Supreme Court Holds That 10b-5 Plaintiffs Need Not Prove "Materiality" at Class Certification Stage

On February 27, 2013, the Supreme Court of the United States held that plaintiffs are not required to prove that alleged misrepresentations or omissions are "material" in order to secure class certification in securities litigation. The decision lowers the hurdle for the plaintiffs' bar to certify investor classes, and raises the risk that marginal claims survive. The result is that the *in terrorem* settlement value of securities claims may increase, exposing issuers, corporate officers and directors, and their insurers to additional risk and cost.

Amgen Inc. v. Connecticut Retirement Plans and Trust Funds arose out of a claim by investors that allegedly false statements and omissions by Amgen "artificially inflated" the market price for Amgen's stock, inducing losses for purchasers when the "truth" was revealed. The District Court certified a class of investors even though Amgen presented substantial evidence that the market had been fully alerted to the risks the plaintiffs alleged were undisclosed. According to Amgen, since the market was actually aware of the information the plaintiffs claimed was omitted, any ostensible misstatements could not have affected the stock price. The Ninth Circuit affirmed certification of the class, holding that a class action plaintiff need not *prove* that allegedly false statements or omissions are "material" to justify certification of a class. That decision created a split with the Second Circuit, which had held the opposite – proof of "material" misstatements is a prerequisite to class certification in securities litigation.

In a 6-3 opinion authored by Justice Ginsburg, the Supreme Court resolved the conflict among the circuit courts, and held that proof of materiality is not a prerequisite to class certification. The Court's reasoning turns on its reading of Federal Rule of Civil Procedure 23(b)(3), which requires that "*questions* of law or fact *common* to class members *predominate* over any questions affecting only individual members" in order for plaintiffs to obtain class certification. According to the Court, while a plaintiff must ultimately "prove" a misstatement or omission in order to establish liability, "proof" is not an ingredient of a "question" that is common to class members on the class certification inquiry. Since "materiality" is an essential element of any securities fraud action, the "question" whether an actionable statement is "material" will always be "common" to class members, extinguishing the risk that "individual" questions of materiality will "predominate." Since the class action rule is aimed at efficient resolution of such common "questions," certification of a class cannot be conditioned upon one party's answer to the materiality inquiry. "Proof" of "materiality" is accordingly not a prerequisite to class certification.

In reaching this conclusion, the Court rejected the Second Circuit's view that proof of "materiality" was no different than proof of "market efficiency," which only a year ago the Court held was a condition to class certification in "fraud on the market" cases. Since *Basic v. Levinson* was decided in 1988, class action securities plaintiffs have been able to substitute evidence of an "efficient market" – in which all material information is accurately reflected in market prices – for proof of actual "reliance" on a misstatement. Simply put, if actionable misstatements do not move stock prices in an efficient market, they cannot be "material." On that view, it made no sense to *require* proof of market efficiency in order to invoke the "fraud on the market" doctrine, but *not* require proof that misstatements were "material," thus capable of actually influencing prices in an efficient market.

The Court was not persuaded. According to the Court, questions of "market efficiency" and "materiality" are different in the class certification calculus. Justice Ginsburg reasoned that "materiality" is a question to be resolved in every securities action, and thus always raises "common" issues for every class member. But "market efficiency" is not an indispensable element of a securities fraud claim. It only arises when the plaintiff invokes the "fraud on the market" doctrine to extinguish the obligation to prove individual reliance.

Since "market efficiency" is an essential element of the "fraud on the market" doctrine, it should be proved at class certification when the plaintiff invokes that doctrine. The difference between an issue that is omnipresent and one that is only invoked in certain cases was dispositive on whether the question must be resolved as a condition to class certification.

That reasoning is unsatisfying in the real world because the vast majority of securities actions *are* brought under the "fraud on the market" theory. The Court's distinction accordingly authorizes an anomaly: a plaintiff must prove that the market for an issuer's stock is *capable* of being moved by misstatements but not that allegedly fraudulent statements *actually* moved that market. The result is that any ostensible misstatement for issuers whose capitalization even hints at market efficiency can give rise to class action enforcement – even if the alleged fraud could not have induced an actual investment decision.

The Court also rejected policy arguments – echoed by the U.S. Chamber of Commerce and other industry organizations – that lowering the threshold to class certification will increase settlement pressure and promote more vexatious claims. According to the Court, that was an issue properly addressed to Congress, not the judiciary. Since nothing in the text of the class certification rule limited plaintiffs' permission to pursue such claims, the Court declined to adopt what it termed an "atextual" encumbrance on plaintiffs' power.

The Court's ruling is a setback for efforts to curb abusive class action securities litigation. Without the obligation to prove materiality in order to secure class certification, plaintiffs' lawyers now have a license to litigate marginal disclosure claims so long as they can establish an efficient market for an issuer's stock. Since the "reforms" of the Private Securities Litigation Reform Act have not stanched the flow of class action cases whenever stock prices drop, the Court's ruling may only perpetuate the trend.

If you have any questions or would like to learn more about the issues raised by the Court's decision, please contact your usual Ropes & Gray advisor. For the full text of the Supreme Court's decision in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, please click here.