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# Third Circuit Rejects A "Fraud Created The Market" Theory for Presumption of Reliance in Federal Securities Fraud Class Actions

In a ruling last week that should help to limit federal securities fraud class actions, the U.S. Court of Appeals for the Third Circuit squarely rejected use of the "fraud created the market" theory to establish presumption of the essential element of reliance in securities fraud claims. *Malack v. BDO Seidman, LLP*, No. 09-4475 (3d Cir. Aug. 16, 2010).

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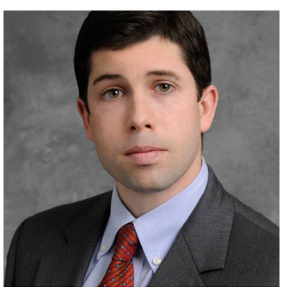

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The Third Circuit's clear and thorough opinion addresses a contentious issue that has long split the federal appellate courts, and sides strongly against expansion of the presumption of reliance in securities fraud cases.

## Background: The "Fraud Created The Market" Presumption

Class actions are the predominate method for public company shareholders to assert securities fraud claims. The often widespread distribution of a public company's stock creates incentives for shareholders to file such actions in circumstances where, without the availability of class-wide relief, claims would not be brought at all.

An important limitation on class actions is that they may only be brought where the claims share a factual basis that is common among members of a putative class. Securities fraud class actions alleging that plaintiffs were harmed by purchasing or selling securities based on misleading information – most often asserted under the general antifraud provision of § 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 promulgated thereunder – generally resort to a "fraud on the market" presumption to demonstrate that all members of the class were similarly harmed by the dissemination of misleading information and thereby establish the essential reliance element of the claim. The "fraud on the market" presumption is based on the efficient market hypothesis, which posits that the price of a security trading in the secondary market (i.e., among public investors) generally reflects information regarding that security (and its issuer) that is available to the marketplace. The "fraud on the market" presumption was endorsed by the U.S. Supreme Court in the seminal decision of *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

Several federal courts have extended this principle further, however, employing a "fraud created the market" theory to establish presumption of reliance. Under this theory, the mere fact that a security is permitted to be publicly-traded is presumed to cause investors to make certain basic assumptions about that security: including, for example, that the security is not patently worthless, that the issuer is legally entitled to sell the security, and that facts justify the securities' initial price and perhaps other economic terms. Under such a theory, where it is alleged that such basic assumptions are false, then a class action may be brought, because all initial purchasers are presumed to be similarly harmed. In particular, the U.S. Courts of Appeals for the Fifth, Tenth and Eleventh Circuits have accepted the "fraud created the market" theory in some form as a means to establish presumption of reliance, while the Seventh Circuit has rejected that theory. Prior to Malack, the Third Circuit had not been called upon to decide the issue.

## The Malack Opinion

*Malack* involved a putative class whose members purchased notes from an issuer that had filed registration statements and prospectuses with the SEC. When the issuer ultimately filed for bankruptcy, the notes were rendered worthless. The *Malack* plaintiffs brought suit for securities fraud under Exchange Act § 10(b) and SEC Rule 10b-5, alleging that audits of the issuer were deficient, and that without clean audit opinions, the notes would never have been registered and issued and plaintiffs would never have purchased the notes and been harmed. The trial court rejected plaintiffs’ resort to the “fraud created the market” theory as the basis to establish presumption of reliance, and declined to certify a class.

On appeal of that ruling, a unanimous three-judge panel of the Third Circuit flatly rejected use of the “fraud created the market” theory, affirming the trial court’s denial of class certification. The Court reasoned that proof that a security is marketable, standing alone, does not suggest anything about the value or quality of the security. The Court noted that “common sense” showed that the issuer and other entities bringing a security to market – including any underwriters, auditors and legal counsel – often have significant incentives to bring the security to market at the highest possible price, regardless of its quality or value. The Court also noted that the SEC neither purports to regulate the merits of any issuance, nor claims to endorse the accuracy of any publicly-filed disclosures. Also, unlike the “fraud on the market” theory, the “fraud created the market” theory was not supported by empirical studies or economic theory, and that the efficient market hypothesis, which is an essential basis for the “fraud on the market theory,” does not suggest that the market for newly issued securities (a primary market) is “efficient.” Finally, the Court reasoned broadly that recent guidance from the U.S. Supreme Court and from Congress did not support the judicial use of a presumption in a manner that would increase the number of class actions brought under the securities laws. Rather, significant legislation, such as the Private Securities Litigation Reform Act of 1995, was intended to reduce the frequency of securities class action filings in the United States. A judicially-developed “fraud created the market” theory for presumption of reliance would give rise to undue incentives for plaintiffs’ attorneys to bring – and undue pressure on defendants to pay money to settle – claims of doubtful validity. The Court reasoned that such a state of affairs could only hurt investors.

*The Malack Court’s thorough opinion presents a high hurdle for plaintiffs in securities fraud class actions by eliminating one basis upon which presumption of reliance could be established.*

## Going Forward

The *Malack* Court’s thorough opinion presents a high hurdle for plaintiffs in securities fraud class actions by eliminating one basis upon which presumption of reliance could be established. It also represents a strong critique of judicial rulemaking as a vehicle to expand potential liability under the federal securities laws. Should the *Malack* plaintiffs seek to appeal the Third Circuit’s ruling, the U.S. Supreme Court, which has not been particularly solicitous of plaintiffs asserting federal securities fraud in recent decisions, would be presented with an opportunity to address an issue that has long vexed the lower courts.

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