DechertOnPoint

June 2012 / Special Alert

A legal update from Dechert's Litigation Group

Related Practices

- Appellate
- Complex Commercial Litigation
- White Collar and Securities

Legal Analysis: Anticipating How the U.S. Supreme Court May Rethink Fraud-on-the-Market Standards for Securities Class Actions

Key Points

- The Supreme Court has granted review in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds* to address the findings that a district court must make before certifying that a securities fraud case may proceed as a class action.
- The question presented is whether securities fraud plaintiffs must prove that an alleged misrepresentation or omission is "material" as a predicate to class certification based on the so-called "fraud-on-the-market theory," which is a linchpin of class treatment in most securities fraud cases.
- The Court's decision in *Amgen* has the potential to redraw the important battle lines in private securities litigation, since class certification is often pivotal to the outcome in such lawsuits.
- There is a possibility *Amgen* could have an even more fundamental impact if the Court takes the opportunity to reconsider the validity or appropriate application of the fraud-on-the-market theory.

The Supreme Court in recent Terms has taken up a number of issues relating to class certification, including last year in *Wal-Mart Stores, Inc. v. Dukes*,[1] where the Court confirmed that district courts must conduct a "rigorous analysis" to support each of the findings required for class certification under Rule 23 of the Federal Rules of Civil Procedure. On June 11, 2012, the Court granted certiorari in a securities fraud case, *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*,[2] to address the scope of the findings that must be made under Rule 23 to support invocation of the "fraud-on-the-market theory," a key underpinning for class certification in most private securities fraud suits. The question presented in *Amgen* is whether a district court must find that the alleged misrepresentation or omission is "material" before it may certify a class based on the fraud-on-the-market theory.

Amgen is likely to determine the contours of the class certification battle for the majority of securities fraud lawsuits going forward. If materiality must be found to support class certification, defendants will have a fertile opportunity to defeat class treatment because materiality is often a central issue that can be attacked through sophisticated expert evidence. If not, plaintiffs will have a relatively easy time establishing the prerequisites for fraud-on-the-market theory, and class certification in securities litigation involving widely traded securities will remain routine. The issue is critical for both sides because very few securities class actions ever get to trial and most are settled following certification of the plaintiff class. More broadly, *Amgen* could potentially serve as a vehicle for the Court to rethink the foundation or application of the fraud-on-the-market theory.

[1] 131 S. Ct. 2541 (2011).

[2] 80 U.S.L.W. 3678 (U.S. June 11, 2012) (No. 11-1085).

Dechert LLP

Fraud-on-the-Market Theory

Class treatment is imperative for plaintiffs in most private securities fraud suits because the losses claimed by individual investors are likely to be too small to justify litigation, and the ability to aggregate claims can give the plaintiffs the leverage to force a large settlement. The most common basis for class certification in securities fraud cases is Rule 23(b)(3), which permits class treatment where common questions of law or fact predominate over individualized questions.[3]

Whether a class may be certified under Rule 23(b)(3) depends on whether the plaintiffs can prove the elements of their claim using evidence common to the class. The elements of a private securities fraud claim under section 10(b) of the Securities Exchange Act and SEC Rule 10b-5 are (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the alleged misrepresentation or omission and the purchase or sale of a security; (4) reliance on the misrepresentation or omission by the plaintiffs (also called "transaction causation"); (5) economic loss; and (6) loss causation.[4] Of these elements, the biggest potential hurdle to class certification is reliance or transaction causation, because evidence of whether a given plaintiff purchased or sold the security in actual reliance on the defendant's alleged misrepresentation is inherently unique to each individual plaintiff.

In *Basic Inc. v. Levinson*,[5] however, four Justices of the Supreme Court approved plaintiffs' use of the so-called "fraud-on-the-market theory" to avoid the need for individualized proof of reliance. The fraud-on-the-market theory depends on economic assumptions about the efficiency of securities markets in incorporating material public information about a company's business into the trading price of the company's stock. The theory posits that the effect of any public statement containing a material misrepresentation or omission will be reflected in the trading price of the security, provided the security is traded in an efficient market (usually meaning that the security is widely traded in an open and developed market, as is often the case with an established stock trading in large volume on a public exchange like Nasdaq or the New York Stock Exchange).[6] Any investor who trades in the security in such an efficient market during the relevant period is presumed to do so in reliance on the material misrepresentation or omission.[7]

The four-Justice majority in *Basic* also reasoned that the defendant may rebut the presumption of reliance with "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price."[8] Such rebuttal evidence could include, for example, evidence that market makers or other major participants in the market already knew about the material information, or evidence that the plaintiff investor in fact traded in the security without reliance on the integrity of the trading price — for example, where the plaintiff actually believed that the security was under- or overpriced because of misinformation in the market or where the plaintiff in fact purchased or sold the security for reasons other than its trading price at the relevant point in time.[9]

Recent Cases Addressing Class Certification

In recent years, the Supreme Court has made it clear that district courts may certify a class only if they find, after a rigorous examination, that the plaintiffs have satisfied all of Rule 23's requirements. Most prominently, in *Wal-Mart, Inc. v. Dukes*, the Court held that plaintiffs satisfy the requirement of "commonality" under Rule 23(a)(2)[10] only if they "affirmatively demonstrate" that their claims "depend upon a common contention" that is "capable of classwide resolution."[11] The Court emphasized "that [class]

3 *See* Fed. R. Civ. P. 23(b)(3).

4 *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317 (2011); *see* 15 U.S.C. § 78j(b); 17 CFR § 240.10b-5.

5 485 U.S. 224 (1988).

6 The assumption that a stock listed on a major exchange is trading in an efficient market can be rebutted, however. *See, e.g.*, *In re Fed. Home Loan Mortg. Corp. (Freddie Mac) Sec. Litig.*, Nos. 09 Civ. 832, 09 MD 2072, — F.R.D. —, 2012 WL 1028642 (S.D.N.Y. Mar. 27, 2012).

7 *See Basic*, 485 U.S. at 241-47 (Opinion of Blackmun, J., for four Justices). (Three Justices — Chief Justice Rehnquist and Justices Scalia and Kennedy — did not participate in *Basic v. Levinson*.)

8 *Id.* at 248 (Blackmun, J.).

9 *See id.* at 248-49 (Blackmun, J.); *id.* at 251 (White, J., concurring in part and dissenting in part).

10 *See* Fed. R. Civ. P. 23(a)(2) (providing that a class may be certified "only if . . . there are questions of law or fact common to the class").

11 131 S. Ct. at 2551.

certification is proper only if 'the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied,'" and "[f]requently that 'rigorous analysis' will entail some overlap with the merits of the plaintiff's underlying claim," since "'class determination generally involves considerations that are enmeshed in the factual and legal issues comprising the plaintiff's cause of action.'" [12]

Consistent with *Wal-Mart*, several courts of appeals have held that when deciding whether to certify a class under Rule 23, district courts must make findings by a preponderance of the evidence that each requirement of Rule 23 is met; must resolve all factual or legal disputes relevant to class certification, even if they overlap with the merits of the underlying claim, including the elements of the plaintiffs' cause of action; and must consider expert testimony offered by the party seeking class treatment or the party opposing it. [13] With regard to the fraud-on-the-market theory and Rule 23(b)(3)'s requirement that "questions of law or fact common to class members predominate over any questions affecting only individual members," [14] courts of appeals have ruled that district courts must rigorously examine whether the plaintiffs have proven the facts needed to invoke the presumption of reliance, including, for example, by receiving expert evidence on the efficiency of the market. [15] Courts have also held that the defendant must be allowed to present arguments and evidence to rebut the presumption before the district court may certify a class. [16]

On the other hand, just last Term, in *Erica P. John Fund, Inc. v. Halliburton Co.*, [17] the Supreme Court clarified that the findings required to support application of the fraud-on-the-market theory at the class certification stage do not encompass all elements of the underlying securities fraud claim. While noting that under *Basic v. Levinson*, securities fraud plaintiffs must prove certain facts to justify invoking the presumption of reliance—including that the alleged material misrepresentation was made in a public statement, that the stock was trading in an efficient market, and that the relevant transaction took place between the time the public statement was made and the moment the truth was revealed — the Court held that the plaintiffs need not prove the element of loss causation. [18] The Court reasoned that the issue of reliance "focuse[s] on facts surrounding the investor's decision to engage in the transaction," and that "[u]nder *Basic*'s fraud-on-the-market doctrine, an investor presumptively relies on a defendant's misrepresentation if that 'information is reflected in [the] market price' of the stock at the time of the relevant transaction." [19] In contrast, loss causation (that is, the fact that a misrepresentation affecting the integrity of the market price *also* caused a subsequent economic loss to investors) "addresses a matter different from whether [the] investor relied on a misrepresentation, presumptively or otherwise, when buying or selling [the] stock." [20]

Ninth Circuit Decision in *Amgen*

The issue now before the Supreme Court in the *Amgen* case is whether the element of materiality, like market efficiency, is among the predicates that plaintiffs must prove before a class may be certified based on the fraud-on-the-market presumption of class-wide reliance, or whether, like loss causation, materiality is different from reliance and separate from the economic basis for the fraud-on-the-market theory.

In its decision below, the Ninth Circuit upheld class certification in a securities fraud suit alleging that Amgen, a biotech company, misstated and failed to disclose material safety information about two products for the treatment of anemia. [21] The court ruled that the plaintiffs did not have to prove that the information at issue was material to obtain class treatment for their

12 *Id.* at 2551-52 (quoting *Gen. Tel. Co. of Sw. v. Falcon*, 457 U.S. 147, 160-61 (1982)).

13 *See, e.g.*, *In re Hydrogen-Peroxide Antitrust Litig.*, 552 F.3d 305 (3d Cir. 2008). *See also* Christine C. Levin, Michael I. Frankel & Irene Ayzenberg-Lyman, "How Rigorous is 'Rigorous': A Growing Trend in Favor of Applying *Daubert* at the Class Certification Stage," *Business Torts & RICO News* (Aug. 2010), *available at* http://www.dechert.com/How_Rigorous_is_Rigorous_A_Growing_Trend_in_Favor_of_Applying_Daubert_at_the_Class_Certification_Stage_08-20-2010/.

14 Fed. R. Civ. P. 23(b)(3).

15 *See, e.g.*, *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 633-36 (3d Cir. 2011).

16 *See id.* at 637-38; *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008).

17 131 S. Ct. 2179 (2011).

18 *Id.* at 2185-86.

19 *Id.* at 2186 (quoting *Basic*, 485 U.S. at 247).

20 *Id.*

21 *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170, 1172 (9th Cir. 2011).

claims. The court reasoned that materiality is an element of the merits of a securities claim that should be left for summary judgment or trial, and it would therefore be inappropriate to require proof of materiality under Rule 23.[22] Rather, according to the court, plaintiffs need only allege that the information was material with sufficient plausibility to survive a motion to dismiss under Rule 12(b)(6).[23] In addition, the Ninth Circuit refused to give the defendant any opportunity at the class certification stage to rebut the fraud-on-the-market presumption by showing that the information in question was in fact immaterial.[24]

Implications of the Supreme Court's Grant of Review

There are at least four possible ways the Supreme Court might decide *Amgen*.

The Court might agree with the petitioners that lack of materiality defeats any basis for a fraud-on-the-market presumption. After all, as the Court stated in *Erica P. John Fund*, an investor can only presumptively rely on a statement of fact if the information conveyed in the statement is reflected in the market price of the stock at the time of the relevant transaction,[25] and according to the fraud-on-the-market theory, the only information reflected in the trading price of a security in an efficient market is *material* information. Thus, any failure by the plaintiff to show that the alleged misstatement is material (or a sufficient showing by the defendant that the information at issue is immaterial) ought to negate the presumption of reliance and therefore the basis for class certification under Rule 23(b)(3). The Ninth Circuit's stricture against making any findings under Rule 23 that overlap with the merits of the underlying claim runs contrary to the recent teachings of *Wal-Mart v. Dukes* and similar cases.[26]

If the Supreme Court rules for petitioners and holds that materiality is fair game under Rule 23, defendants in securities fraud suits will have an additional potent line of attack to defeat class treatment. Materiality is often a significant issue of fact and can be susceptible to proof by expert evidence and sophisticated economic analysis. Any significant argument for defeating class certification is important for defendants because the denial of a Rule 23 certification motion is usually the death knell of a securities fraud case.

Second, if, instead, the Court agrees with the Ninth Circuit that materiality need not be found at the class certification stage and need only be plausibly alleged, the range of issues raised by the fraud-on-the-market theory will remain (or in certain circuits will become) relatively narrow. (Notably, the Second Circuit, where a large share of securities fraud cases are filed, has ruled that materiality must be proven at the class certification stage,[27] so a contrary holding from the Supreme Court could appreciably increase the number of securities cases certified as class actions.) In many cases, it is often a straightforward proposition to prove that the stock was trading in an efficient market, that the alleged misstatement in question was public, and that the plaintiffs purchased or sold the stock during the relevant timeframe. An affirmance of the Ninth Circuit will mean that the granting of class certification in securities fraud suits will continue to be the norm, not the exception. And winning class certification is pivotal for plaintiffs because it typically leads in short order to a significant settlement.

Third, the Court could adopt the middle-ground position taken by the Third Circuit that plaintiffs need not prove materiality under Rule 23 but that defendants must be given the opportunity to rebut materiality, including through expert testimony, at the class certification stage.[28] The Court granted certiorari in *Amgen* on this separate question of the defendant's

---

22 *Id.* at 1175.

23 *Id.* at 1177.

24 *Id. But see DVI*, 639 F.3d at 638 ("the lack of market impact may indicate the misstatements were immaterial — a distinct basis for rebuttal" of the presumption of reliance, "thereby defeating the Rule 23(b) predominance requirement").

25 *See* 131 S. Ct. at 2186.

26 The Supreme Court in *Wal-Mart* emphasized that district courts are required to resolve "merits question[s]" bearing on class certification, even if the plaintiffs "will surely have to prove [those issues] *again* at trial in order to make out their case on the merits." 131 S. Ct. at 2552 n.6 (emphasis in original). On June 25, 2012, the Court granted certiorari in yet another case addressing a similar question under Rule 23(b)(3): "Whether a district court may certify a class action without resolving whether the plaintiff class has introduced admissible evidence, including expert testimony, to show that the case is susceptible to awarding damages on a class-wide basis." *Comcast Corp. v. Behrend*, — U.S.L.W. — (U.S. June 25, 2012) (No. 11-864).

27 *See In re Salomon*, 544 F.3d 474.

28 *See DVI*, 639 F.3d at 638.

rebuttal rights, as distinct from the plaintiffs' burden under Rule 23.[29]

The fourth and perhaps most intriguing possibility is that the Court might use this case to reconsider the very validity or utility of the fraud-on-the-market theory. In seeking certiorari, the petitioners in *Amgen* have pointed out that while the Justices in *Basic* relied upon empirical studies supporting the efficient-market hypothesis, more recent studies tend to show that the typical factors used by district courts to identify an efficient market cannot predict with assurance that all public information will be incorporated into a stock's trading price, and other studies indicate that securities markets may be efficient in different ways at different times—incorporating only certain types of information into the stock price, or only information from certain sources, or only when certain conditions are present.[30] The petitioners argue that a rule like the Ninth Circuit's, which avoids any rigorous examination of materiality, "will therefore be inadequate to support a conclusion at class certification that reliance can in fact be proven on a class-wide basis through the fraud-on-the-market theory."[31] Indeed, back in *Basic* itself, Justice White and Justice O'Connor warned that the legal presumption approved by the majority was based on an untested economic theory that the Court was ill-equipped to understand, and they questioned the key assumption that investors ever really rely upon the "integrity" of a stock's trading price.[32]

If the Court in *Amgen* were to entertain a suggestion to reexamine the legal or economic validity of the fraud-on-the-market presumption of reliance, or the circumstances in which the presumption may appropriately apply, this case could well have a sweeping impact on the frequency and viability of securities fraud class actions.

■ ■ ■

This update was authored by Steven G. Bradbury (+1 202 261 3483; steven.bradbury@dechert.com) and Elisa T. Wiygul (+1 215 994 2708; elisa.wiygul@dechert.com).

29 *See* 80 U.S.L.W. 3678 (No. 11-1085).

30 Petition for Writ of Certiorari at 21-22, *Amgen* (No. 11-1085) (citing authorities).

31 *Id.* at 22.

32 *See* 485 U.S. at 252-56 (White, J., joined by O'Connor, J., dissenting in relevant part).

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or the attorney listed.

Steven G. Bradbury
Washington, D.C.
+1 202 261 3483
steven.bradbury@dechert.com

Sign up to receive our other *DechertOnPoints*.