Class Action Defense Strategy Blog

April 14, 2011 by Sheppard Mullin

Third Circuit Follows The Second Circuit Permitting Defendants To Rebut The Fraud-On-The-Market Presumption At The Class Certification Stage

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In *In re DVI Inc. Securities Litigation*, Nos. 08-8033 & 08-8045, 2011 WL 1125926 (3d Cir. Mar. 29, 2011), the United States Court of Appeals for the Third Circuit affirmed an order granting in part a motion under Rule 23 of the Federal Rules of Civil Procedure to certify a class in a securities fraud action. In this decision, the Court made important determinations regarding the application of the fraud-on-market presumption of investor reliance and the role of loss causation at the class certification stage, holding that, in the Third Circuit, a plaintiff need not establish loss causation as a prerequisite to invoking the fraud-on-the-market presumption, but also holding that, once established, the presumption may be rebutted by showing that the misleading statements or corrective disclosures at issue did not affect the market price of the security. This decision is significant because it aligns the Third Circuit with the Second Circuit in allowing a defendant the opportunity to rebut the fraud-on-the-market presumption at the class certification stage.

Investors in Diagnostic Ventures, Inc. ("DVI") brought this securities fraud class action against multiple parties, including DVI's auditor, Deloitte & Touche LLP, and its legal counsel, Clifford Chance LLP, alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240.10b-5. Plaintiffs moved to certify a class under Federal Rule of Civil Procedure 23 on behalf of all DVI investors who purchased securities between August 10, 1999 and August 13, 2003, the period in which the company allegedly made misrepresentations. With respect to Deloitte, plaintiffs alleged that the auditor committed securities fraud by wrongfully issuing unqualified audit reports concerning DVI, hiding DVI's allegedly improper accounting practices, and declining to force the company to disclose allegedly fraudulent acts. With respect to Clifford Chance, plaintiffs alleged that the law firm assisted DVI in an improper scheme via fraudulent financial reports, by conspiring with other defendants to hide material information about DVI's financial condition, and by deflecting inquiries from the SEC.

The United States District Court for the Eastern District of Pennsylvania granted plaintiffs' motion for class certification as to all defendants but Clifford Chance. The district court held that plaintiffs satisfied the predominance requirement in Rule 23(b)(3) with respect to Deloitte by successfully invoking the fraud-on-the-market presumption of investor reliance. The district

court held, however, that plaintiffs were not entitled to the presumption with respect to Clifford Chance because the law firm's alleged fraudulent conduct was not publicly disclosed. Both sides cross-appealed on the issue of whether plaintiffs had established common questions of law or fact under Rule 23(b)(3).

On appeal, Deloitte challenged the district court's application of the fraud-on-the-market presumption and its finding that predominance was satisfied in this case. Deloitte argued that the district court's factual findings on the efficiency of the market for DVI securities was an abuse of discretion and that loss causation must be established as a prerequisite before invoking the presumption of reliance at the class certification stage.

In considering these issues, the Third Circuit recognized that in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the United States Supreme Court established a rebuttablepresumption of investor reliance based upon the fraud-on-the-market theory. The Court reasoned that requiring proof of individualized reliance from each member of a proposed class would effectively prohibit a suit from proceeding as a class action because "individual issues then would . . . overwhelm[] the common ones." The Third Circuit distinguished loss causation from the separate question of investor reliance, noting that loss causation requires a causal connection between an alleged material misrepresentation and a corresponding loss, whereas reliance requires a causal connection between an alleged material misrepresentation and a purchase or sale of a security.

The Third Circuit affirmed. The Court rejected the argument that plaintiffs must establish loss causation as a prerequisite to invoking the fraud-on-the-market presumption of reliance in the first instance, thereby distancing itself from the Fifth Circuit's holding in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,487 F.3d 261 (5th Cir. 2007). Instead, the Court explicitly agreed with the Second Circuit, and its ruling in *In re Salomon Analyst Metromedia Litig.*,544 F.3d 474 (2d Cir. 2008), finding "that a defendant's successful rebuttal demonstrating misleading material statements or corrective disclosures did not affect the market price of the security defeats the presumption of reliance for the entire class, thereby defeating the Rule 23(b) predominance requirement."

The Third Circuit also affirmed the district court's refusal to certify a class with respect to Clifford Chance. Here again, the Third Circuit agreed with the Second Circuit, holding that a plaintiff cannot invoke the fraud-on-the-market presumption of reliance in a private action under Rule 10b-5(a) and (c) unless the deceptive conduct has been publicly disclosed and attributed to the actor. Because plaintiffs did not contend Clifford Chance's alleged role in masterminding the fraudulent 10-Q was disclosed to the public, they could not invoke the presumption. Accordingly, their claim against the law firm could not be certified as a class action because individual issues of reliance predominated.

This decision marks a middle-ground in the Circuit split concerning consideration of "loss causation"-related evidence at the class certification stage. [*See* our prior blog article on this topic here.] On one hand, the Fifth Circuit, under *Oscar*, requires that a plaintiff show price impact as a prerequisite for class certification. On the other end of the spectrum, the Seventh Circuit, in *Schleicher v. Wendt*,618 F.3d 679 (7th Cir. 2010), holds that a plaintiff does not need to show that a misstatement affected the market price before obtaining class certification and

that, in essence, the only relevant fraud-on-the-market element is whether the issuer's stock trades in an efficient market. *In re DVI* falls somewhere in between. On one hand, deciding that loss causation is not a prerequisite to class certification and, on the other, confirming that a defendant may indeed rebut the fraud-on-the-market presumption by showing an absence of price impact. The Supreme Court may soon resolve the split in *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09-1403, a case which addresses similar issues and is set for oral argument on April 25, 2011.