# Tightening the Noose on Class Certification Requirements (I): Another Whack at the Fraud-on-the-Market Presumption in Securities Fraud Class Actions

## CASE AT A GLANCE

The Connecticut Retirement Plans and Trust Funds sued Amgen Inc. and corporate officers in a securities fraud class action for losses stemming from alleged misleading statements. The Court will determine whether a class plaintiff, in order to rely on the so-called "fraud-on-the-market" presumption, must prove the materiality of the alleged misstatements as part of the class certification process.

***Amgen, Inc., et al. v. Connecticut Retirement Plans and Trust Funds***
**Docket No. 11-1085**

**Argument Date: November 5, 2012**
**From: The Ninth Circuit**

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## ISSUES

Must a plaintiff seeking certification of a securities fraud class action who invokes a rebuttable fraud-on-the-market presumption provide evidence that alleged misstatements were material to the impact on a company's stock price? In addition, the Court will consider whether a trial court also must give the defendant the opportunity, during the class certification process, to present rebuttal evidence that the alleged misstatements were not material to affect a stock's price.

## FACTS

The Connecticut Retirement Plans and Trust Funds (Connecticut Retirement) filed a securities fraud class action lawsuit against Amgen, Inc., and individual executives (Amgen) on October 1, 2007, in California federal court. The plaintiff alleged that the company artificially inflated the market price for Amgen stock by making misrepresentations about the safety of two Amgen drugs, Aranesp and Epogen. Aranesp and Epogen stimulate red blood cell production and reduce the need for patient blood transfusions, including cancer patients with chemotherapy related anemia. In addition, the drugs have been used for other "off-label" purposes.

Connecticut Retirement alleged that the defendants had knowingly and recklessly made material misstatements and omissions about the Amgen drugs from April 2004 through May 2007, in violation of the Securities Exchange Act of 1934 and Rule 10b-5 of the federal securities laws. It alleged that Amgen had made misrepresentations relating to a 2004 FDA advisory committee meeting, the outcomes of clinical trials of Aranesp, the safety of on-label use of the drugs, and the marketing of these products. Connecticut sought certification under Federal Rule of Civil Procedure 23(b)(3) on behalf of a class of Amgen stock purchasers between April 2004 and May 2007.

In seeking class certification, the plaintiff invoked the so-called "fraud-on-the-market" presumption endorsed by the U.S. Supreme Court in *Basic v. Levinson,* 485 U.S. 224 (1988), which permits a court to presume reliance by all stock purchasers in an efficient market. At class certification the plaintiffs presented expert testimony to show that Amgen stock had been traded in an efficient market, but made no showing about the materiality of Amgen's alleged misstatements.

Amgen opposed class certification on the grounds that Connecticut Retirement did not and could not establish the materiality of the alleged misstatements. Consequently, Amgen argued, Connecticut Retirement was not entitled to take advantage of the "fraud-on-the-market" presumption to bootstrap a classwide finding of reliance. In absence of this presumption, Amgen argued, the court could not certify the class action under Rule 23(b)(3), which requires that common questions of law or fact predominate over individual questions. In addition, Amgen contended that it ought to be entitled to rebut the presumption by showing that the market was already privy to the truth, and therefore no alleged misrepresentation had any impact on its stock price.

The district court certified the class action, rejecting Amgen's arguments. See *In re Amgen Inc. Sec. Litig.,* 544 F. Supp. 2d 1009 (C.D. Cal. 2008). The court held that Amgen's arguments requiring proof of materiality did not concern Rule 23 requirements for class certification, but instead pertained to the merits of the underlying securities fraud claims. The court indicated that the class certification inquiry was not the appropriate time to consider whether a defendant's statements were material so as to affect a market price. The court indicated that inquiries into issues such as materiality and loss causation—elements of a Rule 10b-5 claim—are properly taken up at a later stage of proceedings.

The Ninth Circuit Court of Appeals affirmed the district court's class certification order, holding that Connecticut Retirement did not need to prove the element of materiality in order to avail itself of the fraud-on-the-market presumption of reliance. *In re Amgen Inc. Sec. Litig.,* 660 F.3d 1170 (9th Cir. 2012). The appellate court held that a plaintiff did not need to prove materiality at class certification because whether any alleged misstatements were material or immaterial, the class claims stood or fell together: thus, materiality was a question common to the class and affected investors alike.

Further, the Ninth Circuit held that in adopting the *Basic* presumption, the Supreme Court had not required proof of materiality for class certification. And, unlike the showing of an efficient market, a plaintiff need not prove the materiality of the alleged misstatements as a precondition for class certification. Instead, the Ninth Circuit agreed with the district court that materiality was an element of the merits of a security fraud claim that should be addressed at trial or by a summary judgment motion. The appellate court held that the plaintiff had only to "allege materiality with sufficient plausibility to withstand a 12(b)(6) motion to dismiss."

Finally, because the Ninth Circuit held that a plaintiff need not prove the materiality of alleged misstatements as a precondition for class certification, the court also upheld the district court's refusal to consider Amgen's rebuttal evidence on that issue. The appellate court rejected Amgen's contention that it should be permitted to introduce evidence of the fraud-on-the-market defense at class certification, reasoning that this defense is just a method of refuting the materiality of the alleged misrepresentations.

## CASE ANALYSIS

Shareholder securities fraud class actions are a specialized type of fraud litigation. When a plaintiff individually pursues an ordinary common law fraud claim, the plaintiff must prove that he or she knew of an alleged fraudulent or misleading statement, and relied on that statement to the claimant's detriment. This is known as the "reliance" element of a fraud claim, and in individual lawsuits, this is a highly individual fact question that turns on what a plaintiff knew and read, where the plaintiff obtained the information, and other individual factors.

Pursuing fraud claims in the class action context, however, has been extremely difficult because the reliance element of a fraud claim often undermines the ability of class plaintiffs to obtain certification. In order to certify a fraud class action for damages under Rule 23(b)(3), plaintiffs must demonstrate that common issues of law or fact predominate over individual issues. Therefore, because common law fraud claims entail an inherently individual reliance issue, almost all courts have refused to certify fraud class actions because such classes cannot satisfy the predominance requirement.

Securities fraud class actions—as a subset of fraud actions—are governed by a federal statutory scheme under the Securities Exchange Act of 1934, which is implemented by Rule 10b-5. A private plaintiff seeking relief for a securities law violation must allege and prove certain elements: (1) a material misrepresentation or omission by the defendant, (2) scienter (intent to misrepresent or deceive), (3) a connection between the misrepresentation or omission and the purchase of a security, (4) reliance upon the misrepresentation or omission, (5) economic loss, and (6) loss causation. *Matrixx Initiatives, Inc. v. Siracusano,* 131 S. Ct. 1309 (2011). Because reliance is an element of a securities fraud action and is inherently individualized, this would prevent class certification of virtually all securities fraud class actions.

In 1988, the Supreme Court announced a doctrine to enable class certification in securities fraud class actions by substituting a rebuttable presumption: security purchasers may rely on the integrity of the market price, which is presumed to incorporate all public, material misrepresentations. See *Basic Inc. v. Levinson*. This so-called *Basic* presumption, or the "fraud-on-the-market" presumption, enables a plaintiff in a securities fraud class action to submit proof of an efficient market of reliance in lieu of individual proof that would otherwise always undermine and defeat the predominance requirement for a Rule 23(b)(3) class action.

In order to invoke the fraud-on-the-market presumption, a plaintiff must establish that (1) the defendant made public, material misrepresentations, (2) the defendant's shares were traded in an efficient market, and (3) the plaintiff traded shares between the time the misrepresentations were made and the time the truth was revealed.

However, the Court in *Basic* did hold that, after a plaintiff satisfies these criteria, a defendant could then rebut the reliance presumption by showing that the misrepresentation in fact did not lead to a distortion in price. The *Basic* decision indicates that a defendant may rebut the presumption of reliance by refuting the elements of the presumption (such as market efficiency) or by making "[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."

If a defendant successfully rebuts the reliance presumption, then the causal connection between the misrepresentation and the plaintiff's reliance would be broken. At that point, plaintiffs must respond with sufficient evidence to reestablish the presumption. If the plaintiffs cannot, then they would have to establish reliance on a plaintiff-by-plaintiff basis. Thus, if plaintiffs cannot demonstrate that they are entitled to a presumption of reliance on the market price, or otherwise show that common issues predominate over individual issues, then a court may not certify a class action under Rule 23.

The core dispute in *Amgen* centers on whether a plaintiff, in seeking to invoke classwide reliance afforded by the "fraud-on-the-market" presumption, has to demonstrate as a precondition to class certification that the alleged misstatements are material to a finding of a Rule 10b-5 violation.

The *Amgen* appeal follows one year after the Court's decision in *Erica P. John Fund, Inc. v. Halliburton,* 131 S. Ct. 2179 (2011). There a corporate defendant (Halliburton) similarly asked the Supreme Court to tighten class certification requirements in securities fraud cases that invoke the "fraud-on-the-market" presumption. Similar to this *Amgen* appeal, Erica P. John Fund, Inc., brought a securities fraud class action on behalf of its shareholders against Halliburton, alleging it committed securities violations by deliberately falsifying information and misleading the public. On appeal, Halliburton contended that a plaintiff must prove "loss causation" as a predicate to application of the *Basic* fraud-on-the-market presumption.

In a unanimous opinion authored by Chief Justice Roberts, the Court rejected Halliburton's suggestion to tighten a plaintiff's pleading burden of proof at class certification, which would have required securities plaintiffs to provide additional proof in order to invoke and rely on the "fraud-on-the-market" presumption in lieu of actual reliance. The Court answered the simple question whether a plaintiff in a Rule 10b-5 securities class action must prove loss causation to obtain class certification with an unqualified "No."

In *Erica P. John Fund, Inc.,* the Court rejected prior appellate decisions that suggested that a plaintiff needed to prove loss causation in order for a court to apply the presumption of reliance to certify a Rule 23(b)(3) class. In so doing, the Court reaffirmed the continuing vitality of the Court's creation of a rebuttable presumption of reliance based on the fraud-on-the-market theory in *Basic*. The Court indicated that a rule requiring the proof of loss causation as a precondition to class certification contravened *Basic*'s fundamental premise: that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his or her transaction.

The Court noted that loss causation addresses something different than whether an investor relied on a misrepresentation when buying or selling a stock. Thus, the element of reliance in a private Rule 10b-5 action refers to *transaction causation,* and not loss causation (which requires a showing of subsequent economic loss). The Court held that appellate decisions requiring proof of loss causation for class certification was not justified by the *Basic* decision or its logic. The Court indicated that it had never before mentioned that proof of loss causation as a precondition for invoking *Basic*'s presumption of reliance. In addition, the term "loss causation" does not even appear in the *Basic* decision. However, the Court limited its opinion by not addressing any other question about the *Basic* decision, its presumption, or how or when the *Basic* presumption might be rebutted.

Amgen maintains that the Rule 23(b)(3) predominance requirement can only be satisfied in securities fraud actions through the fraud-on-the-market presumption, and that plaintiffs cannot invoke the presumption unless the plaintiffs establish all of its predicates, including the materiality of the alleged misstatements. Amgen contends that the Supreme Court held, in *Basic,* that plaintiffs must prove prior to class certification that the alleged misstatements underlying their claims were material.

Proof of materiality, Amgen argues, is a key predicate to the fraud-on-the-market theory that is central to the presumption of classwide reliance. Amgen asserts that because immaterial statements do not affect a stock's price, there is no basis to assume that investors relied in common when they bought or sold Amgen stock.

As a purely procedural matter, Amgen argues that the Ninth Circuit's ruling is contrary to the spirit of the Court's decision in *Wal-Mart Stores, Inc. v. Dukes,* 131 S. Ct. 2541 (2011). Amgen suggests that the *Dukes* Court reaffirmed a rigorous analysis standard for class certification, which requires courts to examine all relevant matters at the certification stage, including those matters that are related or even integral to the merits of the underlying claim. Amgen contends that the issue is not whether a court will have an opportunity to reexamine a question later in the proceedings, but whether an action should be allowed to proceed at all before the plaintiffs have established the Rule 23 requirements.

In addition, in a series of policy-based arguments, Amgen suggests that permitting courts to certify securities fraud class actions without first finding all the predicates for the fraud-on-the market presumption would have harmful consequences. These negative consequences include the enormous settlement pressure upon defendants to settle securities fraud class actions, without the plaintiffs ever having to prove one of the predicates to the theory (materiality of the misstatements) that would allow for the class action in the first place.

Finally, Amgen urges that the Court in *Basic* expressly stated that the fraud-on-the-market presumption was rebuttable, and that a successful rebuttal defeats class certification. Therefore, the lower courts erred in disallowing Amgen's rebuttal evidence of truth in the market. According to Amgen, it makes no sense to force defendants to wait until later in the proceedings to show that, as a consequence of the immateriality of the alleged misstatements, the class action should never have been certified initially.

In response, Connecticut Retirement argues that the lower courts correctly decided that a plaintiff does not need to prove the materiality of the alleged misstatements in order to invoke the fraud-on-the-market presumption to certify a class under Rule 23. To engraft this requirement on plaintiffs seeking certification of a securities fraud class action would go beyond what Rule 23 requires, or the Court's precedents. Connecticut Retirement points out that the Court, just last term, resisted imposing proof of loss causation as a precondition to the fraud-on-the-market presumption in *Erica P. John Fund, Inc.*

In addition, Connecticut Retirement argues that the materiality of a defendant's misstatements is indisputably a common question for the entire class. In this view, the immateriality of a defendant's misstatements would not demonstrate dissimilarity among class members that would defeat a predominance of common questions. Instead, such a showing would demonstrate the immateriality of the statements affecting all class members alike. If a misstatement is material or immaterial, it would be so for all investors who are members of the class.

According to Connecticut Retirement, the Court's *Basic* decision merely requires that the plaintiff demonstrate the existence of an efficient market. If the plaintiff can demonstrate that securities were traded in an efficient market, then reliance converges with the common questions of materiality and falsity. In Connecticut Retirement's view, the *Basic* decision did not alter the fact that materiality is a common question that need not be proved to certify a class.

Connecticut Retirement contends that proof of the materiality of a defendant's misstatements is a merits question that should be deferred until a later stage of proceedings. Proof of materiality, Connecticut Retirement argues, is a fact-intensive issue that would impose considerable discovery burdens and impair judicial efficiency at the class certification stage. The appropriate time for a court to test the materiality of alleged misstatements—which is an element of a Rule 10b-5 claim—is on a summary judgment motion or at trial.

Parsing the *Wal-Mart* decision, Connecticut Retirement suggests that the commonality for class certification requires that the action be capable of providing common answers for the entire class. In this view, *Basic*'s provision for rebuttal evidence would only be

appropriate at the class certification stage if this evidence would demonstrate intraclass dissimilarities that would prevent common *answers* that are apt to drive the litigation. Connecticut Retirement argues, however, that rebuttal evidence on materiality would not disprove commonality; instead, it would disprove materiality for the entire class. Thus, rebuttal of materiality is not appropriate at the class certification stage.

Connecticut Retirement further refutes Amgen's policy-based arguments, contending that it is inappropriate to ask the Court to adopt "naked policy arguments" rather than follow the dictates of Rule 23 and jurisprudence applying the rule. Policy arguments related to class litigation are in the proper purview of the legislature, which has considered and struck the proper balance between consumer protection and corporate operations. Moreover, Connecticut Retirement contends that there is sparse empirical support for the defendant's invocation of the "in terrorem" effect of class certification in the securities class action arena.

## SIGNIFICANCE

In the broadest sense, *Amgen,* similar to last year's *Erica P. John Fund, Inc.,* is significant because the Court again will determine whether to uphold liberal standards for certification of securities class actions or will tighten those *Basic* requirements for invoking and applying the fraud-on-the-market presumption of reliance. The fight embodies a dispute concerning what plaintiffs have to demonstrate at the class certification stage to permit a court to allow a securities class action to proceed.

And, similar to *Erica P. John Fund, Inc., Amgen* could have broad implications for stock market investors seeking recovery for investment fraud. Connecticut Retirement and its amicus Public Citizen have cast the appeal as a consumer protection case, asking the Court not to turn investors away from the courthouse door at the class certification stage. The United States government, as amicus, has joined the plaintiffs in asking the Court to uphold the *Basic* holdings.

The Court will have to determine whether federal courts may require plaintiffs to prove the materiality of alleged misstatements at the class certification stage. The plaintiff has suggested that this requirement embodies illegitimate "heightened pleading" at the class certification stage and imposes an improper assessment of the merits of the case, before trial. The plaintiff further suggests that this is an unfair burden to impose on plaintiffs at an early stage of litigation, when the appropriate stage of proceedings for determining this "merits" question is either on a motion for summary judgment, or at trial.

The defendant, on the other hand, views the role of the court at class certification as evaluating whether it makes common sense to proceed with a proposed class action that could not actually be tried because the alleged misstatements actually were not material to have affected market pricing. The defendant sees no point in permitting class certification to proceed when at some later time it is subsequently proven that the alleged misstatements were not material and therefore could not have affected market pricing.

If the alleged misstatements cannot be proven to have been material, as part of the class certification process, then the defendants suggest that a proposed class action that cannot satisfy the Rule 23 requirements ought to be dismissed at the certification stage. The defendants cite to the large economic costs entailed in defending class actions, and the settlement pressure on defendants to settle cases if a court certifies a class even in the instance of meritless claims.

In recent years, the Supreme Court has evinced a trend towards supporting heightened pleading requirements for ordinary and class action complaints. In addition, several prominent lower federal courts, including the Second and Third Circuits, also have issued landmark decisions clarifying and strengthening the evidentiary burdens of production and persuasion at class certification. On the other hand, the Court just last year in *Erica P. John Fund, Inc.* refused to read a proof of "loss causation" requirement into class certification proceedings in order to apply the presumption of reliance.

As with *Erica P. John Fund, Inc.,* it is of some note that the Court has changed personnel since the *Basic* decision in 1988. Only four justices joined the Court's *Basic* opinion then: Justices Blackmun, Brennan, Marshall, and Stevens. Hence, none of the Court's *Basic* supporters remain on the Court. Chief Justice Rehnquist and Justices Scalia and Kennedy did not participate in the *Basic* decision, and Justices White and O'Connor dissented in relevant parts. Hence, the Court now has been almost completely reconstituted since the *Basic* decision, which first articulated the fraud-on-the–market presumption.

Moreover, when Justice Alito sat on the Third Circuit, he held on motions to dismiss that a plaintiff must establish a misrepresentation's price impact in order to invoke *Basic*'s fraud-on-the-market presumption. See *In re Burlington Coat Factory Sec. Litig.,* 114 F.3d 1410 (3d Cir. 1997); *Oran v. Stafford,* 226 F.3d 275 (3d Cir. 2000). It remains to be seen whether, in consideration of *Amgen,* Justice Alito will import his views into the class certification context, which he apparently did not in last year's *Erica P. John Fund, Inc.* decision.

It will also be interesting to see how the Court analyzes the fundamental issue in *Amgen* in the context of the very similar issue raised by *Erica P. John Fund, Inc.,* which must be fresh in the Justices' minds. On the one hand, upholding the Ninth Circuit's decision and preserving a liberal interpretation of the *Basic* decision and presumption would seem consistent with the Court's analysis in *Erica P. John Fund, Inc.* On the other hand, the Court will have to distinguish the concept of materiality from that of loss causation to explain why the Ninth Circuit's decision requires reversal. Such a decision would then place an additional burden on plaintiffs seeking certification of security fraud class actions.

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*PREVIEW of United States Supreme Court Cases,* pages 72–76.

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