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Materiality

A *Basic* Question: Is Materiality the Better Standard for Class Certification in Securities Fraud Lawsuits?

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The growing disagreement among federal courts over the timing for proving materiality in securities-fraud class actions highlights how unworkable the fraud-on-the-market (FOTM) inquiry currently is. In *Basic Inc. v. Levinson*,[1] the U.S. Supreme Court held that a purported class of shareholders may take advantage of the FOTM presumption of reliance if it can make certain showings at the class-certification stage. In the intervening 20-plus years, Courts of Appeals have become divided on whether this showing includes proof at the class certification stage that the misstatement at issue is "material." In other words, are plaintiffs merely required to prove that a security is traded on an efficient market, which assumes any material misstatement impacts the price, or must plaintiffs also prove that the statement at issue was, in fact, material, thus impacting the price of the stock?

It is likely only a matter of time before the Supreme Court will need to address this issue. Three Courts of Appeals have held that plaintiffs must prove materiality to take advantage of the FOTM presumption, while three other Courts of Appeals have held the opposite.

When the Supreme Court does resolve this circuit split, the best approach may be to reexamine one of the core premises in *Basic*: its reliance on efficiency. *Basic's* holding rests on the assumption that perfectly efficient markets exist, and in such efficient markets, *any* material statement will have a corresponding effect on price. But numerous examples over the last two decades have revealed that this assumption is not always true: While *many* material statements will affect price in a reasonably "efficient" market, *no* market is so perfectly efficient that price impact can be assumed. A better inquiry would focus on the market effect on the price when the statement was issued. Using this approach, there is no question that the statement at issue moved the market–and thus, no question that the FOTM presumption is appropriate. This, in essence, is a materiality inquiry.

Looking to market impact (and thus, to materiality) at the class certification stage has several practical benefits. Besides being a more theoretically sound application of the FOTM theory, looking to market impact instead of market efficiency would discourage strike suits of well-traded stocks, allow more meritorious suits of less widely traded stocks, and provide lower courts with a more administrable class certification process. These benefits provide ample reason to reexamine *Basic*.

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Basic's Vague Materiality Holding and the Circuit Split that It Engendered

The FOTM theory is a necessary presumption for securities fraud suits to proceed as class actions. Federal Rule of Civil Procedure 23(b) requires plaintiff to demonstrate that common issues predominate over individualized issues. If reliance must be established for each member of the class, it normally will prevent class certification because individualized issues will predominate over common ones. In *Basic*, the Supreme Court resolved this conflict by holding that a purported class may invoke the "fraud-on-the-market theory," which provides that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price," to enjoy a rebuttable presumption of reliance.[2]

Courts around the nation agree that in order to take advantage of *Basic's* presumption of reliance, a plaintiff must show that the misrepresentation at issue was public and that the stock at issue traded in an "efficient" market–that is, a market that quickly incorporates all information. But *Basic* did not state clearly whether materiality should be a required showing to enjoy the FOTM presumption at the class certification stage, or only considered as a merits issue.

Basic's lack of clarity on this point has caused a circuit split. The First, Second, and Fifth Circuits have held that a materiality showing is required at the class certification stage.[3] These decisions rely either on *Basic's* footnote 27, which notes that the Court of Appeals below had stated that, among other things, "in order to invoke the presumption, a plaintiff must allege and prove . . . that the misrepresentations were material," or on *Basic's* admonition that "the presumption of reliance may be rebutted by '[a]ny showing that severs the link between the alleged misrepresentation and the price received (or paid) by the plaintiff.'"[4] The Fifth Circuit also has considered the policy reasons for establishing a materiality requirement at this stage.[5]

Taking a contrary tack, the Third and Seventh Circuits–and most recently, the Ninth Circuit in its November 2011 decision *Connecticut Retirement Plans and Trust Funds v. Amgen, Inc*.[6]–have declared that a materiality analysis should wait until the merits stage because it is a merits inquiry common to the entire class.[7] These decisions generally reason that the positions of the First, Second, and Fifth Circuits misread *Basic's* footnote 27, and in reality, "[a]ll note 27 in *Basic* does is state that the court of appeals deemed materiality essential; the Justices did not adopt it as a precondition to class certification."[8]

Why *Basic's* Current Efficiency-Based Framework Does Not Work

With three Courts of Appeals in favor of imposing a materiality requirement at the class certification stage and three against, it appears that the circuit split will continue to grow until the Supreme Court resolves the issue. The Supreme Court had the opportunity to resolve this issue last year in *Erica P. John Fund v. Halliburton*. It declined to do so, however, and considered only the question of "loss causation."[9] If and when the Supreme Court does face the materiality issue, it should take the opportunity to reexamine *Basic's* premises entirely–and likely would find that *Basic's* reliance on the efficiency of capital markets is misplaced. In its stead, the Supreme Court should implement a "price impact" requirement, which is essentially a materiality inquiry. Let's first turn to why *Basic's* efficiency-based framework is unsuccessful.

– *Basic* Was Wrong in Concluding that Well-Developed Markets Are Perfectly Efficient

First, *Basic's* efficiency-based framework should be reexamined because *Basic's* assumptions about the ubiquity and strength of the efficiency of capital markets are not wholly accurate. *Basic* holds that the FOTM presumption can be invoked only when a plaintiff can show that the relevant market is "efficient"–that is, the market is so well-developed that it "reflects all publicly available information" in its price, including "any public material misrepresentations."[10] This is a concept embodied in the "efficient capital markets hypothesis." *Basic* reasoned that because every public material misrepresentation made in an "efficient" market is reflected in a security's price, "an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action."[11] In short, *Basic* combined the efficient capital markets hypothesis and the FOTM theory to fashion a shortcut for securities fraud plaintiffs seeking class certification: Rather than showing that a "fraud on the market" actually took place, all that is necessary is to show that the relevant market is efficient. If it is, any public material misrepresentation would effect a "fraud on the market." Although *Basic* claimed "not to assess the general validity of" the efficient capital markets hypothesis and the FOTM theory,[12] it nevertheless accepted them in holding that a presumption of reliance is appropriate when market efficiency has been established.

But in the years since *Basic*, the premise that "the market price of shares traded on well-developed markets reflects all publicly available information" has been shaken–at least to a degree. Clearly, some well-developed markets incorporate *most* information into prices *relatively* quickly. However, evidence suggests that even the most open markets are not completely efficient, and therefore will incorporate some information slowly (or not at all). This development shakes *Basic's* reliance on a market efficiency inquiry.

A prominent example of an unexpected market inefficiency can be found in *In re Merck & Co. Securities Litigation*.[13] In *Merck*, important information regarding the pharmaceutical giant–certainly a large and widely-followed firm in a well-developed market–first was released to the public in a complicated format through an SEC filing, to no demonstrable market effect.[14] The efficient capital markets hypothesis would suggest that this information would be incorporated rapidly into Merck's stock price. But when an article in the *Wall Street Journal* "read[] between the lines of this disclosure" several weeks later, the result was a significant decline in price.[15] While it could be argued that the evidence was not considered material, it seems more likely that the market did not incorporate the information until

the *Wall Street Journal* article emerged. Empirical research has shown similar market inefficiencies in many other instances.[16] In light of this evidence, *Basic's* assumption that a particular alleged fraud *necessarily* will be incorporated into the stock price is not a certainty.[17]

– Efficiency Is Hard for Parties to Litigate and for Courts to Determine

Second, since *Basic*, lower courts have implemented difficult and imprecise tests to judge market efficiency. *Basic* permits plaintiffs, upon a showing of efficiency, to substitute a rebuttable presumption of reliance for a showing that the alleged misrepresentations at issue actually influenced the market price. This substitution suggests both that (1) many large markets are perfectly efficient; and (2) evaluating a security's overall efficiency is more practicable than determining whether the misstatement at issue actually distorted the market price.[18] But as explained above, markets are rarely, if ever, totally efficient. What's more, showing efficiency is in most cases a more difficult task than demonstrating distortion of market price caused by a particular misstatement.

No one–not even economic experts–has devised an agreed-upon test for demonstrating efficiency.[19] It is hardly surprising, then, that courts examining efficiency to assess the soundness of applying *Basic's* FOTM presumption have trouble doing so. Courts have resorted to examining proxies associated with efficient markets. If the proxies indicate a sufficiently large and developed market, the market is deemed efficient. Courts look to the percentage of shares traded weekly; whether "a significant number" of analysts follow and report on the stock; the existence of market makers trading the stock; and other factors.[20] Courts struggle with applying these factors, and many have questioned the accuracy of examining them.[21]

– A Focus on Market Efficiency Improperly Limits the *Basic* Presumption to Large Markets Only

Finally, it is worth noting that by being limited to "efficient" (i.e., well-developed) markets, *Basic's* presumption of reliance is underutilized. That means that in less developed markets–where fraud is more likely to occur[22]–*Basic* probably cannot be used by a purported class, even if clear market movement due to a misstatement could be shown. For example, under prevailing caselaw, *Basic's* presumption of reliance has been held to be unavailable to investors in newly-issued securities,[23] mortgage-backed bonds,[24] and securities in less developed markets,[25] even when the false statement at issue is significant. A class-action remedy, thus, frequently is unavailable because the class cannot show efficiency.

Similarly, because *Basic's* presumption is likely to lead to class certification whenever fraud in a large, well-traded company is suspected (because such markets almost automatically are considered "efficient"), less-meritorious fraud cases against large companies are more likely to have a class certified. Although defendants can assert a lack of actual reliance as a defense on the merits, as a practical matter, once a class action is certified, such cases overwhelmingly are likely to settle.[26] Because such settlements are procured most easily from the largest and most well-traded companies (which have the most to lose and can most readily afford them), they create a significant impact on the capital markets.[27]

A Materiality Inquiry Should Replace *Basic's* Efficiency-Centric Approach

As noted above, *Basic's* efficiency requirement has a number of problems. But accepting that courts' efficiency tests are not administrable, or that even well-developed markets sometimes are inefficient, does not mean that a presumption of reliance based on the FOTM theory could not survive–far from it. Instead, courts simply could look to materiality–in the form of a price-impact requirement–rather than focusing on efficiency as counseled in *Basic*, to justify the FOTM presumption.

The core inquiry in whether the FOTM presumption of reliance is appropriate is whether the market as a whole relied *on a particular piece* of allegedly fraudulent information. It does not demand a high overall level of market efficiency–simply that the market be efficient enough to have relied on the precise misstatement at issue in a particular class action.[28] Therefore, all that is necessary to justify application of the FOTM presumption is evidence of the *particular* complained-of misstatement's effect on a security's market price–not whether that market incorporated *all* information into market price (as *Basic* demands). In light of this, courts easily could shift the focus of FOTM inquiries from a market's overall efficiency to the question whether the fraud *at issue* affected market price. This, in essence, is a materiality/price impact inquiry, involving evidence on whether a security's price was affected by the particular relevant misstatement.[29]

Determining whether a particular piece of information affected a security's price is achievable easily in most instances by undertaking an event study–an economic analysis of the stock price. Event studies have been accepted by courts, academics, and the SEC,[30] and are more accurate than the efficiency proxies currently studied by courts. By using event studies, looking to materiality, in the form of price impact, is simply a more administrable standard than the efficiency inquiry put forth by *Basic*.

Although those Courts of Appeals that disapprove of a materiality inquiry have been loath to examine materiality because of its connection to the merits, this unwillingness is unsupportable. The mere fact that "materiality" is also an element of proof for the underlying securities fraud cause of action does not lessen its significance at the class certification stage. The FOTM presumption is a rebuttable one that must be invoked at the class certification stage–and as explained above, FOTM most easily and accurately is demonstrated by a price-impact analysis. As the Second Circuit has observed, "there is no reason to lessen a district court's obligation to make a determination that

every Rule 23 Requirement is met before certifying a class just because of some or even full overlap of that requirement with a merits issue."[31] Thus, plaintiff must establish fully the FOTM presumption–and a defendant should have the opportunity to rebut it–at the class certification stage.

Conclusion

If the Supreme Court revisits *Basic* to resolve the circuit split exacerbated by *Amgen*, it should revisit it entirely and reexamine its doctrinal underpinnings and real-world effects. If the Court does, it may find that a materiality standard at the class certification stage makes good sense.

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[1] 485 U.S. 224 (1988).

[2] *Id.* at 241-48. Federal Rule of Civil Procedure 23(b)(3) requires that common questions of law or fact "predominate" over questions particular to individual class members' claims. Without a presumption of reliance, questions of individual investors' reliance likely would predominate, rather than common questions of law or fact, making class certification impossible.

[3] *See In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 481 (2d Cir. 2008) (noting that the FOTM presumption may be invoked when a purported class shows that "a defendant has (1) publicly made (2) a material misrepresentation (3) about stock traded on an impersonal, well-developed (i.e., efficient) market"); *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 264 (5th Cir. 2007) ("Reliance is presumed if the plaintiffs can show that '(1) the defendant made public material misrepresentations. . . .' ") (citation omitted), *abrogated on other grounds by Erica P. John Fund v. Halliburton*, 131 S. Ct. 2179, 2183, 2186 (2011); *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 8 n.11 (1st Cir. 2005).

[4] *Oscar*, 487 F.3d at 265; *see also PolyMedica*, 432 F.3d at 8 n.11 (stating that plaintiff must prove materiality to enjoy FOTM presumption) (quoting *Basic*, 485 U.S. at 248 n.27 (1988)); *Salomon*, 544 F.3d at 481 (same).

[5] *See Oscar*, 487 F.3d at 265 (discussing settlement pressure caused by class certification).

[6] 660 F.3d 1170 (9th Cir. 2011).

[7] *See Amgen*, 660 F.3d at 1177; *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631 (3d Cir. 2011) ("To invoke the fraud-on-the-market presumption of reliance, plaintiffs must show they traded shares in an efficient market, and the misrepresentation at issue became public.") (citations omitted); *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010) (noting that "whether statements were false, or whether the effects were large enough to be called material, are questions on the merits").

[8] *Amgen*, 660 F.3d at 1176 (quoting *Schleicher*, 618 F.3d at 687).

[9] In *Halliburton*, the plaintiff appealed the Fifth Circuit's holding that the prospective class should not be certified because the plaintiff could not show that corrective disclosures were related to previous misstatements. The question presented to the Supreme Court was whether a plaintiff must prove that the defendant's deceptive conduct caused the claimed economic loss in order to take advantage of the FOTM presumption at the class certification stage. However, the appellee, Halliburton, urged that the Supreme Court resolve a different question: whether a plaintiff could enjoy the FOTM presumption in the absence of any showing of market impact from the misrepresentations at issue. Halliburton asked the Supreme Court to consider the market-impact question instead of addressing the loss causation issue because language used by the Fifth Circuit appeared to impose a price impact requirement rather than a true loss causation requirement. *See* 131 S. Ct. at 2187 (reviewing Halliburton's argument). However, the Supreme Court declined to consider the appropriateness of a "price impact" requirement. Instead, it took the Fifth Circuit "at its word" when it used the term "loss causation" and considered only the question squarely presented by the appellant. Unsurprisingly–since even Halliburton conceded that plaintiffs should not be required to prove loss causation in order to invoke *Basic's* presumption of reliance–the Supreme Court rejected the Fifth Circuit's loss causation requirement. *Id.*

[10] *Basic*, 485 U.S. at 246-47 & n.24.

[11] *Id.* at 247.

[12] *Id.* at 242.

[13] 432 F.3d 261 (3d Cir. 2005).

[14] *Id.* at 269-70.

[15] *Merck*, 432 F.3d at 263, 265.

[16] *See, e.g.*, Rebecca Files et al., *Stealth Disclosure of Accounting Restatements* (Apr. 27, 2009), *available at* http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=1395768 (providing evidence of large disparities in market reaction to accounting restatements as a result of the prominence of the restatements); Saeyoung Chang & David Y. Suk, *Stock Prices and the Secondary Dissemination of Information: The Wall Street Journal's "Insider Trading Spotlight" Column*, 33 Fin. Rev. 115, 115-17 (1998) (showing that the *Wall Street Journal's* publication of reports of trading by corporate insiders rapidly and significantly affects that corporation's stock price, even though the SEC usually makes such reports public several days earlier).

[17] *See, e.g.*, Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 Wis. L. Rev. 151, 176 (2009) (noting possibility that market missed implications of *Merck's* initial disclosures).

[18] *See Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, 967 F.2d 742, 748 (2d Cir. 1992) ("To saddle a plaintiff with proving the 'generally indeterminable fact of what would have happened but for the omission [or the misrepresentations that skewed the market value of stock] would reduce the protection against fraud afforded by Section 10(b).'" (quoting *duPont* v. *Brady*, 828 F.2d 75, 78 (2d Cir. 1987))).

[19] Because economists "do not know how to []calculate the price that fully reflects the available information," it is difficult at best to test whether a market fully reflects all publicly available information. Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. Corp. L. 517, 525 (2003); Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. Fin. 1575, 1575 (1991) ("[M]arket efficiency per se is not testable.").

[20] *Cammer* v. *Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989); *see also Krogman v. Sterritt,* 202 F.R.D. 467, 478 (N.D. Tex. 2001); *O'Neil* v. *Appel*, 165 F.R.D. 479, 503 (W.D. Mich. 1996).

[21] *See, e.g.*, Victor L. Bernard et al., *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of Fraud-on-the-Market Theory*, 73 Neb. L. Rev. 781, 796 (1994).

[22] *See* Geoffrey Christopher Rapp, *Proving Markets Inefficient: The Variability of Federal Court Decisions on Market Efficiency in* Cammer v. Bloom *and its Progeny*, 10 U. Miami Bus. L. Rev 303, 322-23 (2002); Advisory Comm. on Smaller Public Companies, Final Report to the U.S. Securities & Exchange Commission 139 (2006), *available at* http://www.sec.gov/info/ smallbus/acspc/acspc-finalreport.pdf (noting that "small firms consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms").

[23] *See In re Initial Pub. Offerings Sec. Litig.*, 471 F.3d 24, 42 (2d Cir. 2006); *Freeman* v. *Laventhol & Horwath*, 915 F.2d 193, 199 (6th Cir. 1990).

[24] *See Teamsters Local 445 Freight Div. Pension Fund v. Bombardier Inc.*, 546 F.3d 196, 210 (2d Cir. 2008).

[25] *See Krogman* v. *Sterritt*, 202 F.R.D. 467, 474-78 (N.D. Tex. 2001).

[26] *See* Jordan Milev et al., *Trends 2010 Year-End Update* 15 (Dec. 14, 2010) (unpublished manuscript), *available at* http://www. nera.com/67_7118.htm (noting that since "December 1995, over 3,400 [securities class actions] have been filed, and over that time only 28 cases have gone to trial"); Richard A. Nagareda, *Class Certification in the Age of Aggregate Proof*, 84 N.Y.U. L. Rev. 97, 99 (2009) (observing that class certification usually "sets the litigation on a path toward resolution by way of settlement"); Bruce H.

Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 Ariz. L. Rev. 733, 743 (2004) (stating that "many certified class actions settle quickly"); Bryant G. Garth, *Studying Civil Litigation Through the Class Action*, 62 Ind. L.J. 497, 501 (1987) (reporting a 78 percent settlement rate for certified class actions and only a 15 percent settlement rate for noncertified cases).

[27] *See* Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson*,* 77 Va. L. Rev. 1017, 1017 (1991) ("Whereas *Basic* in one sense widens the scope of the securities fraud action by lowering the burden of proof for a particular class of plaintiffs, at the same time it limits the scope by withholding effective legal redress from another class of plaintiffs, traders in inefficient markets.").

[28] As long as a market functions well enough that the specific representation at issue was incorporated into a security's price, *see* Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 Cornell L. Rev. 907, 911 (1989), a showing of general efficiency is unnecessary. *See* Macey et al., *supra* note 11, at 1021 (1991); Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. Chi. L. Rev. 879, 904 (1998) (stating that "adherence to the [efficient capital markets hypothesis] is not critical for the fraud-on-the-market theory").

[29] *See generally* Macey et al., *supra* note 11.

[30] *See In re N. Telecom Ltd.*, 116 F. Supp. 2d 446, 460 (S.D.N.Y. 2000); *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1181 (N.D. Cal. 1993); Mark L. Mitchell & Jeffry M. Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 Bus. Law. 545, 572-84 (1994) (describing SEC enforcement actions using event study analysis).

[31] *In re Initial Public Offerings Sec. Litig.*, 471 F.3d 24, 41 (2d Cir. 2006).