Class Certification Requirements in 10b-5 Cases

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On October 4, 2010, the Supreme Court invited the acting solicitor general to file a brief expressing the views of the United States in *Erica P. John Fund, Inc.* v. *Halliburton Co.*, in which plaintiff seeks certiorari regarding the Fifth Circuit's decision in *Archdiocese of Milwaukee Supporting Fund, Inc.* v. *Halliburton Co.* 597 F.3d 220 (5th Cir. 2010) (AMS Fund). AMS Fund challenged three general kinds of purported misstatements by Halliburton from June 3, 1999 to December 7, 2001. In AMS Fund, the Fifth Circuit confirmed that it requires plaintiffs to establish loss causation, by a preponderance of the evidence, to trigger the fraud-on-the-market presumption. *Id.* at 335. The Fifth Circuit is the lone circuit requiring such affirmative proof by securities fraud plaintiffs at the class certification stage.

The United States' amicus brief described the circuit conflict on the issue as follows: The "Seventh Circuit expressly rejected the Fifth Circuit's requirement that loss causation be proven at the class certification stage," but the Second Circuit allows a defendant to defeat the presumption of reliance by demonstrating that, among other things, the "market price was not affected by the alleged misstatements." Brief for the United States as Amicus Curiae, *Erica P. John Fund, Inc. v. Halliburton Co.*, 09-1403, 2010 WL 2007735, *18–*22 (May 13, 2010). Federal courts fall into three general categories regarding loss causation:

1. Plaintiff's burden to prove loss causation: In the Fifth Circuit, plaintiffs bear the burden during class certification of proving, by a preponderance of the evidence, the element of loss causation. Without such proof, that circuit holds that the "fraud on the market" presumption does not apply and no class may be certified.
2. Defendant may prove absence of loss causation: In the Second Circuit, plaintiffs need not show loss causation to prevail on class certification. However, the court clarified that a defendant may, at this stage, present a rebuttal case on loss causation and prevent class certification if it can show its absence.
3. Loss causation not relevant to class certification: Unlike the Second and Fifth Circuits, the Seventh Circuit and numerous district courts have held that loss causation is not an issue to be determined during class certification.

See Scott B. Schreiber and Robert Alexander Schwartz, "Efficient Markets, Effective Adjudication: Loss Causation and Class Certification in Financial Fraud and Subprime Litigation," Securities Regulation & Law (2009). These three categories represent a sliding scale of requirements imposed by the three circuits that reflect their views of the prudential and equitable concerns invoked by securities fraud class certifications. The question before the Supreme Court is which formulation best protects the appropriate interests of both parties at the certification stage.

Fraud-on-the-Market Theory

At common law, a plaintiff asserting fraud must plead and prove that he relied on the misstatement at issue. In *Basic* v. *Levinson*, 485 U.S. 224 (1988), the Supreme Court explained that in a modern securities market, the market passes information to the investor through the price of the stock. Thus, the court held that plaintiffs may invoke a rebuttable presumption of

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reliance based on the fraud-on-the-market theory, under which the price of a stock in an efficient market reflects "publicly available information." *Id.* at 242–247. A defendant may rebut this presumption of reliance by "[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." *Id.* at 248.

Thus, the lynchpin of class certification in securities fraud cases is whether plaintiffs can invoke the fraud-on-the market theory to show class-wide reliance on the statements at issue. Without being able to do so, plaintiffs could not meet the predominance standard articulated in Federal Rule of Civil Procedure 23(b)(3), requiring that "the questions of law or fact common to class members predominate over any questions affecting only individual members." The split between the circuits concerns how to ensure that the fraud-on-the-market theory is appropriately invoked before certifying a class.

The Circuit Conflict

The Fifth Circuit

The Fifth Circuit uses the element of loss causation as a proxy to examine the factual prerequisites for presuming reliance—market efficiency and materiality. The court first adopted this approach in *Oscar Private Equity Investments* v. *Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), and then expanded upon it in the decision being petitioned for review, AMS Fund.

In *Oscar*, the court reviewed an order certifying a class of all investors who purchased the common stock of Allegiance Telecom during a 10-month period. On the last day of the class period, Allegiance restated its line-count downward by about 10 percent but also disclosed a mix of other non-actionable information. The share price plummeted and within 90 days, Allegiance filed for bankruptcy. *Id.* at 263.

The defendants argued to the district court that in light of the storm of negative information to emerge on the final day of the class period, it would be impossible to assume investors effectively relied on the line-count information because the information had a legally significant impact on share price. The district court reasoned that this argument went to loss causation, which, it held, was not at issue at the class certification stage. *Id.* at 266.

The Fifth Circuit reversed, holding that the burden is on the plaintiff to prove "that the misstatement actually moved the market. . . . Essentially, we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption." *Id.* at 265. Because anything that "severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff" would disqualify plaintiffs from presuming reliance on a class-wide basis, loss causation must be addressed at the certification stage for a court to assure itself that common issues will predominate over individual ones. *Id.* at 265–66 (quoting *Basic*, 485 U.S. at 245).

The Fifth Circuit explained the *in terrorem* power of certification in support of its rule: "The power of the fraud-on-the-market doctrine is on display here. With proof that these securities were being traded in an efficient market, the district court effectively concluded that if plaintiffs can establish at trial that defendants acted with the requisite intent . . . then defendant would be liable for millions of dollars in paper losses . . . ." Moreover, "a district court's certification order

often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it." *Id.* at 266–67.

AMS Fund reinforced the Fifth Circuit's reasoning in *Oscar*, holding that "we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption. And we require this showing by a preponderance of all admissible evidence." 597 F.3d 33, 335 (5th Cir. 2010) (internal quotation marks and citations omitted). The *AMS Fund* court clarified that it looks to loss causation at the corrective disclosure because it necessarily implies that the fraudulent information previously inflated the stock price.

> We must bear in mind that the main concern when addressing the fraud-on-the-market presumption of reliance is whether allegedly false statements actually inflated the company's stock price. By relying on a decline in price following a corrective disclosure as proof of causation, a plaintiff need prove that its loss resulted directly *because* of the correction to a prior misleading statement; otherwise there would be no inference raised that the original, allegedly false statement caused an inflation in the price to begin with.

Id. at 336 (emphasis in original). There the plaintiffs identified three general kinds of purported misstatements by Halliburton from June 3, 1999, to December 7, 2001. The first regarded Halliburton's exposure to asbestos litigation liability and its associated reserves, the second involved the benefit to Halliburton from its merger with Dresser Industries, and the third involved the company's accounting of revenue from cost over-runs on fixed price construction and engineering contracts. As to the first and third categories, the court held that there were no actionable corrective disclosures because the alleged statement that moved the market either had little to do with the purported earlier misstatement alleged or did not "correct" any information in the misstatement alleged. *Id.* at 339–44.

Regarding the second, the corrective disclosure contained "multiple pieces of negative news," and so plaintiffs needed "expert testimony and analytical research or an event study that demonstrates a linkage between the *culpable* disclosure and the stock price movement." *Id.* at 341–42 (emphasis in original). Because plaintiffs' expert failed, in her event study, to isolate the non-actionable negative information from the alleged corrective statement at issue, plaintiffs failed to show loss causation. *Id.* at 342.

The Fifth Circuit has thus articulated its way of ensuring that the fraud-on-the-market theory is correctly applied—and reliance correctly presumed—before unleashing the coercive impact class certification can have on defendants.

The Second Circuit
In *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474, 482 (2d Cir. 2008), the Second Circuit held that proof that the alleged misrepresentation actually "moved the market" is not required at the class certification stage. First, the court explained that when the *Basic* court spoke to "material" misstatements, it did not mean to require a showing of a material effect "on the market price." *Id.* at 482. Rather, the plaintiff must simply show that "the reasonable investor" would have viewed the misinformation as "having significantly altered the total mix of information," proof of which might take many forms. *Id.* at 485.

In clear contrast to the Fifth Circuit's reasoning in *Oscar*, the Second Circuit explained that this less-exacting burden is required by *Basic* to meet the objective of enabling plaintiffs to proceed with otherwise unfeasible cases and to allocate the risk of mistaken adjudication onto the defendant. Nevertheless, the court held that it is proper and consistent with these principles to permit the defendant "to rebut the presumption, prior to class certification, by showing . . . the absence of a price impact." *Id.* at 484. Defendants may do so, for example, by showing "that the market price was not affected by the alleged misstatements, or [that] other statements in the 'sea of voices' of market commentary were responsible for price discrepancies." *Id.* at 485.

The Second Circuit thus places the burden as to loss causation on defendants instead of the plaintiff. In so doing, it shifts the protective calculus of the fraud-on-the-market theory further in the direction of plaintiffs than the Fifth Circuit, but nonetheless allows defendants to prove an absence of loss causation, which would cause class-wide reliance to fall apart.

The Seventh Circuit

In Schleicher v. *Wendt*, 618 F.3d 679, 687 (7th Cir. 2010), the Seventh Circuit went one step further than the Second Circuit and squarely held that "plaintiffs need not establish loss causation before a class can be certified." In *Schleicher*, the Seventh Circuit found that because the market for Conseco's stocks was efficient, "investors therefore can use the fraud-on-the market doctrine as a replacement for person-specific proof of reliance and causation." *Id.* at 682. It summarily dismissed defendants' argument that "a court must determine whether false statements materially affected the price" as a merits question that courts cannot consider at the certification stage. *Id.* at 685.

The Seventh Circuit explained its reasoning as to why loss causation, measured at the time of the corrective disclosure, may not always be used as a proxy for whether the market incorporated the alleged misstatements into the price of the stock:

> Suppose a lie on September 1 increases a stock's price by $1 a share. Market professionals (brokerages, investment banks, and arbitrageurs, among others) regularly conduct their own investigations to discover why a stock's price has moved, net of general market movements. These investigations may turn up the truth. Suppose that by October 1 professional investors had discounted the issuer's statement as probably false. These investors would trade with each other until they were satisfied by the price, which would quickly lose the $1 it gained because of the fraud. If the issuer then formally announced the truth on November 1, the stock's price would not budge. The announcement was no news at all; the truth was reflected in the price by November 1.

Id. at 686-87. The court continued:

> [a]fter a class has been certified and other elements of the claim have been established, the court will need to pin down when the stock's price was affected by any fraud. That decision, like the other issues, can be made on a class-wide basis, because it affects investors in common.

Id. at 687. It concluded that plaintiffs may invoke the fraud-on-the-market theory of reliance as long as the market for the stock is "thick enough to transmit defendants' statements to investors by way of the price" and nothing else. District courts in other circuits have reached similar conclusions. See, e.g., *In re Credit Suisse AOL Sec. Litig.*, 253 F.R.D. 17, 29–30 & n.15 (D. Mass. 2008); *In re Boston Scientific Corp. Sec. Litig.*, 2009 WL 723490, *10 (D. Mass. Mar. 10, 2009); *Connecticut Retirement Plans and Trust Funds* v. *Amgen, Inc.*, 2009 WL 2633743, *12 (C.D. Cal. Aug. 12, 2009).

Thus, while the Seventh Circuit acknowledges that "certification substantially increases the settlement value of a securities suit," it nonetheless grants plaintiffs the boon of presumed reliance without entertaining serious challenges as to whether the market in fact incorporated the alleged misstatement. *Id.* at 682–83.

Conclusion

Plaintiffs will argue that the class action vehicle was intended to enable them to bring meritorious lawsuits that otherwise would not make economic sense by aggregating their claims such that the Seventh Circuit's approach makes equitable sense. But perhaps the very scenario posited by the Seventh Circuit best illustrates wherein the true conflict between the circuits lies. If the price of the stock at issue does not budge on November 1 when the corrective disclosure is made because market professionals guessed at the truth a month earlier, then, according to the Seventh Circuit, those who purchased between September 1 and October 1 may still be injured.

But the fact remains that defendants were forced to defend against those purchasers between October 2 and November 1 who could not have proved reliance on the alleged misinformation and for whom individualized trials on the issue would have to be held. Who should bear the burden for this risk? The Fifth Circuit places this burden on the plaintiffs seeking certification, the Second Circuit on the defendants to a limited extent, and the Seventh Circuit squarely on the defendants. The Supreme Court now has the opportunity to determine which formulation adequately protects the interests of both parties in securities fraud class action litigation.

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