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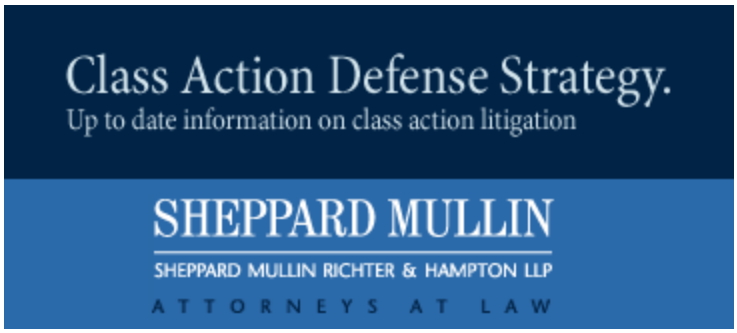

Class Action Defense Strategy

Posted at 11:53 AM on October 2, 2009 by Sheppard Mullin

Federal Circuits Grapple With Standard of Proof and the "Fraud-On-The-Market" Presumption At Class Certification Stage

In recent years, a split among the circuits has developed in federal securities class actions with regard to the procedure and standard of proof required to certify a class. At the class certification stage of the proceedings, district courts are instructed to conduct a "rigorous analysis" of the various requirements set forth in Federal Rule of Civil Procedure 23, while at the same time refrain from deciding issues that go to the substantive merits of the case. This tension, coupled with ambiguity in Circuit-level authority, has created uncertainty among many district courts. Most recently, the United States Court of Appeals for the Sixth Circuit granted interlocutory review in *In re Abercrombie Fitch & Co*., No. 09-0310 (6th Cir. Aug. 24, 2009), to consider this precise issue. The court, in its order granting review, noted that although the Sixth Circuit had yet to address the issue, its sister circuits, including the First, Second, Fourth and Fifth Circuits, have articulated various different standards to be applied.

One essential element of a federal securities fraud claim is the plaintiff's reliance upon the alleged misleading statement or omission. Normally, whether a plaintiff relied upon the alleged misleading statement or omission is an individual question, specific to each plaintiff. To overcome this problem in securities fraud class actions, plaintiffs typically invoke the "fraud-on-the-market" presumption of class-wide reliance upon the alleged misleading statements or omissions at issue in the case. The fraud-on-the-market theory, recognized by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), is based upon the hypothesis that in an open and developed securities market (such as the New York Stock Exchange or NASDAQ), the price of a company's stock will be determined by all material information about the company. Under the theory, because investors are presumed to rely upon the "integrity" of that market price in making their investment decisions, courts may presume for purposes of certifying a class that investors relied upon on public material misrepresentations or omissions.

The fraud-on-the-market presumption is rebuttable. As explained in *Basic*, the presumption can be rebutted by showing, among other things, that the market and investors actually knew the truth and could not have been deceived by the alleged misleading statements or omissions. The

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questions facing the district courts, then, are what showing must a plaintiff make at the class certification stage in order to trigger the fraud-on-the-market presumption of reliance and whether the defendant may present evidence to rebut that showing, even if that evidence also would address an issue that goes to the substantive merits of the case.

Some Circuits have provided guidance to their district courts regarding the standard of proof and appropriate level of merits inquiry at class certification — particularly in securities fraud class actions. For example, the Fourth Circuit held that a district court may not blindly accept a plaintiff's allegations in a class certification complaint because doing so fails to satisfy the court's requirement to take a "close look" into relevant matters and would "automatically lead to a class certification order." *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 259 (4th Cir. 2004). The Second Circuit came to a similar conclusion but articulated a slightly different standard, holding that a district court errs when it applies a "some showing" standard of proof at the class certification level. The court concluded that a district court must receive enough evidence to be satisfied that each element of Rule 23 is satisfied. *In re Initial Public Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006). The Fifth Circuit has gone the furthest. In *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), the court held that a plaintiff must affirmatively establish loss causation — typically adjudicated at summary judgment or at trial — at the class certification stage. The issue remains uncertain in other circuits. The Ninth Circuit, for example, has yet to address these questions since the wave of recent decisions from other Circuits. District courts, therefore, apply older authority to bar rebuttal evidence at the class certification stage and defer the issue until after a class is certified.

This issue is of particular importance in large securities class actions. As the Sixth Circuit recognized when it granted petition for interlocutory review in *Abercrombie & Fitch*, "certification of a class will place significant pressure on [defendants] to settle the case rather than risk the potential of a huge damage award." Looking forward, as the Circuits continue to weigh in with differing decisions, this issue may well merit review by the United States Supreme Court.

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