Client Alert.

June 11, 2012

Supreme Court to Revisit the Fraud-on-the-Market Presumption

By Jordan Eth and Mark R.S. Foster

Today, the Supreme Court agreed to hear an appeal involving certification of securities fraud class actions. The case, *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, No. 11-1085, --- S. Ct. ----, 2012 WL 692881 (June 11, 2012), presents two questions: (1) whether, in a misrepresentation case under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, the district court must require proof of materiality before certifying a plaintiff class based on the fraud-on-the-market theory; and (2) whether, in such a case, the district court must allow the defendant to present evidence rebutting the applicability of the fraud-on-the-market theory before certifying a plaintiff class based on that theory.

In the decision below that is on appeal, the Ninth Circuit answered "no" to both questions. But other circuits have answered "yes" in other cases. The circuit-split means that, at present, defendants are being treated differently in different parts of the country.

A clear answer from the Supreme Court to these questions could have a significant effect on securities litigation. A decision that endorses the Ninth Circuit's approach could make securities litigation more costly for defendants, particularly in circuits where plaintiffs are presently required to prove materiality at class certification. Conversely, a decision rejecting the Ninth Circuit's approach could provide defendants an early opportunity to challenge the viability of class action claims.

BACKGROUND

The *Amgen* case presents the Court with its first opportunity in almost a quarter of a century to revisit the fraud-on-the-market presumption of reliance that a four-justice majority articulated in *Basic v. Levinson*, 485 U.S. 224 (1988). The *Basic* court held that reliance (one of the six elements in a Section 10(b) action) can be presumed in cases involving securities that trade in efficient markets.

Basic forged the presumption of reliance out of practical considerations. The Court found that a securities fraud case could not proceed as a class action if investors were required to prove direct individual reliance on a misrepresentation. *Basic* stated that an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations can be presumed for purposes of a 10b-5 action.

The fraud-on-the-market presumption formulated by *Basic* permits rebuttal. *Basic* explained that defendants may rebut the presumption with any showing that severs the link between the alleged misrepresentation and the price received (or paid) by the plaintiff. After *Basic* was decided, the Court has not had the opportunity to provide direction on how and when a defendant may rebut the presumption of reliance. Indeed, just last year, the Court expressly declined to consider such questions in *Erica P. John Fund Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011), finding that it was not necessary to do so to resolve the case. (*Halliburton* ruled that plaintiffs are not required to prove the element of loss causation at the class certification stage of a case.)

Lacking recent guidance from the Supreme Court about the mechanics of the fraud-on-the-market presumption, circuits have divided on the answers to the questions presented by the *Amgen* appeal. To date, five circuits have adopted three rules.

The Seventh and Ninth Circuits have the most plaintiff-friendly rule. Those courts hold that proof of materiality by plaintiffs is not a precondition for class certification. They also foreclose defendants from attempting to rebut the presumption of reliance at class certification. In the opinion under review in *Amgen*, the Ninth Circuit ruled that consideration of materiality in connection with the rebuttal of the fraud-on-the-market presumption involves an adjudication on the merits that generally must await summary judgment or trial.

The Third Circuit's rule is a middle-ground approach. Plaintiffs in the Third Circuit need not prove materiality at class certification. However, defendants may attempt to rebut the fraud-on-the-market presumption at class certification, including by affirmatively showing that alleged misrepresentations were immaterial.

The Second and Fifth Circuits have the most defendant-friendly rules. Those courts require plaintiffs to affirmatively prove that alleged misrepresentations were material. Absent such proof, a court will not presume that allegedly misleading statements affected a stock price in an efficient market. Those two circuits also allow defendants to present evidence to rebut the application of the fraud-on-the-market theory at class certification. A defendant can defeat class certification by showing that an alleged misstatement did not affect a company's stock price.

SIGNIFICANCE

The Supreme Court's decision in *Amgen* should provide guidance on materiality and the fraud-on-the-market presumption that could affect the costs, risks, and dynamics in private securities litigation. There is a possibility that the Court could use the case as a vehicle to reevaluate the strength of the efficient-market hypothesis that underpins the fraud-on-the-market presumption articulated in *Basic*. Decades of empirical research undertaken since *Basic* was decided suggests that market efficiency is more complicated and nuanced than theorized decades ago. The law may need to adapt accordingly.

Contact:

Jordan Eth
(415) 268-7126
jeth@mofo.com

Mark R.S. Foster
(415) 268-6335
mfoster@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.