SULLIVAN & CROMWELL LLP

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Securities Class Actions

U.S. Supreme Court Holds That Materiality Need Not Be Proven at Class Certification Stage To Trigger the "Fraud-on-the-Market" Presumption of Reliance in Securities Fraud Actions

SUMMARY

In *Amgen Inc.* v. *Connecticut Retirement Plans & Trust Funds*, No. 11-1085 (Feb. 27, 2013), the U.S. Supreme Court held that a plaintiff in a Section 10(b) securities fraud class action need not demonstrate the materiality of the alleged misstatement(s) in order to certify a class based on the "fraud-on-the-market" presumption. *Amgen*, along with the Supreme Court's earlier decision in *Erica P. John Fund, Inc.* v. *Halliburton Co.*, 563 U.S. ___ (2011), limit defendants' potential arguments against class certification in Section 10(b) actions.

BACKGROUND

In *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), the U.S. Supreme Court endorsed the "fraud-on-the-market" presumption of reliance. As explained in *Amgen*, the premise of this presumption is that "the price of a security traded in an efficient market will reflect all publicly available information about a company; accordingly, a buyer of the security may be presumed to have relied on that information in purchasing the security." *Basic* thus recognized a rebuttable presumption of reliance on an alleged public, material misrepresentation when securities are traded in an efficient market, even if the investor cannot show that he considered such a misrepresentation. The presumption is ordinarily necessary for putative class claims asserted under Section 10(b) and Rule 10b-5 to be certified under Federal Rule of Civil Procedure 23 because, without it, the individual questions of whether each investor relied on the misstatement would overwhelm over common, class-wide issues and preclude class certification.

In *Amgen*, plaintiffs brought a putative securities fraud class action under Section 10(b) and Rule 10b-5 against Amgen Inc. and several of its officers, alleging that defendants made actionable

misrepresentations about the safety, efficacy and marketing of two of the company's flagship drugs. The district court granted class certification, and the Ninth Circuit affirmed the class-certification order. In so doing, the Ninth Circuit rejected Amgen's argument that the "fraud-on-the-market" presumption was inapplicable because (i) plaintiffs failed to prove that the alleged misrepresentations were material, and (ii) Amgen's rebuttal evidence demonstrated the immateriality of the misrepresentations. The Ninth Circuit held that because materiality is an element of a securities fraud claim to be proved at trial, a plaintiff need not prove it at the earlier class-certification stage; rather, a plaintiff must show only that materiality is susceptible to proof at trial on a class-wide basis. The Ninth Circuit's decision was in accord with a decision of the Seventh Circuit, but conflicted with decisions of the Second and Third Circuits, which required, in varying degrees, analysis of materiality prior to triggering the "fraud-on-the-market" presumption at the class-certification stage.

SUPREME COURT'S OPINION

In a 6-3 opinion, the Supreme Court held that that a plaintiff need not prove materiality in order to trigger the "fraud-on-the-market" presumption of reliance and obtain class certification in a Section 10(b) securities fraud action.

The Court framed the issue as whether plaintiffs satisfied the predominance requirement of Rule 23(b)(3) (*i.e.*, the requirement that common questions predominate over individual ones), and concluded that proof of materiality is not required to satisfy that requirement for two reasons. *First*, because the question of whether an alleged misstatement is material is an objective one based on whether the information would be important to a reasonable investor, materiality can be proved through evidence common to the class. *Second*, because materiality is a substantive element of a claim under Section 10(b), a lack of materiality "would end the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate."

The Court rejected Amgen's argument that because materiality is a predicate for the "fraud-on-the-market" presumption, it should be proved before class certification, as is the case with the other predicates, such as whether the alleged misrepresentations were public and whether the stock traded in an efficient market. The Court agreed with Amgen that "market efficiency, publicity, and materiality can all be proved on a classwide basis" and "are all essential predicates of the fraud-on-the-market theory." But the Court distinguished questions of the public nature of the misstatement and market efficiency from materiality because, although their absence precludes a plaintiff from invoking the "fraud-on-the-market" presumption of reliance, "market efficiency and publicity are not indispensable elements of a [Section 10(b)] claim." "[W]here the market for a security is inefficient or the defendant's alleged misrepresentations were not aired publicly," a plaintiff may still prove reliance the "traditional" way, *i.e.*, by demonstrating that she was personally aware of the alleged misrepresentation and engaged in a transaction on that basis. "A failure of proof on the issue of materiality, in contrast, not only precludes a

plaintiff from invoking the fraud-on-the-market presumption of classwide reliance; it also establishes as a matter of law that the plaintiff cannot prevail on the merits of her Rule 10b-5 claim."

The Court also held that policy considerations did not militate in favor of requiring proof of materiality prior to class certification. Although it acknowledged the settlement pressures created by class certification, the Court reasoned that because materiality is a substantive element of a securities fraud claim, it is akin to whether the alleged misrepresentations were false or whether the plaintiff has proven loss causation, neither of which needs to be proven prior to class certification. The Court also found it "significant" that Congress addressed "the settlement pressures associated with securities-fraud class actions" through the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998, both of which attempted to "curb abusive securities fraud lawsuits," but did not require proof of materiality at the class certification stage. Likewise, the Court noted that Congress has "rejected calls to undo the fraud-on-the-market presumption of classwide reliance endorsed in *Basic*."

Justice Alito concurred in the majority opinion, but wrote separately, stating that "reconsideration of the *Basic* ["fraud-on-the-market"] presumption may be appropriate" in a future case. Justice Alito declined to address the issue because no party had asked the Court to overrule *Basic*.

Justice Thomas dissented, in an opinion joined by Justice Kennedy and joined in part by Justice Scalia, arguing that because the fraud-on-the-market presumption is a condition precedent to class certification, proof of materiality, which is one of the elements of that presumption, is required at the certification stage.

Justice Scalia wrote a separate dissenting opinion, arguing that the "fraud-on-the-market" presumption governs class certification as well as substantive liability, and thus all of its requirements, including materiality, must be satisfied for a court to certify properly a class.

IMPLICATIONS OF THE SUPREME COURT'S OPINION

Along with its prior decision in *Halliburton*, the Court's decision in *Amgen* narrows the ability of defendants to defeat class certification in securities fraud actions. Defendants cannot attack the "fraud-on-the-market" presumption at the class-certification stage by arguing that the statements at issue were not material, as had been the law in the Second Circuit following the decision in *In re Salomon Analyst Metromedia Litigation*, 544 F.3d 474 (2d Cir. 2008).

The opinions in *Amgen* make clear, however, that four justices (Scalia, Kennedy, Thomas, and Alito) favor reexamining the continued validity of the "fraud-on-the-market" presumption of reliance. As Justice Alito notes in his concurring opinion, "recent evidence suggests that the presumption may rest on a faulty economic premise." In his dissent, Justice Thomas similarly stated that "[t]he *Basic* decision is itself questionable," quoting from Justice White's dissent in *Basic* that the Court is "not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory."

Although the Court did not consider the issue because Amgen admitted in its answer that its shares traded in an efficient market, footnote six of the majority opinion discussed "modern economic research tending to show that market efficiency is not 'a binary, yes or no question.'" This footnote may provide an avenue for defendants to defeat class certification by arguing that, as to the specific misrepresentation at issue, the market was inefficient. As the Court explained, "a market may more readily process certain forms of widely disseminated and easily digestible information, such as public merger announcements, than information more difficult to acquire and understand, such as obscure technical data buried in a filing with the Securities and Exchange Commission."

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