

THE RE-EMERGENCE OF THE RELIANCE REQUIREMENT IN FEDERAL SECURITIES CLASS ACTIONS

It is well-established that plaintiffs bringing private claims alleging violations of Section 10(b) of the Securities Exchange Act of 1934 (the “1934 Act”) and Rule 10b-5 promulgated thereunder must prove that they relied on the statements or omissions they challenge as materially false or misleading.¹ It is equally well-established that in order to maintain a lawsuit on behalf of a class pursuant to Federal Rule of Civil Procedure 23(b)(3), plaintiffs must demonstrate that the common issues to be resolved on behalf of all class members predominate over any individual issues specific to particular class members, rendering class treatment the most efficient means of adjudication.² Taken together, these two requirements would effectively preclude class certification in all but a handful of purported class actions brought on behalf of a large number of purchasers or sellers of a company’s publicly-traded securities; individual issues of reliance would nearly always predominate over any common issues to resolve on behalf of the purported class.

For nearly two decades, plaintiffs who themselves never relied on the statements they challenge as materially false or misleading have been able to maintain class-action lawsuits by invoking the “fraud-on-the-market” doctrine. This doctrine, endorsed by the United States Supreme Court in *Basic, Inc. v. Levinson*,³ creates a rebuttable presumption that plaintiffs who purchased or sold securities on the open market did so in reliance on the integrity of the market price to reflect all available information regarding those securities. Armed with the benefit of this presumption, plaintiffs have been able to overcome the hurdle of demonstrating that common issues predominate over individual ones in actions alleging fraud in connection with publicly-traded securities.

In the last year or so, however, courts have increasingly recognized that the fraud-on-the-market presumption does not automatically apply to all allegations of fraud involving securities. This article discusses several recent cases that evidence a renewed emphasis on requiring plaintiffs who claim to have been deceived to demonstrate that they actually relied, either directly or through the market, on the misrepresentations or omissions forming the basis of their claims.

Overview of the Fraud-on-the-Market Doctrine

In *Basic*, the United States Supreme Court explained the basis for and benefits of a presumption of reliance based on the fraud-on-the-market theory. Recognizing that reliance is an essential element of a Section 10(b) claim, the Court nevertheless reasoned that the modern understanding of that element must evolve in order to reflect the differences between the “modern securities markets, literally involving millions of shares changing hands daily” and “the face-to-face transactions contemplated by early fraud cases.”⁴ In contrast to face-to-face transactions between buyers and sellers, the Court explained, “[w]ith the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.”⁵ In open-market purchases, the market thus “act[s] as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.”⁶ Noting that Congress itself “expressly relied on the premise that securities markets are affected by information, and enacted legislation to

facilitate an investor’s reliance on the integrity of those markets,” and prompted by “considerations of fairness, public policy, and probability, as well as judicial economy,” the Court agreed that “an investor’s reliance on any public material misrepresentations . . . may be presumed” for purposes of a Section 10(b) claim.⁷

However, the Court was careful to note that the presumption that plaintiffs relied on the integrity of the market is not conclusive, and may be rebutted 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.”⁸ Upon such a showing, “the basis for finding that fraud had been transmitted through the market price [is] gone.”⁹

Plaintiffs Bear the Burden of Demonstrating the Propriety of a Presumption of Reliance

Several recent cases have made clear that plaintiffs who allege fraud in connection with the purchase or sale of publicly-traded securities cannot simply invoke the fraud-on-the-market theory as justification for class treatment. Instead, plaintiffs must demonstrate an entitlement to the presumption by showing “(1) that the defendant made *public* misrepresentations; (2) that the misrepresentations were *material*; (3) that the shares were traded on an *efficient market*,” and that the plaintiffs purchased the shares after the misrepresentations but before the truth was revealed.¹⁰

Furthermore, plaintiffs’ bare allegations will not suffice to establish these requirements, even at the class certification stage. Instead, the district court must conduct a “rigorous analysis” and take a “close look” at relevant matters to determine whether plaintiffs

have satisfied the prerequisites to certification.¹¹ As the Fourth Circuit put it:

We must not lose sight of the fact that when a district court considers whether to certify a class action, it performs the public function of determining whether the representative parties should be allowed to prosecute the claims of absent class members. Were the court to defer to the representative parties on this responsibility by merely accepting their assertions, the court would be defaulting on the important responsibility conferred on the courts by Rule 23 of carefully determining the class action issues and supervising the conduct of any class action certified.¹²

The Alleged Misrepresentations Must Be Public

Whether or not phrased as a “rigorous analysis” or a “close look,” recent cases also have made clear that courts will scrutinize plaintiffs’ allegations and evidence before permitting class certification to rest on the fraud-on-the-market doctrine. For example, in *West v. Prudential Securities, Inc.*,¹³ the Seventh Circuit rejected plaintiffs’ bare allegations that the fraud-on-the-market doctrine could apply to non-public statements. Plaintiffs in *West* alleged that a stockbroker working for Prudential told eleven of his customers that a company was “certain” to be acquired, at a big premium, in the near future, and that he reiterated those statements over a seven-month period.¹⁴ Invoking the fraud-on-the-market theory, plaintiffs sought certification of a class of all open-market purchasers of the company’s stock—not the eleven customers to whom the broker allegedly made the statements.¹⁵

The Seventh Circuit reversed the certification order, reasoning that because the statements allegedly made to the eleven customers never became public, there was no basis for a presumption that fraud was transmitted through the market:

[F]ew propositions in economics are better established than the quick adjustment of securities prices to public information. [citation omitted] No similar mechanism explains how prices would respond to non-public information, such as statements made by [a broker] to a handful of his clients. These do not come to the attention of professional investors or money managers, so the price-adjustment mechanism just described does not operate.¹⁶

The Alleged Misrepresentations Must Be Material

Two recent opinions in actions against investment banking firms regarding allegedly false or misleading research reports by analysts suggest that the materiality element of the fraud on the market presumption requires plaintiffs to make a showing the certification stage that the allegedly false statements had a measurable impact on the market price of the securities. For example, the Second Circuit questioned the application of the fraud-on-the-market doctrine to certify a class in an analyst case arising out of the collapse of WorldCom.¹⁷ Among the claims asserted by the plaintiffs in *Hevesi v. Citigroup* was a Rule 10b-5 claim against Citigroup, its investment banking subsidiary, and its former telecommunications research analyst, Jack Grubman, over allegedly false statements in research reports about WorldCom issued by Grubman from 1999 to 2002. The District Court certified the claims against Citigroup and Grubman as a class action, employing the

fraud-on-the-market doctrine to presume reliance and conclude that class issues predominated in the case over individual issues.¹⁸

The Second Circuit exercised its discretion to hear an interlocutory appeal because the case “presented an issue that is ‘of fundamental importance to the development of the law of class actions.’”¹⁹ “That question is whether a district court may certify a class in a suit against a research analyst and his employer based on the fraud-on-the-market doctrine, without a finding that the analyst’s opinions affected the market prices of the relevant securities.”²⁰ In its order accepting jurisdiction over the appeal, the Court noted that the Citigroup defendants had mounted a “substantial legal argument” in support of the position that the fraud-on-the-market doctrine cannot support class certification in analyst cases without a specific finding that the analyst’s report affected the market prices.²¹ Unfortunately for those hoping for definitive pronouncements on *Hevesi*’s “fundamental question” and “substantial legal argument,” the parties in *Hevesi* reached a settlement before the Second Circuit could rule on the merits of the controversy, leaving district courts in the Second Circuit and elsewhere to come to their own conclusions for the time being.

In *DeMarco v. Lehman Brothers Inc.*, Southern District of New York Judge Jed Rakoff agreed with the position advanced by Citigroup in *Hevesi*, holding that the fraud-on-the-market doctrine and the consequent presumption of reliance can justify class certification in an analyst case only if the plaintiff adduces evidence that makes a *prima facie* showing that the analyst’s opinion actually affected the market price of the securities.²² The Court based its decision on the “qualitative difference between a statement of fact emanating from an issuer and a statement of opinion emanating from a research analyst.”²³ As the Court explained:

A well-developed efficient market can reasonably be presumed to translate the former into an effect on price, whereas no such presumption attaches to the latter. This, in turn, is because statements of fact emanating from an issuer are relatively fixed, certain and uncontradicted. Thus, if an issuer says its profits increased 10%, an efficient market, relying on that statement, fixes a price accordingly. If later it is revealed that the previous statement was untrue and that the profits only increased 5%, the market reaction is once again reasonably predictable and ascertainable.

By comparison, a statement of opinion emanating from a research analyst is far more subjective and far less certain, and often appears in tandem with conflicting opinions from other analysts as well as new statements from the issuer. As a result, no automatic impact on the price of a security can be presumed and instead must be proven and measured before the statement can be said to have “defrauded the market” in any material way that is not simply speculative.²⁴

The Court found that the plaintiff had failed to present evidence sufficient to make such a *prima facie* showing and denied class certification.²⁵

The Subject Securities Must Trade on an Efficient Market

Finally, the opinion of the Fourth Circuit in *Gariety* emphasizes that plaintiffs must make at least a *prima facie* showing that the subject securities in fact

traded on an efficient market. *Gariety* arose from the demise in 1999 of the First National Bank of Keystone, whose stock plaintiffs held. As evidence that Keystone’s shares traded on an efficient market, the district court cited a drop in the price of those shares during the days after regulators announced that Keystone was insolvent.²⁶ The Fourth Circuit concluded that this “single piece of information, standing alone, does not represent adequate evidence” of an efficient market.²⁷ Instead, the Court reasoned, a district court faced with a motion to certify a class should “consider factors such as, among others, whether the security is actively traded, the volume of trades, and the extent to which it is followed by market professionals.”²⁸

Judge David Godbey of the U.S. District Court for the Northern District of Texas similarly relied on the absence of an efficient market to deny class certification in *Bell v. Ascendant Solutions, Inc.*²⁹ There, plaintiffs alleged that the defendant and its executives issued false and misleading statements regarding sales, revenues and business model around the time of the company’s public offering, thus artificially inflating its stock price.³⁰ The court held that because plaintiffs failed to establish the efficiency of the market for the company’s stock, plaintiffs would have had “to establish individual reliance for each individual plaintiff—thus foreclosing class certification.”³¹ Because individual reliance could not be presumed, “the Rule 23 requirement of predominance is not established.”³²

Fraud-On-The-Market: What Next?

Courts seem to be suggesting that the fraud-on-the-market doctrine is not a perpetually green light for certification of class actions brought under the securities laws. Recent decisions show that courts are beginning to turn back cases that fail to satisfy the

doctrine’s basic assumptions. Whether these decisions reflect a significant change in direction or a minor detour remains to be seen. Given the myriad securities class actions working their way through the court system in the wake of the post-1999 stock market decline and the corporate scandals brought to light in the early part of this decade, however, continued rapid development of the law in this field over the next few years seems likely.

Footnotes

¹ See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1975).

² See Fed. R. Civ. P. 23(b)(3). Plaintiffs who contend that a defendant’s misrepresentations artificially affected the open market price of a company’s securities typically attempt to certify classes under (b)(3), and not under Rule 23(b)(1) (addressing class certification where adjudication would prejudice rights of absent parties or create the risk of inconsistent adjudications establishing incompatible standards of conduct) or Rule 23(b)(2) (addressing class certification where plaintiffs seek primarily injunctive or declaratory relief).

³ 485 U.S. 224 (1988).

⁴ *Id.* at 243-44.

⁵ *Id.* (quoting *In re LTV Secs. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

⁶ *Id.*

⁷ *Id.* at 245-46.

⁸ *Id.* at 249.

⁹ *Id.*

¹⁰ *Gariety v. Grant Thornton LLP*, 368 F.3d 356, 364 (2004) (emphasis added) (citing *Basic*, 485 U.S. at 248 n.27).

¹¹ *Id.* at 365.

¹² *Id.* at 366-67.

¹³ 282 F.3d 935 (7th Cir. 2002)

¹⁴ *Id.* at 936.

¹⁵ *Id.* at 936-37.

¹⁶ *Id.* at 938; see also *Gariety*, 368 F.3d at 369 (instructing district court on remand to “address more completely whether Grant Thornton made a public misrepresentation for which it may be found primarily liable”).

¹⁷ See *Hevesi v. Citigroup, Inc.*, 366 F.3d 70 (2d Cir. 2004).

¹⁸ See *In re WorldCom, Inc. Sec. Litig.*, 219 F.R.D. 267 (S.D.N.Y. 2003).

¹⁹ *Hevesi*, 366 F.3d at 80 (quoting *In re Sumitomo Copper Litig.*, 262 F.3d 134,

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140 (2d Cir. 2001)).

²⁰ *Id.*

²¹ *Id.* at 79.

²² 222 F.R.D. 243, 247 (S.D.N.Y. 2004).

²³ *Id.*

²⁴ *Id.*

²⁵ *But see* DeMarco v. Robertson Stevens, Inc., Case No. 03 Civ. 590 (GEL), 2005 WL 120233 (S.D.N.Y. Jan.

20, 2005) (declining to require a showing of measurable impact at the class certification stage of another analyst case, but noting that such a showing would be required on the merits to meet the materiality element of the fraud-on-the-market presumption).

²⁶ *See* 368 F.3d at 368.

²⁷ *Id.*

²⁸ *Id.*

²⁹ 2004 U.S. Dist. LEXIS 12321 (N.D. Tex. July 1, 2004).

³⁰ *Id.* at *1.

³¹ *Id.*

³² *Id.*

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