court's new way of thinking mandated a change in the law in favor of adoption of an analogous federal limitations period. In re *Data Access Sys. Sec. Litig.*, 843 F.2d 1537 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131.

186. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No 100-704, 102 Stat. 4680 (1988) [hereinafter ITSFEA].

187. ITSFEA § 5, 102 Stat. 4680 (1988) (to be codified at 15 U.S.C. 78t-1).

188. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 169 (1983).

189. HOUSE REPORT, *supra* note 157, at 7; see also Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 157 (1989).

Congress reasoned that rules and regulations governing securities trading by persons in possession of "material nonpublic information" are in the public interest and necessary to protect investors. It found that despite the SEC's enforcement efforts, additional methods to deter and prosecute violations of SEC rules and regulations were appropriate. ITSFEA § 2.

material, non-public information in connection with trades effected on or through the facilities of a national securities exchange;<sup>190</sup> (2) an affirmative statutory requirement for broker-dealers and investment advisors to establish, maintain and enforce written supervisory procedures to prevent the misuse of material, non-public information;<sup>191</sup> (3) a "bounty provision" allowing the SEC to award payments to persons providing information about insider trading violations;<sup>192</sup> (4) increases in criminal penalties;<sup>193</sup> (5) an express cause of action for those who traded the same class of securities "contemporaneously" with, and on the opposite side of the market from, the insider trader;<sup>194</sup> (7) authorization for the SEC to cooperate with foreign governmental authorities in international investigations;<sup>195</sup> and (8) that the SEC must study the adequacy of present securities laws to meet their goal of protecting investors.<sup>196</sup>

The Act contains no definition of "insider trading." In considering the bill, the Committee decided "not to alter the substantive law with respect

190. ITSFEA § 3(a)(2). The Act gives the court discretion to impose penalties of up to three times the profit gained or loss avoided against traders, aiders and abettors and controlling persons. See ITSFEA §§ 3 & 5. Penalties imposed in actions brought by the Commission under ITSFEA are payable to the Treasury of the United States. 1934 Act § 20A(b) (as amended by ITSFEA). In actions brought by contemporaneous traders, the total amount of damages recovered cannot exceed the profit gained or loss avoided in the transactions that are the subject of the violation. 1934 Act § 20A(b) (as amended by ITSFEA). The total amount of damages imposed on any one person in a contemporaneous trader action is diminished by any amounts disgorged in an action brought by the Commission under ITSFEA.

191. ITSFEA § 3(b) (amending § 15 of 1934 Act, 15 U.S.C. § 78o (1988), by adding new subsection (f)).

192. ITSFEA § 3(a) (amending 1934 Act by adding § 21A(e), allowing SEC to pay up to 10% of penalties received from violators to informants).

193. ITSFEA § 4.

194. ITSFEA § 5 (amending 1934 Act by adding § 20A), which states:

Any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, non-public information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

Section 5 also authorizes the Commission to promulgate rules and regulations it considers necessary to further public interests or to protect investors and to bring actions against.

*Id.*; see also ITSFEA § 5 (amending 1934 Act by adding § 20A(a)(1)(A) (authorizing Commission to bring actions) and § 20A(c) (authority to promulgate rules)).

195. ITSFEA §§ 6 & 8.

196. ITSFEA § 7. Congress found that since the last comprehensive review of the federal securities laws, rules, and regulations, the volume and nature of securities transactions and the nature of the securities industry had changed dramatically. ITSFEA § 7(a). The advent of the modern international, institutionalized securities market prompted Congress to direct the Commission to "make a study and investigation of the adequacy of the Federal Securities laws and rules and regulations thereunder for the protection of the public interest and the interests of investors." ITSFEA § 7(b).

to insider trading.”<sup>197</sup> The express private right of action on behalf of contemporaneous traders was designed to codify existing implied private rights of action based on insider trading and to clarify the law regarding the duty of noninsiders by adopting the “misappropriation theory.”<sup>198</sup> The civil liability provisions of the Act are intended to dovetail with existing private implied rights of action. The House Committee that reported on the bill considered a provision that contained an express cause of action for persons other than contemporaneous traders.<sup>199</sup> That provision arose out of a concern about the effects of insider trading on tender offers.<sup>200</sup> The Committee reported the bill to the House without the provision

to avoid creating an express private cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which may have been implied by courts in this area. Rather, the Committee wanted to give the courts leeway to develop such implied private rights of action in an expansive fashion in the future.<sup>201</sup>

The limitations period for contemporaneous trader actions is “5 years after the date of the last transaction that is the subject of the violation.”<sup>202</sup> The statute of limitations in section 20A clearly provides both a “closer analogy” and a “more appropriate” limitations period than is provided by state law or the one year provisions of the federal statutes.

The touchstone of statutory interpretation is, of course, congressional intent. Courts should attempt to determine what limitations period Congress intended to apply to 10b-5 actions.<sup>203</sup> When Congress enacted the one year

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197. HOUSE REPORT, *supra* note 157, at 11. The Report cites *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983), for the proposition that there is no “general duty” to disclose material nonpublic information before trading. The Report goes on to state that “insiders” and others having a relationship to the issuer do have a duty and that, in the view of the Committee, a person who misappropriates nonpublic information from sources other than market participants also has a duty based on the “misappropriation theory.” HOUSE REPORT, *supra* note 157, at 10 (citing *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff’d*, 484 U.S. 19 (1987)). The Act is intended to “overturn court cases which have precluded recovery for plaintiffs where the defendant’s violation is premised upon the misappropriation theory.” *Id.* at 11 (citing *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983)).

While Congress appears to cling to the notion that merely using nonpublic information is not per se “insider trading,” it has not limited the duty to those who have some relationship to the issuer. It has sought to proscribe trading on nonpublic information obtained by “misappropriation” from sources other than market participants. See *Carpenter*, 791 F.2d at 1031; Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984).

198. See generally Aldave, *supra* note 197.

199. See Kaswell, *supra* note 189, at 167-68.

200. *Id.*

201. HOUSE REPORT, *supra* note 157, at 27.

202. 1934 Act § 20A(b)(4) (as amended by ITSFEA).

203. See, e.g., *In re Data Access Sys. Sec. Litig.*, 843 F.2d 1537, 1546-47 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131; *Friedlander v. Troutman, Sanders, Lockerman & Ashmore*, 788 F.2d 1500, 1503 (11th Cir. 1986).

statute of limitations in 1934 for certain strict liability and negligence-based claims, it could not have "intended" for that same limitations period to apply to 10b-5 actions since the implied right of action under section 10(b) did not yet exist; indeed, the legislative history of the 1934 Act does not indicate that Congress even considered the possibility of implied actions under section 10(b).<sup>204</sup> Congress enacted ITSFEA, on the other hand, against the backdrop of numerous judicial decisions construing 10b-5 claims. Its legislative history acknowledges that private 10b-5 claims "have traditionally served as an important supplement to the Commission's enforcement of federal securities laws"<sup>205</sup> and that Congress intended to give the courts leeway to develop such implied private rights of action "in an expansive fashion in the future."<sup>206</sup>

In determining whether Congress "intended" for 10b-5 actions to be governed by the one year statute enacted in 1934 or the five year statute enacted in 1988, Congress' expressed intent to encourage the courts to develop 10b-5 actions in an "expansive fashion in the future," coupled with the fact that 10b-5 actions did not even exist in 1934, would seem dispositive. To the extent the Congress "intended" for either period to control, it could only have intended to apply the five year statute of ITSFEA.

The Committee Report also indicates that the express liability provisions of ITSFEA were designed to work hand-in-hand with implied private causes of action under 10b-5. It contemplates that various private causes of action for injuries caused by insider trading should be implied outside the "contemporaneous trader" situation. As an example of an implied cause of action in the insider trading concept, the Report points to *Anheuser-Busch Companies, Inc. v. Thayer*,<sup>207</sup> in which a tipper disclosed the plaintiff's intent to acquire another corporation, thereby pushing up the price of the stock by insider trading, allegedly increasing the tender offer price by \$80 million. The Report recognized that Anheuser-Busch, the plaintiff in the case, was not a "contemporaneous trader," for whom an express cause of action would have existed under the 1934 Act. It concluded, however, that an implied 10b-5 cause of action should exist on Anheuser-Busch's behalf but wished to clarify in ITSFEA what sorts of insider trading would constitute a violation of rule 10b-5.<sup>208</sup>

The close relationship between express and implied causes of action under section 10(b) of the amended 1934 Act evidences Congress' intent to impose a five year statute of limitations on 10b-5 claims. Congress contemplated that a situation like the one described in the Committee Report would give rise to both implied and express causes of action. The House

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204. See *Data Access*, 843 F.2d at 1547 (citing Note, *Implied Liability Under The Securities Exchange Act*, 61 HARV. L. REV. 858, 861 (1948)); A. BROMBERG, *SECURITIES LAW: FRAUD-SEC RULE 10B-5*, § 2.2(300)-(340)(1968); S. REP. NO. 792, 73rd Cong., 2d Sess. 5-6 (1934).

205. HOUSE REPORT, *supra* note 157, at 26.

206. *Id.* at 27 (emphasis added).

207. No. CA3-85-0794-R (N.D. Texas 1986).

208. HOUSE REPORT, *supra* note 157, at 28.

Committee reporting on the bill went to great lengths to point out that a company in the position of Anheuser-Busch would be entitled to damages in an implied action far in excess of the damages provided under the Act. Presumably, contemporaneous traders would be entitled to damages as well. It is unreasonable to assume that Congress intended two different statutes of limitation to govern an action by two plaintiffs against a single defendant for the same cause of action arising out of the same series of events.

In view of this development, there would seem to be no adequate textual, historical, or policy justification for the Supreme Court to prefer a limitations system enacted by Congress half a century ago, with certain delimited rights of action in mind, over the traditional method of adopting state statutes, or certainly over a limitations period that Congress so recently enacted with full knowledge of the nature of claims under section 10(b). The limitations period in ITSFEA clearly provides a "closer analogy" than available state alternatives or other federal securities law alternatives.

The ITSFEA five year limitations period also supplies a "more appropriate" limitations period for 10b-5 actions than either state law analogies or the one year period applicable to the more restricted express causes of action. The 1934 Act has a broad remedial purpose of affording protection and relief to defrauded investors.<sup>209</sup> That legislative purpose of facilitating an effective remedy for defrauded investors is frustrated by undue litigation on the collateral question of what statute of limitations is most appropriate for the sorts of claims made,<sup>210</sup> and most certainly, by unduly short limitations periods. The purpose of statutes of limitation supposedly is to add certainty, but if litigants must always litigate the issue of what limitations period is most applicable to the claims as they have been pleaded, there is no certainty at all.

Like RICO, which was at issue in *Malley-Duff*, and section 1983, which was at issue in *Wilson v. Garcia*, section 10(b) and rule 10b-5 "encompass numerous and diverse topics and subtopics"<sup>211</sup> and therefore may be analogized to a number of state law claims, including common law fraud, breach of contract, professional malpractice, conversion, breach of fiduciary duty, misappropriation, and violations of blue sky laws and licensing requirements, among others. Under these circumstances, uniform characterization "is required to avoid intolerable 'uncertainty and time-consuming litigation'"<sup>212</sup> inimical to the purposes underlying the federal securities laws.

The Court's reasons in *Malley-Duff* for adopting a federal limitations period for civil RICO claims are enlightening, and should provide needed guidance in this murky area of law. After recognizing the real world inefficiencies caused by the fact that plaintiffs would be denied their remedy

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209. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983).

210. See *Reed v. United Transp. Union*, 488 U.S. 319, 324 (1989).

211. In re *Data Access Sys. Sec. Litig.*, 843 F.2d 1551, 1543 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 131 (1988).

212. *Agency Holding Corp. v. Malley-Duff & Assocs.*, 483 U.S. 143, 150 (1987) (quoting *Wilson v. Garcia*, 471 U.S. 261, 272 (1985)).



if they "wrongly postulate" what limitations period will be applied by some court in the future, and that defendants cannot determine their potential liabilities without "knowing with confidence when their delicts lie in repose,"<sup>213</sup> the Court noted five specific factors making adoption of an analogous federal limitations rule "more appropriate" than state analogies.

First, civil RICO was patterned on the federal Clayton Act and relevant portions of the two acts are virtually identical.<sup>214</sup> Second, both the RICO and Clayton Acts "are designed to remedy economic injury by providing for the recovery of treble damages, costs and attorney's fees."<sup>215</sup> Third, both acts depend upon private enforcement to handle "a serious national problem for which public prosecutorial resources are deemed inadequate."<sup>216</sup> Fourth, both acts address the "same type of injury" in that the plaintiff must be injured in his "business or property."<sup>217</sup> Fifth, the legislative history indicated an intent to pattern RICO on the Clayton Act.<sup>218</sup>

These same factors point to adoption of the five year limitations period of ITSFEA. As with RICO, generally there is no adequate state law analogy to rule 10b-5. As to common law fraud, the Supreme Court has observed that common law fraud doctrines were developed in contexts "light years away from the world of commercial transactions to which Rule 10b-5 is applicable."<sup>219</sup> One of Congress's paramount objectives in enacting section 10(b) was to "rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct."<sup>220</sup> In essence, the 1933 and 1934 Acts together replaced the doctrine of *caveat emptor* with one of "Seller Beware." Thus, "[a]ctions under rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law."<sup>221</sup> Given these recognized differences, common-law fraud fails to provide a close analogy to claims under section 10(b), and the limitations period governing common-law fraud claims therefore reflects only a crude approximation of the appropriate balance of competing interests at stake in a section 10(b) case.

The same can be said for state blue sky limitations periods. For example, section 410(a)(1) of the Uniform Securities Act, which has been adopted in some form by most states, provides an express private right of action similar to section 12(2) of the Securities Act, 15 U.S.C. 771(2).<sup>222</sup> This civil cause

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213. *Id.* at 150.

214. *Id.* at 150-51.

215. *Id.* at 151.

216. *Id.*

217. *Id.*

218. *Id.*

219. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744-45 (1975).

220. *Herman & Mclean v. Huddleston*, 459 U.S. 375, 389 (1983).

221. *Basic, Inc. v. Levinson*, 485 U.S. 224, 245 n.22; see also 5 A. JACOBS, *supra* note 158, § 11.01.

222. See, e.g., *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988).

of action, unlike section 10(b),<sup>223</sup> does not require proof of reliance<sup>224</sup>, causation<sup>225</sup>, or scienter.<sup>226</sup> In addition, like sections 12(2) and 11 of the 1933 Act, the civil cause of action in section 410 of the Uniform Securities Act restricts the range of persons who may be held liable, making it quite dissimilar from section 10(b) and rule 10b-5.

On the other hand, the five year period in ITSFEA would afford the "proper balance"<sup>227</sup> between the legitimate interests of investors and potential defendants and the practicalities of litigation make application of a limitations period drawn from section 20A for implied claims under section 10(b) and rule 10b-5 "more appropriate" than other alternatives. The same considerations that compel uniform characterization of these claims in the first instance negate any reasonable argument that one type of claim under section 10(b) should be governed by the five year period while others should be governed by different periods. In many cases, there may be no difficulty in distinguishing between an insider trading claim and some other types of rule 10b-5 claims. In other cases, however, the parties readily could recast a claim as either one or the other. If one sort of action is governed by section 20A(b)(4)'s limitations period, while another is limited differently, parties will have an incentive to engage in "artful pleading" in the hopes of "persuad[ing] the court that the facts and legal theories of a particular . . . claim" fall under whichever period of limitations is longer.<sup>228</sup>

Five years is not an unreasonable length of time for a potential defendant to wait before knowing that the statute of limitations has run on any potential claims against him.<sup>229</sup> The sale of securities is known to be a highly

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223. Scienter is a requirement of a 10b-5 action based on insider trading. *See, e.g., Dirks v. SEC*, 463 U.S. 646, 663 n.23 (1980).

224. The Draftsmen's Commentary to § 410 of the Uniform Securities Act states:

The "by means of" clause in line 8 is not intended as a requirement that the buyer prove *reliance* on the untrue statement or omission.

*Id.* (emphasis in original); *see also* 12 J. LONG, *supra* note 43, § 1.04[4][b], at 1-17.

225. *E.F. Hutton & Co. v. Rouseff*, 537 So. 2d 978 (Fla. 1989); *Lynch v. Cook*, 196 Cal. Rptr. 544, 148 Cal. App. 3d 1072 (Cal. Ct. App. 1983); *Bradley v. Hullander*, 272 S.C. 6, 249 S.E.2d 486 (1978); *Bowden v. Robinson*, 136 Cal. Rptr. 871, 67 Cal. App. 3d 705 (Cal. Ct. App. 1977); 12 J. LONG, *supra* note 43, § 1.04[4][b], at 1-17.

226. *Rouseff v. Dean, Witter & Co.*, 453 F. Supp. 774, 779 (N.D. Ind. 1978); *Sprangers v. Interactive Technologies, Inc.*, 394 N.W.2d 498, 503 (Minn. Ct. App. 1986); *Kittilson v. Ford*, 93 Wa. 2d 223, 608 P.2d 264 (1980); *Bradley v. Hullander*, 272 S.C. 6, 249 S.E.2d 486 (1978).

227. *DelCostello v. International Bhd. of Teamsters*, 462 U.S. 151, 171 (1983) (quoting *United Parcel Serv., Inc. v. Mitchell*, 451 U.S. 56, 70-71 (1981) (Stewart, J. concurring)).

228. *Owens v. Okure*, 488 U.S. 235, 239 (1989).

229. Section 20A does not state on its face whether the statute is tolled until the plaintiff has constructive notice of the fraud. The Seventh Circuit in *Short v. Belleville Shoe Manufacturing Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,379 (7th Cir. July 30, 1990), opined that the general equitable tolling doctrine will be applicable to the limitations period in § 20A. The tolling issue notwithstanding, equitable estoppel should prevent the defendant from asserting the statute of limitations where the defendant has been guilty of active concealment

regulated industry. Entering into that field carries with it certain risks, and considering the billions of dollars that are invested in the markets each year, it is not unreasonable to require that promoters of securities be held responsible for their misdeeds for a length of time sufficient to allow the injured parties to discover the fraud.

Finally, there should be no concern that a five year limitations period will "open the floodgates" of 10b-5 litigation. Filings of securities fraud class actions have declined sharply over the last decade.<sup>230</sup> Moreover, adoption of ITSFEA's five-year rule would *reduce* much of the burden now placed on federal courts by eliminating collateral litigation on issues of tolling and discovery.

Because ITSFEA was enacted recently, few courts have had the opportunity to address the applicability of its five year limitation period to other 10b-5 causes of action under the 1934 Act. The plaintiffs in *Elysian Federal Savings v. First Interregional Equity*<sup>231</sup> and *Ceres Partners v. GEL Associates*<sup>232</sup> argued that the five year limitations period found in ITSFEA is the most closely analogous limitations period for all 10b-5 actions and urged its adoption as a general limitations period for 10b-5 claims. The SEC also has urged this view in *amicus* briefs filed before the Second Circuit in the appeal of *Ceres* and before the United States Supreme Court in *Lebman v. Aktiebolaget Electrolux*.<sup>233</sup> Though both district courts were unpersuaded by the plaintiff's arguments, the courts' criticisms were less than compelling. Both courts opined that the five year ITSFEA limitations period is not analogous to 10b-5 actions generally because ITSFEA only applies to insider trading. But after rejecting ITSFEA on the grounds that it applies only to certain 10b-5 actions, both courts adopted limitations periods from other express civil liability provisions of the Securities Act of 1933 that apply to even fewer 10b-5 actions.

Most recently, the Seventh Circuit in *Short v. Belleville Shoe Manufacturing Company*<sup>234</sup> adopted the reasoning of *Data Access* and refused to

of the fraud.

In *Katz v. Amos Treat & Co.*, 411 F.2d 1046, 1055 (2d Cir. 1969), for example, the Second Circuit in an opinion by Judge Friendly, a rather prescient observer of the securities laws, held that the three year limitations period of section 13 of the 1933 Act was no bar to a claim for the sale of unregistered securities because during the time before and after the sale, the defendant had been assuring the plaintiff "that the issue was at the SEC." See also, e.g., *Eaton v. Coal Par of West Virginia, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,675 (S.D. Fla. 1984) (section 12(1)); *Dyer v. Eastern Trust & Banking Co.*, 336 F. Supp. 890 (D. Me. 1971) (§ 12(1)). Similarly, Justice Black held in *Glus v. Brooklyn E. Dist. Terminal*, 359 U.S. 231, 232-34 (1959), that the principle that no man should be allowed to take advantage of his own wrong "has frequently been employed to bar inequitable reliance on statutes of limitations." *Id.*

230. Filings of securities fraud class actions have dropped by over 50% since the early 1970s. Whereas 305 such actions were filed in federal courts in 1974, only 118 were filed in 1989. *Class Action Reports*, at 316 (July-August 1989).

231. 713 F. Supp. 737, 742 (D.N.J. 1989).

232. 714 F. Supp. 679, 684 (S.D.N.Y. 1989).

233. 854 F.2d 1319 (1988), *cert. denied*, 109 S. Ct. 3214 (1989).

234. [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,379 (7th Cir. July 30, 1990).

adopt ITSFEA's limitations period for all 10b-5 actions.<sup>235</sup> In an opinion authored by Judge Easterbrook, the *Short* court described the choice between section 13 of the 1933 Act and section 20A of ITSFEA as "difficult."<sup>236</sup> It conceded that ITSFEA represents Congress' "latest thoughts" on the issue of a statute of limitations for securities fraud, but chose section 13: (i) because adopting a rule in accordance with the Third Circuit's *Data Access* opinion would promote uniformity and (ii) because of Judge Easterbrook's view that a five year statute of limitation that allows for tolling is too long. The plaintiff in *Short* intends to petition the Supreme Court for certiorari<sup>237</sup> and given the uncertain state of the law caused by the Third and Seventh Circuit's departure from established practice, the Court should no longer shy from this issue. The Court should grant certiorari.

If the Supreme Court grants certiorari in *Short*, the first of the Seventh Circuit's two grounds for rejecting section 20A's limitations period, conformity with the Third Circuit, should not be a consideration. Uniformity by itself is no substitute for congressional intent. It is anomalous to choose *Data Access* over ITSFEA when *Data Access* preceded Congress' "latest thoughts" on the issue. Moreover, if the Supreme Court adopts the limitations period in section 20A, the Court will do more to promote uniformity than if the Court adopts section 13 of the 1933 Act. The Seventh and Third Circuit's approach creates less uniformity in 10b-5 actions because the one year/three year rule of *Data Access* will govern some 10b-5 claims. On the other hand, the ITSFEA limitations period will govern claims that can be pleaded as insider trading actions. Many "garden variety" 10b-5 claims, including practically all issuer transactions, involve sales by persons who can be described as "insiders," and most, if not all, fraud actions involve contentions that the defendant withheld "material, nonpublic information," *i.e.*, the truth. Accordingly, under the Seventh Circuit's new approach, the longer statute of limitations under ITSFEA will invite plaintiffs' lawyers to cast their claims as ITSFEA claims and thereby create additional uncertainties as to which limitations period to apply.

The second part of the Seventh Circuit's rationale in *Short* represents judicial activism at its most dangerous and egregious. Judge Easterbrook opined that although section 20A may represent Congress's "latest thoughts" on the limitations issue, five years is too long a period to allow defrauded investors because "[p]rudent investors almost always can sniff out fraud (or enough smoke to justify litigation) within three years. Section 13 cuts off only the claims of the most trusting or somnolent. . . ."<sup>238</sup> Judge Easterbrook also stated his preference for a statute of repose rather than

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235. See *Norris v. Wirtz*, 818 F.2d 1329, 1332 (7th Cir. 1987). In *Norris*, a case preceding *Data Access*, Judge Easterbrook decried the longstanding practice of adopting state limitations periods, but was not presented with any authority allowing him to depart from the traditional rule.

236. *Short*, [Current] Fed. Sec. L. Rep. (CCH) at 96,855.

237. Telephone call to plaintiff's counsel, Robert A. Useted, August 14, 1990.

238. *Short*, [Current] Fed. Sec. L. Rep. (CCH) at 96,856.

an ordinary limitations period on the theory that in the absence of a repose, an investor may sell securities and "gamble with other people's money."<sup>239</sup>

Judge Easterbrook's views would be more appropriate in a petition to his elected representatives than in a judicial opinion. The opinion abandons its legitimate intellectual undertaking, an attempt to divine congressional intent, in favor of the imposition of the judges' personal predilections. The Court's contention that ITSFEA allows investors to gamble for five years with others' money is incredible. Does Judge Easterbrook seriously contend that the securities laws now existing in the Seventh Circuit allow investors to gamble even for three years with other people's money? Many, if not most 10b-5 actions are brought to recover damages for the sale of worthless securities. Investors have no motivation to wait to bring suit if they are defrauded. Regardless of the limitations period, plaintiffs in 10b-5 actions do not have an automatic "put" or "call" option—to win their case they must prove *scienter*, something akin to deliberate or severely reckless fraud.

Nor is there any basis for the empirical contention that prudent investors can almost always find fraud in three years. As discussed in considerable detail earlier in this article, malfeasors routinely structure their schemes to return to the investor capital disguised as "profits" in order to lull investors for considerable lengths of time. Indeed, in the *Short* case, the plaintiff pleaded that the defendants' fraud had been purposefully concealed from her through the defendants' deliberate misrepresentations over a course of twelve years.

Even if Judge Easterbrook is correct in his contention that a one year/three year rule only cuts off the claims of "the most trusting," that hardly militates in favor of adoption of such a rule in light of 10b-5's *scienter* requirement. The Seventh Circuit's opinion in *Short* reflects a judicial attitude of "buyer beware," the antiquated view that the 1934 Act was designed to redress. To leave the most trusting and naive without a remedy at the hands of the most unscrupulous and deceitful turns the statute into a mockery of justice. After all, the purpose of the securities acts is to protect investors,<sup>240</sup> and naive investors have always been accorded protection under the statutes.<sup>241</sup>

The *Short* decision merely underscores the need for the United States Supreme Court to decide the issue. Only then can a rule be adopted that will truly promote uniformity among the circuits.

#### CONCLUSION

In determining what limitations period should be applied to implied rights of action under section 10(b) and rule 10b-5, courts should look to

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239. *Id.* at 96,856.

240. *See, e.g.,* *Wilco v. Swann*, 346 U.S. 427, 431 (1953); *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

241. *See, e.g.,* *Norris & Hirschberg v. SEC*, 177 F.2d 228, 233 (2d Cir. 1949); *SEC v. Galaxy Foods, Inc.*, 417 F. Supp. 1225, 1239 (E.D.N.Y. 1976), *aff'd*, 556 F.2d 559 (2d Cir. 1977).

the most analogous period of limitations, regardless of which legislature wrote the statute of limitations. Although the traditional rule of looking to state law to supply a limitations period has in the past added enormous complications to what should be a simple determination, it nonetheless was appropriate to look to state limitations because the federal alternative, the sundry one year/three year federal periods for the express civil liability sections of the 1933 and 1934 Acts, was no more analogous to section 10(b) than similar state laws and did not further the goals and policies of section 10(b) and rule 10b-5. With the enactment of a five year limitations period in connection with the Insider Trading and Securities Fraud Enforcement Act of 1988, there now exists a federal limitations period that is more analogous than any other state or federal period and which reflects Congress' balance of plaintiffs' needs for sufficient time to discover violations of rule 10b-5 with defendants' desire for repose. The Supreme Court now has the flexibility to, and should, adopt this five year limitations period for all rule 10b-5 actions.

