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Third Circuit Rejects The "Fraud-Created-The-Market" Theory Of Reliance In A Section 10(b) Private Securities Fraud Action

In *Malack v. BDO Seidman, LLP*, No. 09-4475, 2010 WL 3211088 (3d Cir. Aug. 16, 2010), the United States Court of Appeals for the Third Circuit declined to recognize a presumption of reliance based upon the so-called "fraud-created-the-market" theory to state a claim under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and, consequently, satisfy the predominance requirement of Federal Rule of Civil Procedure 23(b)(3) for certifying a class. In so holding, the Third Circuit followed the Seventh Circuit and the recent trend of federal courts to narrow and limit Section 10(b) liability to its current contours.

The action centered around plaintiffs-appellants Malack and other investors who purchased notes from American Business Financial Services, Inc. ("American Business"), a subprime mortgage originator, between October 3, 2002, and January 20, 2005. The notes promised to pay interest well above the prime rate without the involvement of underwriters or brokers, were non-transferrable, could only be cashed in after they matured and had no market for resale. The notes were issued pursuant to American Business's 2002 and 2003 registration statements and prospectuses filed with the Securities and Exchange Commission ("SEC"). BDO Seidman, LLP ("BDO") provided the audit opinions necessary to complete the filings with the SEC. The notes later became worthless during the subprime mortgage meltdown.

On February 15, 2008, Malack filed a putative securities fraud class action against BDO, alleging that its audits of American Business were deficient. According to Malack, had BDO done its job properly, it would not have issued American Business clean audit opinions. Malack further alleged that without clean audit opinions, American Business would not have been able to register the notes with the SEC, the notes would not have been marketable and Malack and the other investors would not have purchased the notes. Based upon these allegations, Malack asserted that BDO violated Section 10(b) and Rule 10b-5.

Malack sought class certification. The United States District Court for the Eastern District of Pennsylvania denied class certification because Malack was unable to show that the proposed class was entitled to a presumption of reasonable reliance. Hence, the district court concluded that the proposed class did not satisfy the predominance requirement of Rule 23. Malack appealed. The Third Circuit accepted the appeal, and affirmed.

The Third Circuit examined the elements of Malack's claims "through the prism" of Rule 23 to determine whether the district court properly denied class certification. The Third Circuit noted that plaintiff's reliance one of the six elements to state a Section 10(b) claim. The Third Circuit observed that the element of reliance requires a showing of a causal nexus between the misrepresentation and the plaintiff's injury, as well as a demonstration that the plaintiff exercised the diligence that a reasonable person under all of the circumstances would have exercised to protect his own interests. The Third Circuit noted that the Supreme Court of the United States had previously held that a presumption of reliance exists in two circumstances. The first was set forth in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), where the Supreme Court held that proof of materiality of an omitted fact is sufficient to presume reliance in cases involving primarily a failure to disclose. Second, in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court recognized the fraud-on-the-market theory as a means for establishing a presumption of reasonable reliance where a fraudulent misrepresentation affects the price of a security traded in an efficient market.

In contrast to the two accepted methods by which a plaintiff may establish a presumption of reliance, Malack sought to rely on a third approach, approved only by the Fifth Circuit, the "fraud-created-the-market" theory. *See* *Shores v. Sklar*, 647 F.2d 462, 464 (5th Cir. 1981). The fraud-created-the-market theory posits that the securities laws allow an investor to rely upon the integrity of the market to the extent that the securities it offers to him for purchase are entitled to be in the marketplace. Under this theory, a presumption of reliance is established where a plaintiff proves that the defendants conspired to bring to market securities that were not entitled to be marketed. To be unmarketable, the securities must be "so lacking in basic requirements that [they] would never have been approved by the [issuing entity] nor presented by the underwriters had any one of the participants in the scheme not acted with intent to defraud or in reckless disregard of whether the other defendants were perpetrating a fraud." *Id.* at 468. The fraud-created-the-market theory rests on the conjecture that a "[security's] availability on the market [i]s an indication of [its] apparent genuineness." *Id.* at 470. Malack pointed to "common sense and probability" as support for this conjecture.

The Third Circuit held that neither common sense nor probability bolstered the idea that securities on the market, by the mere virtue of their availability for purchase, are free from fraud. First, the Third Circuit held that "common sense," to the extent Malack invoked it as support, called for rejecting the proposition that a security's availability on the market is an indication of its genuineness and is worthy of an investor's reliance. The Third Circuit noted that for a security's availability on the market to be an indication of its true marketability, there must be some entity involved in the process of taking the security to market that acts as a bulwark against fraud. The Third Circuit continued that the entities most commonly involved in bringing a security to market do not imbue the security with any guarantee against fraud. Furthermore, the Third Circuit held that the SEC likewise cannot be reasonably relied upon to prevent fraud because it does not conduct "merit regulation." Rather, it seeks only to confirm that the issuer adequately disclosedinformation pertaining to the security. Thus, the Third Circuit held that there is no reason to view the notes' presence on the market as being indicative of their merit or genuineness.

Second, the Third Circuit held that Malack's "vague invocation" of probability also failed to lend any support to the assertion that a security's availability on the market is an indication of its genuineness. Unlike the other two accepted theories for establishing presumption of reliance, which were supported by empirical studies and economic theory, the Third Circuit held that the fraud-created-the-market theory had the support of neither. Furthermore, because Malack did not articulate any specific reason why probability supported his view, the Third Circuit declined to "further speculate on the issue."

Additionally, the Third Circuit pointed to other considerations weighing against establishing the fraud-created-the-market theory. First, the theory did not serve the securities laws' goal of informing investors through disclosures from which they can help themselves. In contrast, the fraud-created-the-market theory would "allow monetary recovery for those who refuse to look out for themselves." Second, the Third Circuit cited to Supreme Court decisions and Congressional actions reflecting the recent trend of narrowing and limiting Section 10(b) liability to its present contours, and that any expansion is to be made by Congress, not the courts. Henceforth, endorsement of the fraud-created-the-market theory would extend Section 10(b) liability beyond those contours.

This decision demonstrates the Third Circuit's refusal to endorse the fraud-created-the-market theory as a basis for establishing a presumption of reliance in a private securities fraud action. Furthermore, in holding with the Seventh Circuit, the Third Circuit's decision highlights the federal courts' concerns with the judicial expansion of the Section 10(b) private cause of action beyond its present boundaries. It also reflects the divergence from the Fifth Circuit, creating a circuit-split ripe for review by the United States Supreme Court.

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