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Expert Analysis

Materiality Assessment at The Class Certification Stage in Securities Fraud Class Actions

By Jeffery A. Dailey, Esq., and Michelle A. Reed, Esq.
Akin Gump Strauss Hauer & Feld

Class certification has been considered the million-dollar question to securities fraud class action plaintiffs and defendants. The damages from a single investor suit may only be worth hundreds of dollars, whereas damages in a class action are typically in the hundreds of millions. The pivotal question of class certification in securities cases — whether plaintiffs may invoke the "fraud on the market" presumption of reliance — often defines defendants' risk exposure.

The circuits have been divided on two issues:

- Whether materiality is an element that must be proved in order to invoke the fraud-on-the-market presumption of reliance at the class certification stage.
- Whether defendants must be allowed to present evidence rebutting such evidence.

On June 12 the U.S. Supreme Court granted *certiorari* in the case of *Connecticut Retirement Plans & Trust Funds v. Amgen Inc.* to resolve these issues.[1] The ultimate outcome of *Amgen* may change the timing and value of class-action settlements nationwide.

CLASS CERTIFICATION IN SECURITIES FRAUD CLASS ACTIONS

To certify a class action, plaintiffs must demonstrate the Federal Rule of Civil Procedure 23(a) requirements of numerosity, commonality, typicality and adequacy. Securities plaintiffs must further invoke Rule 23(b)(3), which requires that "the court find [] that the questions of law or fact common to class members predominate over any questions affecting only individual members." In the securities context, a key common question is whether investors actually relied on the alleged misstatement.

Because reliance is typically an individual question, the Supreme Court in *Basic Inc. v. Levinson* created the fraud-on-the-market presumption of reliance to enable courts to certify class actions in securities cases.[2] The Supreme Court reasoned that, in an

efficient market, investors rely on market price, which reflects all material information; therefore, investors can be presumed to have relied on the alleged misstatement.

"An investor who buys or sells stock at the price set by the market [presumably] does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action," the high court said.[3]

Plaintiffs bear the burden of proof when invoking this presumption, and defendants may rebut the presumption.[4] Without the fraud-on-the-market presumption, individual issues of investors' reliance will predominate, and the class cannot be certified.

HISTORY OF *AMGEN*

The Supreme Court created the fraud-on-the-market presumption of reliance to enable courts to certify class actions in securities cases.

The *Amgen* appeal stems from a 2009 grant of class certification in a Rule 10b-5 class action alleging that Amgen and certain officers made misstatements and omissions in connection with the safety of two drugs. The District Court found that the plaintiff properly invoked the fraud-on-the-market presumption of reliance by "showing that Amgen's stock traded in an efficient market (which Amgen conceded) and that the alleged misstatements were public (which Amgen did not contest)."[5]

The court held that the plaintiff "did not need to *prove* — but rather could merely allege — that Amgen's supposed falsehoods were material."[6] The defendants were not allowed the opportunity to rebut the presumption of reliance at the class certification stage because "rebuttal of the presumption was a trial issue."[7]

The 9th U.S. Circuit Court of Appeals affirmed the District Court's decision, holding that "plaintiffs need not prove materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certification stage."[8]

Amgen petitioned for a writ of *certiorari*, arguing that the inconsistency among federal appeals courts encourages forum-shopping and effectively denies defendants a merits hearing on the issue of materiality.

"Given the immense settlement pressure generated by class certification orders in securities fraud litigation, defendants in the 7th and 9th Circuits will frequently be forced, by practical realities, to settle cases for enormous sums regardless of whether they have a meritorious materiality defense that would rebut application of the fraud-on-the-market theory," the petition said. "A rule that postpones consideration of materiality until summary judgment or trial effectively means that, in most cases, there will be no examination of materiality — at any stage of litigation."[9]

Plaintiff Connecticut Retirement Plans & Trust Funds said the appeals courts simply had not had sufficient time to absorb recent Supreme Court precedent.[10] The Supreme Court granted *certiorari* June 12.

CIRCUIT SPLIT

The *Amgen* decision by the 9th Circuit further split the federal courts of appeal on plaintiffs' burden of proof in invoking the fraud-on-the-market presumption. The 2nd and 5th circuits require plaintiffs to prove materiality for class certification and offer defendants the opportunity to present evidence to rebut the applicability of the presumption.

The 2nd Circuit in *In re Salomon Analyst* said "[t]he point of *Basic* is that an effect on market price is presumed based on the materiality of all the information and a well-developed market's ability to readily incorporate that information into the price of

securities."[11] Both factors — market efficiency and materiality — were considered factual predicates to the class-wide presumption of reliance. A *prima facie* showing of materiality was deemed insufficient, and defendants were permitted to present rebuttal evidence before the court certified a class.

Similarly, the 5th Circuit requires plaintiffs to offer "proof of a material misstatement ... in order to trigger the fraud-on-the-market presumption."[12] Plaintiffs must make more than a mere showing of materiality.

"When a court considers class certification based on the fraud-on-the-market theory, it must engage in thorough analysis, weigh the relevant factors, require both parties to justify their allegations and base its ruling on admissible evidence," the 5th Circuit said.[13]

The 3rd Circuit presents a middle ground, holding that plaintiffs need not prove materiality as part of an initial showing, but defendants may rebut the applicability of the fraud-on-the-market presumption by disproving the materiality of the alleged misrepresentation.[14]

In contrast, the 9th and 7th circuits hold that plaintiffs do not need to prove materiality to invoke the presumption because materiality is a merits inquiry to be resolved at trial. The 7th Circuit held it impermissible for courts to even "peek" at the "merits" question of materiality at the class certification stage: "Whether statements were false, or whether the effects were large enough to be called material, are questions on the merits."[15]

The 9th Circuit in *Amgen* concurred, saying the plaintiff "must plausibly allege — but need not prove at this juncture — that the claimed misrepresentations were material."[16]

IMPACT OF RECENT SUPREME COURT DECISIONS

The Supreme Court has recently issued a series of decisions in the class action-context that will affect *Amgen*'s result, but it is hard to tell in which direction these decisions point.

In *Wal-Mart v. Dukes*, a nationwide gender discrimination proposed class action, the Supreme Court required that courts examine the entire Rule 23 class certification inquiry, regardless of whether it overlaps with the merits.[17] "[C]ertification is proper only if the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23 [] have been satisfied," the court said. "Frequently, that 'rigorous analysis' will entail some overlap with the merits of the plaintiff's underlying claim. That cannot be helped."[18]

The Supreme Court evaluated the evidence presented and found that in *Dukes*, the element of commonality was not met because the plaintiffs failed to prove a company-wide policy of discrimination and instead were suing "about literally millions of employment decisions at once."[19] Future defendants will argue that this allows district courts to evaluate materiality at the class certification stage, even though it also ultimately bears upon the merits.

In *Erica P. John Fund Inc. v. Halliburton Co.*, the Supreme Court unanimously held that securities fraud plaintiffs "need not ... prove loss causation in order to obtain class certification."[20] Future plaintiffs will say *Halliburton* underscores the necessity to evaluate only class certification elements — numerosity, commonality, typicality, adequacy and predominance — and not the ultimate merits of the claim at the class certification stage.

Finally, in *Matrixx Initiatives v. Siracusano*, the Supreme Court rejected the defendants' proposal of a bright-line statistical signifi-cance test for materiality, holding that materiality "is satisfied when there is a substantial likelihood that the disclosure of the

omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[21] Plaintiffs will say *Matrixx*'s rejection of the proposed requirement for statistical significance to prove materiality in securities cases makes injecting a statistical requirement of materiality into the fraud-on-the-market analysis unnecessary and inappropriate.

FUTURE FOR *AMGEN*

Amgen said materiality is as important as "the efficient-market and public statement predicates to the fraud-on-the-market theory."[22] The company also said: "Absent materiality, the fundamental premise of *Basic* is not established, because an essential link between the misstatement and the plaintiff is entirely missing. The premise of *Basic* is that a purchaser or seller of a security can be presumed to have indirectly relied on a material misstatement through that person's direct reliance on the integrity of the market price for the security, which price, in turn, reflects all material information."[23]

In the end, the alleged misrepresentation may not be reflected in the market price when a plaintiff purchased or sold a security because either the market is not efficient or the statement is not material. As such, materiality is a fundamental element underscoring the fraud-on-the-market presumption.

Plaintiff Connecticut Retirement Plans & Trust Funds responded by saying the "logic and holding of [the 9th Circuit] are entirely consistent with *Dukes*. Because the market in Amgen securities is efficient, the class action mechanism has 'the capacity ... to generate' a common answer on whether Amgen's misrepresentations were material."[24]

The plaintiff also said the Supreme Court "enumerated the 'undisputed' required proofs for invoking the 'rebuttable presumption of reliance' at the class certification stage," requiring a public misrepresentation, an efficient market and a plaintiff transaction that occurred before a corrective disclosure. "Nowhere did [the Supreme Court] mention materiality."[25]

The impact of the Supreme Court's decision may be significant to securities class action plaintiffs and defendants. While more than half of securities class actions settle before a class certification motion is filed, those that proceed to class certification may face higher settlement values if the 9th Circuit's decision in *Amgen* is affirmed.[26]

The Advisory Committee to the Federal Rules of Civil Procedure acknowledged the palpable settlement impact of class certification: "An order granting certification ... may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability."[27]

As the Supreme Court said, "Certification of a large class may so increase the defendant's potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense."[28] Between 2008 and 2012, the median settlement value of settled securities class actions was $9.1 million.[29] That amount increased to $16.5 million for those cases where a class certification motion was merely filed.

The cost of settlement may rise and timing of settlements may accelerate should the Supreme Court free plaintiffs of the requirement to prove materiality at the class certification stage. The later a plaintiff has to prove materiality, the more likely risk-averse defendants will be forced to settle earlier. As such, the timing of the materiality inquiry is the Supreme Court's million-dollar question in the coming term.

NOTES

1 *Amgen Inc. v. Conn. Ret. Plans & Trust Funds,* No. 11-1085, *cert. granted* (June 12, 2012).
2 *Basic Inc. v. Levinson,* 485 U.S. 224 (1988).
3 *Id.* at 247.
4 *Id.* at 248 ("[a]ny showing that severs the link between the alleged misrepresentation and ... the price received (or paid) by the plaintiff" is "sufficient to rebut the presumption of reliance").
5 *Conn. Ret. Plans & Trust Funds v. Amgen Inc.,* 660 F.3d 1170, 1174 (9th Cir. 2011).
6 *Id.*
7 *Id.*
8 *Id.* at 1174, 1177.
9 *See* Amgen Inc. Petition for Writ of *Certiorari* at 15, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds,* No. 11-1085, 2012 WL 707042 (Mar. 1, 2012).
10 *See* Conn. Ret. Plans & Trust Funds Brief for Respondent in Opposition at 10, *Amgen Inc. v. Conn. Ret. Plans & Trust Funds,* No. 11-1085, 2012 WL 1666404 (May 11, 2012).
11 *In re Salomon Analyst Metromedia Litig.,* 544 F.3d 474, 481, 485-86 & n.9 (2d Cir. 2008) (requiring that plaintiff show defendant "publicly made ... a material misrepresentation). Dicta from the 1st and 4th circuits also state that plaintiffs must demonstrate materiality at the class certification stage. *In re PolyMedica Corp. Sec. Litig.,* 432 F.3d 1, 7 n.11 (1st Cir. 2005); *Gariety v. Grant Thornton LLP,* 368 F.3d 356, 364 (4th Cir. 2004).
12 *Oscar Private Equity Invs. v. Allegiance Telecom,* 487 F.3d 261, 265 (5th Cir. 2007), abrogated on other grounds by *Erica P. John Fund Inc. v. Halliburton Co.,* 131 S. Ct. 2179 (2011).
13 *Unger v. Amedisys Inc.,* 401 F.3d 316, 322 (5th Cir. 2005).
14 *In re DVI Inc. Sec. Litig.,* 639 F.3d 623, 631, 638 (3d Cir. 2011).
15 *Schleicher v. Wendt,* 618 F.3d 679, 685, 687 (7th Cir. 2010).
16 *Amgen*, 660 F.3d at 1172.
17 *Wal-Mart Stores v. Dukes,* 131 S. Ct. 2541 (2011).
18 *Id.* (quoting *Gen. Tel. Co. of Sw. v. Falcon,* 457 U.S. 147, 161 (1982)).
19 *Id.* at 2552.
20 *Halliburton*, 131 S. Ct. at 2183.
21 *Matrixx Initiatives v. Siracusano,* 131 S. Ct. 1309, 1318 (2011),
22 Amgen Inc. Petition at 7.
23 Amgen Inc. Petition at 19-20.
24 Conn. Ret. Plans & Trust Funds Brief for Respondent in Opposition at 14 (quoting *Dukes,* 131 S. Ct. at 2551).
25 *Id.* at 15 (quoting *Halliburton*, 131 S. Ct. at 2185).
26 Renzo Comolli *et al.*, NERA Economic Consulting, Recent Trends in Securities Class Action Litigation: 2012 Mid-Year Review at 19 (July 24, 2012).
27 Fed. R. Civ. P. 23(f) Advisory Committee's note, 1998 Amendments.
28 *Coopers & Lybrand v. Livesay,* 437 U.S. 463, 476 (1978).
29 Comolli, *supra* note 26, at 20.

Jeffery A. Dailey (L) of **Akin Gump Strauss Hauer & Feld** in Philadelphia focuses his practice on business litigation, and he has handled matters involving securities laws, accountant liability, banking, privacy laws, insurance issues, business tort and contract. He can be reached at jdailey@akingump.com. **Michelle Reed** (R), of the firm's Dallas office, focuses on complex civil litigation matters, with an emphasis on representing public companies and their officers and directors in securities litigation, internal investigations, and regulatory investigations and enforcement proceedings. She can be reached at mreed@akingump.com.