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Class and Derivative Actions

Securities Litigation and Enforcement

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Supreme Court Securities Law Ruling Adopts Plaintiff-Friendly Standard

When the U.S. Supreme Court last year agreed to hear the case of *Connecticut Retirement Plans v. Amgen*, many corporate defense attorneys viewed it as an opportunity for the Court to impose a higher burden on class action plaintiffs in securities fraud cases, and thus provide corporate defendants greater leverage in settlement negotiations.

But when the Court decided the case this week, it delivered a very different result. The Court adopted a standard with a lower barrier to obtaining class certification, strengthening the position of shareholder plaintiffs' lawyers.

The Court's 6-3 decision resolved the specific issue of whether, in seeking certification of a class in a securities fraud action under section 10(b) of the Securities Exchange Act of 1934, the plaintiff must prove that the defendant's alleged misrepresentations or omissions were material.

Some circuits had held that plaintiffs bear this burden (or that defendants would at least have the opportunity of disproving materiality in response to a class certification motion), while others had held they did not, the approach affirmed by the Supreme Court in *Amgen*.

This issue of legal doctrine has critical real-world impact. When a plaintiff wins certification of a class, a defendant's potential exposure increases dramatically. That means that the plaintiffs gain leverage in settlement negotiations, as defendants have more incentive to settle a class, as opposed to an individual, action. Making it harder to certify a class strengthens the position of defendants; making it easier helps plaintiffs.

Amgen was a typical securities fraud class action suit, meaning that the plaintiff asserted a claim based on the "fraud-on-the-market" theory, That theory makes it easier for plaintiffs to prove the "reliance" element of a section 10(b) claim. Plaintiffs normally show reliance by demonstrating that they individually relied on specific statements by a company or its executives in purchasing its stock. That

would be problematic for a class action, however. Having to prove each plaintiff's individual reliance likely would push to the forefront questions affecting individual class members, whereas Rule 23(b)(3) of the Federal Rules of Civil Procedure requires a showing that questions common to the class predominate.

Adopted by the Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the fraud-on-the-market theory, solves this problem for class plaintiffs. It holds (by creating a rebuttable presumption) that in an efficient public securities market, a plaintiff can be presumed to have relied on the market's valuation of a stock, which is based on all existing material public information. That means there is no need for determining reliance by each plaintiff, removing that obstacle to class certification under Rule 23(b)(3).

Defendants in *Amgen* had argued, and some courts had agreed, that since the fraud-on-the-market theory is only available where the market has been affected by material misrepresentations, plaintiffs should be required not only to plead materiality in their complaints (which they must do under existing substantive law), but also prove materiality at the class certification stage.

In *Amgen*, however, the Supreme Court rejected that view, which Justice Ginsburg's majority opinion declared "would have us put the cart before the horse." The opinion added: "To gain certification under Rule 23(b)(3), *Amgen* and the dissenters urge, Connecticut Retirement must first establish that it will win the fray. But the office of a Rule 23(b)(3) certification ruling is not to adjudicate the case; rather, it is to select the 'metho[d]' best suited to adjudication of the controversy 'fairly and efficiently.' "

The majority treated the issue of materiality as a merits issue, and thus as something the plaintiff would not have to prove until trial, or a motion for summary judgment. While it acknowledged that merits issues may be considered at the class certification stage, it said that consideration is limited to where merits issues "are relevant to determining whether the Rule 23 prerequisites for class certification are satisfied." It concluded that the materiality of the alleged misstatements or omissions was not relevant, because proof of materiality was not needed to ensure that questions common to the class would "predominate over any questions affecting only individual members."

Significantly, the Court addressed the broader public policy arguments advanced by defense groups, based on concern that certification of a class can raise pressure on defendants to settle rather than risk a class-wide damage award. The Court noted that Congress has addressed this concern through "means other than requiring proof of materiality at the class-certification stage." These include the Private Securities Litigation Reform Act of 1995, as well as the subsequent Securities Litigation Uniform Standards Act of 1998, tightening pleading standards for securities class action complaints. Further, it noted that Congress, the Executive Branch and the Court have recognized that private securities actions are a valuable supplement to federal prosecution and SEC regulation.

The decision did offer some consolation for defense lawyers seeking to curtail securities litigation. In a concurrence, Justice Alito said he agreed with the majority analysis under existing law, but he questioned whether the fraud-on-the-market theory itself remains valid, and suggested it should be

reconsidered. Dissenting justices Thomas, Kennedy and Scalia similarly questioned the fraud-on-the-market theory, likely providing encouragement for defense lawyers to raise this issue in future cases.

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