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Pending 6th Circ. Ruling Has Broad Class Action Implications

By **Todd Cosenza, Charles Cording and Amanda Payne** (August 16, 2023)

In 1942, the U.S. Securities and Exchange Commission adopted Rule 10b-5,[1] promulgated under Section 10(b) of the Securities Exchange Act of 1934.[2] Rule 10b-5 prohibits, in connection with the purchase or sale of any security, the making of any untrue statement of a material fact or the omission of a material fact that would render statements made not misleading.

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One essential element of a securities fraud claim under Section 10(b) and Rule 10b-5 is reliance. Reliance is derived from principles of common law fraud where the alleged victim has to have relied on the conduct of the wrongdoer.

This follows in securities fraud class actions, where plaintiffs must prove that they relied on the alleged misstatement when purchasing or selling the security. The reliance requirement ensures that a causal connection exists between the defendant's fraud and the plaintiff's injury.

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Historically, the reliance element has presented conceptual difficulties for plaintiffs, especially when seeking to assert claims on behalf of putative classes of investors, and over time, the U.S. Supreme Court crafted two crucial and — importantly — distinct rebuttable presumptions of reliance:

- The Basic presumption, which was established in the 1988 Basic Inc. v. Levinson decision; and
- The Affiliated Ute presumption, which was established in the 1972 Affiliated Ute Citizens of Utah v. U.S. decision.

For the Basic presumption to apply, plaintiffs must demonstrate market efficiency; thereafter, defendants may rebut the presumption by demonstrating a lack of price impact or any other "showing that severs the link between the alleged misrepresentation and ... the price," the high court said in the 2012 Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System decision.

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Cases alleging misrepresentations are governed by the Basic presumption. In contrast, the Affiliated Ute presumption is limited to class actions alleging omissions — i.e., a failure to disclose notwithstanding a legal duty to speak — and presumes reliance if the omission was material.

For decades, federal courts have grappled with the issue of where so-called half-truths fit into this framework. Half-truths are incomplete affirmative statements that are alleged to have been misleading by virtue of the information omitted by the speaker.

While to this extent half-truths have elements of both misrepresentations and omissions, historically, they have nearly always been treated as a form of a misrepresentation since they involve affirmative

statements like misrepresentations, not failures to speak in the face of a legal duty like omissions.

Nearly all courts of appeal that have addressed the issue have reached the same conclusion: The Affiliated Ute presumption applies only to claims based on omissions, not to claims based on half-truths.

The U.S. Court of Appeals for the Sixth Circuit is the next appellate court with the opportunity **to consider the issue**.

In In re: FirstEnergy Corp. Securities Litigation, a Rule 23(f) petition is currently pending before the Sixth Circuit following the U.S. District Court for the Southern District of Ohio's March 30 order certifying the class, based on an expansive application of the Affiliated Ute presumption to nearly 50 half-truths.

If the Sixth Circuit affirms the district court's class certification order, it will have substantial consequences for defendants in securities fraud class actions.

The Affiliated Ute Presumption

In Affiliated Ute Citizens of Utah v. United States, the Supreme Court in 1972 ruled for the first time that reliance may be presumed on a classwide basis in an alleged securities fraud when (1) the case turns on a defendant's nondisclosure rather than its affirmative statements and (2) the defendant had a duty to disclose.[3]

Affiliated Ute involved unique facts. Members of the Ute tribe, who had acquired stock in a corporation that managed assets derived from tribal holdings, brought suit against a bank and two of its managers under Section 10(b) and Rule 10b-5.[4]

The complaint arose out of the managers' actions in assisting the Indigenous people of the Ute tribe with disposing of their stock. The managers, who knew that the stock traded in both a primary market and resale market, devised a scheme to directly purchase stock from individual members of the Ute tribe and then market it to non-Indigenous buyers at higher prices.[5]

The defendants never told plaintiffs about the resale market and its considerably higher prices — even though the bank had agreed to act on the tribe's behalf.[6]

The Supreme Court held that:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.[7]

And so the eponymous Affiliated Ute presumption was created.

In crafting the Affiliated Ute presumption, the Supreme Court addressed the unique proof problem plaintiffs face in attempting to prove reliance based on a representation that was never made.

The Basic Presumption

In 1988, the Supreme Court issued its monumental decision in Basic Inc. v. Levinson.[8] In that decision, the court adopted a rebuttable presumption of classwide reliance based on the fraud-on-the-market theory in cases involving fraudulent misrepresentations.[9]

In Basic, former shareholders of Basic Inc., a manufacturer of chemical refractories for the steel industry, filed a class action against Basic alleging that it made false or misleading statements regarding merger negotiations in violation of Section 10(b) and Rule 10b-5.[10]

In 1976, Basic became engaged in discussions with another company about a possible merger.[11] However, over the next two years, Basic made three public statements denying that it was engaged

in merger negotiations.[12] Then, at the end of 1978, Basic suddenly announced its approval of a tender offer for all outstanding shares.

One of the issues before the court was whether the court below properly applied a rebuttable presumption of reliance — based on the fraud-on-the-market theory — in certifying the class rather than requiring each class member to show direct reliance on Basic's statements.[13]

The court held that it did, stating 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 a stock's market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.[14]

Thus was born the eponymous Basic presumption.

The Basic presumption arose out of the Supreme Court's recognition of the fact that:

> Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [plaintiff] from proceeding with a class action, since individual issues then would have overwhelmed the common ones.[15]

In the years since Basic, the Supreme Court has developed an intricate and specialized body of case law defining when and how securities class action defendants can rebut the presumptions of reliance at the class certification stage.

In the 2014 Halliburton Co. v. Erica P. John Fund Inc. decision, known as Halliburton II, the Supreme Court reaffirmed the viability of the fraud-on-the-market presumption and attempted to clarify how to apply the presumption in practice.

The holding in Halliburton II, which provides that plaintiffs in securities class actions need not prove price impact to first invoke the fraud-on-the-market presumption, but that defendants must be afforded an opportunity to rebut the fraud-on-the-market presumption of reliance "with evidence of a lack of price impact ... before class certification," reflected a delicate compromise between the arguments brought by the two sides in the case.

Defendants urged that Basic's fraud-on-the-market presumption be overruled, while plaintiffs urged that defendants not have any opportunity to rebut the presumption at class certification.

In Goldman Sachs v. Arkansas Teachers, the Supreme Court further clarified what it meant by "evidence of a lack of price impact," holding that, "[i]n assessing price impact at class certification, courts should be open to all probative evidence on that question — qualitative as well as quantitative — aided by a good dose of common sense."[16]

The Supreme Court thus instructed the U.S. Court of Appeals for the Second Circuit to "take into account all record evidence relevant to price impact, regardless whether that evidence overlaps with materiality or any other merits issue."[17]

The Basic-Affiliated Ute Dichotomy: Will the Sixth Circuit Follow Suit?

Although the Affiliated Ute presumption and the Basic presumption are both rebuttable presumptions of reliance, they differ in important ways. The Affiliated Ute presumption arose out of a case based on omissions, does not require that plaintiffs show market efficiency, and can be rebutted only by showing that the plaintiff did not rely on the omission at issue.

Conversely, the Basic presumption arose out of a case based on misrepresentations, requires that plaintiffs show market efficiency — which usually requires retention of an expert — and can be rebutted by demonstrating a lack of price impact or:

> Any 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.[18]

In other words, the Basic presumption provides stronger guardrails for defendants in securities fraud class action.

Since the Supreme Court's decision in Basic, federal courts have uniformly applied the Basic presumption to cases based on misrepresentations. However, in response to a push by securities class action plaintiffs to avoid the strictures of Basic, questions have arisen as to whether the Affiliated Ute presumption should expand from cases based on pure omissions — such as Affiliated Ute itself — to cases based on half-truths.

Almost all of the federal courts of appeals that have addressed this issue have concluded that the Affiliated Ute presumption only applies to omissions.[19]

This year, the U.S. Court of Appeals for the Sixth Circuit has the opportunity to address the issue. In In re: FirstEnergy, Corp Securities Litigation, plaintiffs filed a putative class action lawsuit in the Southern District of Ohio against FirstEnergy, Corp., an Ohio-based electrical utility company, alleging violations of the federal securities laws in connection with the Ohio House Bill 6 scandal.

Specifically, plaintiffs alleged that FirstEnergy violated Section 10(b) and Rule 10b-5 by making numerous statements that were false or misleading because they failed to disclose FirstEnergy executives' alleged bribery of Ohio public officials. In other words, the plaintiffs' claims were based on half-truths — i.e., statements FirstEnergy made that were incomplete — rather than pure omissions.

On March 30, the district court certified the class.[20] Treating the alleged half-truths as omissions, the district court held that individual issues of investor reliance did not predominate because the Affiliated Ute presumption applied.

The district court reasoned that the Affiliated Ute presumption "appears appropriate" because the defendants made omissions of material fact. Moreover, with no binding Sixth Circuit case law contradicting the court's holding, the court was persuaded that the Affiliated Ute presumption could apply to the alleged misrepresentations, too. The court also held, in the alternative, that the Basic presumption would apply.

On April 13, FirstEnergy filed a Rule 23(f) appeal of the order granting class certification. One of the questions presented on appeal is whether the district court erred in extending the Affiliated Ute presumption of reliance to cover claims based on half-truths.

The Sixth Circuit has yet to rule on FirstEnergy's Rule 23(f) petition.

The Consequences of Expanding the Affiliated Ute Presumption to Misrepresentations

If the Sixth Circuit affirms the district court's order granting class certification, the decision could have significant real-world consequences on future securities fraud class action litigation.

First, defendants in securities fraud class actions, at least in the Sixth Circuit, will face significant obstacles to defeating class certification. Invoking the Affiliated Ute presumption for cases based on half-truths will enable securities class action plaintiffs to conduct an end-run around Basic and all the requirements that come with it, including the need to prove market efficiency.

Defendants, on the other hand, will have a more difficult time rebutting plaintiffs' claims because they have to prove by a preponderance of the evidence that the plaintiffs did not rely on the misrepresentation at issue in making their investment decision.

Second, the number of cases with alleged misstatements framed as half-truths will likely skyrocket, at least in the Sixth Circuit. In contemporary securities class action practice, half-truths are commonplace because almost every alleged misrepresentation can be characterized as omitting information.

Finally, absent the guardrails established by Basic and its progeny, public companies will be exposed to near-automatic class certification in nearly every securities case and face steeper evidentiary

hurdles at the merits stages. Class certification would become a mere formality.

That cannot be what the Supreme Court intended when it crafted its class certification regime. Indeed, had the Supreme Court intended for the Affiliated Ute presumption to trump the Basic presumption, it would not have created the Basic presumption after Affiliated Ute and then reaffirmed it again in Halliburton II.

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Disclosure: Willkie represents a group of former SEC officials and law professors who filed an amicus brief in support of FirstEnergy's petition for a Rule 23(f) appeal.

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[1] 17 C.F.R. § 240.10b-5.

[2] 15 U.S. Code § 78j.

[3] 406 U.S. 128.

[4] 406 U.S. 128.

[5] Id. at 152.

[6] Id. at 152-53.

[7] Id. at 153-54 (emphasis added) (citations omitted).

[8] 485 U.S. 224.

[9] The fraud-on-the-market theory is "based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and business" and therefore misleading statements will "defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." Basic, 485 U.S. at 241-42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

[10] Id. at 228.

[11] Id. at 227.

[12] Id. at 228.

[13] Id. at 229-30.

[14] Id. at 247.

[15] Id. at 242.

[16] Id. at 1960. (emphasis in original) (internal quotations omitted).

[17] Id. at 1961. (emphasis in original).

[18] Basic, 485 U.S. at 242.

[19] See Waggoner v. Barclays PLC, 875 F.3d 79, 93 (2d Cir. 2017); Cox v. Collins, 7 F.3d 394, 395–96 (4th Cir. 1993); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1119 (5th Cir. 1988), vacated on other grounds sub nom. Fryar v. Abell, 492 U.S. 914 (1989); Rowe v. Maremont Corp., 850 F.2d 1226, 1233 n.4 (7th Cir. 1988); In re Volkswagen "Clean Diesel" Mktg., Sales Pracs., & Prod. Liab. Litig., 2 F.4th 1199, 1206 (9th Cir. 2021); Kirkpatrick v. J.C. Bradford & Co., 827 F.2d 718, 722 (11th Cir. 1987); In re Interbank Funding Corp. Sec. Litig., 629 F.3d 213, 220 (D.C. Cir. 2010).

[20] See In re FirstEnergy, Corp. Securities Litigation, 2:20-cv-3785, Slip Op. at 1 (S.D. Oh. Mar. 30, 2023) (ECF No. 435).