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Back To *Basic:* Proof Of Materiality Not Needed To Trigger The Fraud-On-The-Market Presumption Of Reliance

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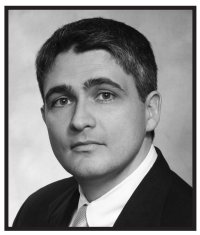
The United States Supreme Court held in *Amgen v. Connecticut Retirement Plans & Trust Funds* that investors need not prove materiality at the class certification stage to invoke the rebuttable presumption of reliance on public misrepresentations under *Basic v. Levinson*.[1] The 6-3 decision resolved a split among circuit courts and set aside Second Circuit precedent that had held that securities plaintiffs must prove materiality to avail themselves of the *Basic* presumption. Although this important decision clarifies the standards for certifying a class in securities fraud cases, it does not necessarily foreclose all references to materiality at the class certification stage and may foreshadow a future Supreme Court showdown on the viability of the fraud-on-the-market presumption of reliance more generally.

Background

In *Amgen*, the lead plaintiff, Connecticut Retirement Plans and Trust Funds ("Plaintiff"), asserted claims pursuant to sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder, alleging that Amgen, Inc. and several of its officers and directors (collectively, the "Defendants") downplayed or concealed FDA safety concerns about two of Amgen's pharmaceutical products, Epogen and Aranesp, and made a series of misleading statements about the company's alleged unlawful marketing practices.[2] According to Plaintiff, these alleged misrepresentations artificially inflated the value of Amgen's stock.[3] Corrective disclosures later made by the Defendants caused Amgen's stock price to decline, allegedly injuring Plaintiff and the putative members of the class.[4]



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To recover damages in a section 10(b) case, a plaintiff must prove reliance on a material misstatement made by defendants.[5] In order for a class to be certified in a typical securities fraud case, the court must find pursuant to Fed. R. Civ. P. 23(b)(3) that "questions of law or fact common to class members predominate over any questions affecting only individual members."[6] One method of establishing reliance is through proof of direct reliance – showing that investors were "aware of a company's statement and engaged in a relevant transaction … based on that specific misrepresentation."[7] But because such a showing is individualized in nature, proving direct reliance at trial would require proof from each member of the proposed class, which would defeat a Rule 23(b)(3) class given that individualized issues of reliance would predominate over class-wide issues.[8]

To address this problem, the Supreme Court, in *Basic*, established a rebuttable presumption that individual investors have relied on material misstatements when the security at issue was traded on an impersonal, well-developed market.[9] The Supreme Court explained that, under the efficient market hypothesis, "the market price of shares traded on well-developed markets reflects all publicly available information and, hence, any material misrepresentations."[10] Incorporating that hypothesis into securities law, the Court held that where investors rely on the market price of securities, it can be presumed that plaintiffs have relied on the material misstatement. At the same time, the Court ruled that this presumption 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, will be sufficient to rebut the presumption of reliance."[11] "For example, if petitioners could show that the 'market makers' were privy to the truth … and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone."[12]

Plaintiff in *Amgen* moved for class certification under Rule 23(b)(3), arguing that, on the issue of reliance, common questions predominated because the fraud-on-the-market presumption of reliance applied. In particular, Plaintiff argued that the allegedly misleading state-

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ments were publicly made and that Amgen traded on an efficient market (a fact that the Defendants admitted in their Answer).[13]

Defendants opposed on the basis that Plaintiff could not invoke the fraud-on-the-market presumption without establishing that the alleged misrepresentations were material.[14] According to Defendants, materiality could not be established because the market was aware of the facts that were supposedly misrepresented.[15] That is, relying on *Basic*, Defendants argued that they "could show that the 'market makers' were privy to the truth," which would rebut the fraud-on-the-market presumption by "sever[ing] the link between the alleged misrepresentation and … the price received (or paid) by plaintiff."[16]

The district court granted Plaintiff's class certification motion. The court held that to avail itself of the *Basic* presumption of reliance, "Plaintiff need only establish that an efficient market exists [and that] other inquiries into issues such as materiality … are properly taken up at a later stage in the proceeding."[17] The court further reasoned that if it "allow[ed] Defendants to present evidence that none of the investors were misled because the truth was on the market, [it] would essentially be allowing Defendants to assert a defense of non-reliance as a basis for denial of class certification. But such is not allowed."[18]

Defendants appealed to the Ninth Circuit, which affirmed.[19] Essentially adopting the district court's reasoning, the Ninth Circuit held that to invoke the fraud-on-the-market presumption in aid of class certification, a plaintiff must establish that "the security in question was traded in an efficient market" and "that the alleged misrepresentations were public."[20] On the issue of materiality, the court held that, at the class certification stage, the plaintiff must "plausibly allege" (but need not prove) that the claimed misrepresentations were material.[21] The court also held that a "rebuttal of the fraud-on-the-market presumption, at least by showing that the alleged misrepresentations were not material, is also a merits issue for summary judgment or trial, not a matter to be taken up in a class certification motion."[22]

In deciding that a securities plaintiff need not establish materiality at the class certification stage, the Ninth Circuit reasoned that no matter how the question of materiality was answered, it would not impact the Rule 23(b)(3) analysis.[23] As the court put it, "[i]f the misrepresentations turn out to be material, then the fraud-on-the-market presumption makes the reliance issue common to the class, and class treatment is appropriate," but if the misrepresentations are immaterial, "then *every* plaintiff's claim fails on the merits (materiality being a standalone merits element), and there would be no need for a trial on each plaintiff's individual reliance."[24] In contrast, a plaintiff's failure to prove the other elements of the fraud-on-the-market presumption would mean reliance could not be established on a classwide basis, but the "claims would not be dead on arrival" because he "could seek to prove reliance individually."[25]

The Ninth Circuit's decision brought to a head a conflict among the circuits on the issue of what plaintiffs must establish at the class certification stage to invoke the fraud-on-the-market presumption. In the Second and Fifth Circuits, the rule had been that a securities plaintiff needed to establish materiality in order to invoke the *Basic* presumption, and defendants were permitted an opportunity prior to certification to rebut the presumption through evidence of immateriality.[26] In the Third Circuit, a securities plaintiff was not required to establish materiality; however, like in the Second and Fifth Circuits, defendants could rebut the presumption prior to certification through proof of immateriality.[27] The Seventh Circuit, like the Ninth Circuit, had held that materiality should not be evaluated at the class certification stage, by either plaintiffs or defendants.[28]

The Supreme Court granted certiorari "to resolve [this] conflict among the Courts of Appeals over whether district courts must require plaintiffs to prove, and must allow defendants to present evidence rebutting, the element of materiality before certifying a class action under § 10(b) and Rule 10b-5."[29]

The Supreme Court's Decision

In an opinion authored by Justice Ginsburg,[30] the Supreme Court held that proof of materiality is not required at the class certification stage. The Court reasoned that proof of materiality is not needed because the test of whether a misrepresentation is material is "an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor."[31] This objective test means that materiality can be resolved through evidence that is common to the class, making materiality a "common question for purposes of Rule 23(b)(3)."[32]

Echoing the Ninth Circuit, the Court buttressed its reasoning by explaining that a failure of proof on the question of materiality will not result in individual issues predominating over classwide issues; rather, it "would end the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate."[33] For similar reasons, the Court held that evidence rebutting the fraud-on-the-market presumption through proof of immateriality also "is no barrier to finding that common questions predominate" because it, too, "bring[s] the litigation to a close."[34] Thus, "even a definitive rebuttal on the issue of materiality would not undermine the predominance of questions common to the class."[35]

In this analysis, the Court distinguished materiality from the other fraud-on-the-market predicates – namely, that the supposed misrepresentations were publicly made, that the stock was traded on an efficient market, and that the purchase or sale of the security occurred after the alleged misrepresentation but before the corrective disclosure – which the Court affirmed must be proven prior to class certification.[36] The Court explained that the timing of the transaction relates to the Rule 23(a) requirements of typicality and adequacy of representation, not the Rule 23(b)(3) requirement of predominance that was at issue in *Amgen*.[37] Moreover, if a plaintiff fails to establish the other fraud-on-the-market predicates, he may be able to establish reliance through the "'traditional' mode of demonstrating that she was personally 'aware of [the defendant's] statement and engaged in a relevant transaction … based on that specific misrepresentation.'"[38] As such, a failure to establish those elements would, unlike a failure to establish materiality, result in individual issues predominating over classwide issues rather than bringing the case as a whole to conclusion.

The majority also rejected Defendants' argument that class certification without proof of materiality would result in undue pressure on defendants to settle cases lest they "run the risk of potentially ruinous liability."[39] In that regard, the Court commented that materiality was no different from other elements of a securities fraud claim – none of which must be proven prior to class certification.[40] The

Court also pointed to Congress's enactment of the Private Securities Litigation Reform Act of 1995, which addressed "perceived abuses" in securities fraud cases by, among other things, imposing heightened pleading requirements, limiting damages and attorneys' fees, providing a safe harbor for forward-looking statements, and staying discovery pending resolution of a motion to dismiss.[41] Given that Congress had already addressed the policy concerns raised by Defendants, the Court concluded that it was not the role of the judiciary to "make its own further adjustments by reinterpreting Rule 23 to make likely success on the merits essential to class certification in securities-fraud suits."[42]

Justices Scalia, Kennedy, and Thomas dissented. In his dissent, Justice Thomas traced the origin of the fraud-on-the-market theory and determined that materiality of the alleged misrepresentation was key in its development and subsequent adoption in *Basic*.[43] He concluded that without proof of materiality, plaintiffs cannot establish that there was a fraud on the market and, therefore, are not entitled to the fraud-on-the-market presumption of reliance.[44] And without that presumption, a class action should not be certified because plaintiffs cannot establish that common questions of reliance will predominate over individual questions.[45] According to Justice Thomas, "[a] plaintiff who cannot prove materiality does not simply have a claim that is 'dead on arrival' at the merits, he has a class that should never have arrived at the merits at all because it failed Rule 23(b)(3) certification from the outset."[46]

Writing separately, Justice Scalia concluded that the majority opinion was contrary to the Court's ruling in *Basic* that "a demonstration of materiality" is necessary "not just for substantive recovery but for certification."[47] He further noted that "[c]ertification of the class is often, if not usually, the prelude to a substantial settlement" and voiced his displeasure with the majority's holding that not only "accept[ed] what some consider the regrettable consequences of the four-Justice opinion in *Basic*; it expand[ed] those consequences from the arguably regrettable to the unquestionably disastrous."[48]

The three dissenters agreed that the *Basic* decision was "questionable" and appeared open to revisiting *Basic's* fraud-on-the-market presumption.[49] Justice Alito, who joined the majority opinion, filed a concurrence that questioned the "economic premise" of the fraud-on-the-market theory and suggested that "reconsideration of the *Basic* presumption may be appropriate."[50]

The Lessons Of *Amgen*

The Supreme Court's *Amgen* decision spells the end of the requirement that securities plaintiffs establish materiality to avail themselves of the fraud-on-the-market presumption of reliance. But it does not alter the requirement that plaintiffs establish by a preponderance of the evidence that the alleged misrepresentations were publicly known, that the stock traded on an efficient market, and that the relevant transaction took place between the time of the alleged misrepresentation and when the truth was revealed. Nor does the *Amgen* decision preclude all references to materiality at the class certification stage – evidence of a stock's price reaction (or lack thereof) to material information may be used to establish that the market for the stock at issue was not efficient and, therefore, that the presumption of reliance should not apply.[51] This was not an issue in *Amgen* because Defendants had already admitted that the market for Amgen's stock was efficient, and they were foreclosed from introducing evidence of inefficiency.

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1 485 U.S. 224 (1988).

2 *See Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, No. 07-CV-2536, 2009 WL 2633743, at *1–3 (C.D. Cal. Aug. 12, 2009).

3 *Id.* at *1.

4 *Id.* at *2.

5 *See Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309, 1317-18 (2011).

6 Fed. R. Civ. P. 23(b)(3).

7 *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2184 (2011).

8 *See Basic*, 485 U.S. at 242.

9 *Id.* at 241-42, 246-47.

10 *Id.* at 246.

11 *Id.* at 248.

12 *Id.*

13 2009 WL 2633743, at *1-2, 8.

14 *Id.* at *8.

15 *Id.* at *12-13.

16 Def. Opp. Class Cert. at 22 Dkt. No. 190 (quoting *Basic*, 485 U.S. at 248).

17 2009 WL 2633743, at *12.

18 *Id.*

19 *See Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, 660 F.3d 1170 (9th Cir. 2011).

20 *Id.* at 1172.

21 *Id.*

22 *Id.*

23 *Id.* at 1175.

24 *Id.* (emphasis in original).

25 *Id.*

26 *See In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474, 484-85, 486 n.9 (2d Cir. 2008); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265, 270 (5th Cir. 2005), *abrogated on other grounds by Erica P. John Fund v. Halliburton Co.*, 131 S. Ct. 2179 (2011).

27 *See In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631, 638 (3d Cir. 2011)

28 *See Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010).

29 *Amgen v. Conn. Ret. Plans & Trust Funds*, No. 11-1085, 568 U.S. __, slip op. at 8 (Feb. 27, 2013).

30 Justice Ginsburg was joined by Chief Justice Roberts and Justices Breyer, Alito, Sotomayor, and Kagan. Justice Alito also filed a concurring opinion. Justice Thomas filed a dissenting opinion, in which Justice Kennedy joined, and in which Justice Scalia joined, except for Part I–B. Justice Scalia also filed a separate dissenting opinion.

31 *Amgen*, slip op. at 11 (internal quotations omitted).

32 *Id.* at 11 (internal quotations omitted).

33 *Id.* at 11.

34 *Id.* at 25.

35 *Id.*

36 *Id.* at 16-17.

37 *Id.* at 15-16.

38 *Id.* at 17 (quoting *Halliburton*, 131 S. Ct. at 2181).

39 *Id.* at 18 (quoting Advisory Committee's 1998 Note on sbd. (f) of Fed. R. Civ. P. 23, 28 U.S.C. App., p. 143).

40 *See id.* at 18-19.

41 *Id.* at 19.

42 *Id.* at 20 (quoting *Schleicher*, 618 F.3d at 686).

43 *See id.* at 13-18 (Thomas, J., dissenting).

44 *Id.* at 1, 10, 18 (Thomas, J., dissenting).

45 *See id.* at 1 (Thomas, J., dissenting).

46 *Id.* at 10 (Thomas, J., dissenting) (internal citations omitted).

47 *See id.* at 1-4 (Scalia, J., dissenting).

48 *Id.* at 4 (Scalia, J., dissenting).

49 *Id.* at 4 n.4 (Thomas, J., dissenting).

50 *Id.* at 1 (Alito, J., concurring).

51 *See*, *e.g.*, 2009 WL 2633743, at *9, n.11 (a market may be efficient where there is "a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price").