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The Supreme Court Considers Proof Required for Class Certification under Rule 10b-5

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The Supreme Court heard oral arguments this past Monday in *Amgen Inc., et al. v. Connecticut Retirement Plans*, No. 11-1085, concerning the level of proof required to certify class actions brought under SEC Rule 10b-5, pursuant to Section 10(b) of the Securities and Exchange Act of 1934. The Court is expected to decide (1) whether a plaintiff class relying on fraud-on-the-market theory must prove that defendant's misrepresentations were material *before* a class can be certified; and (2) whether, in such a case, the defendant must be allowed to rebut such evidence *before* the class can be certified.

BACKGROUND AND CIRCUIT SPLIT

Section 10(b) of the Securities and Exchange Act of 1934 prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Implementing this section, Rule 10b-5 prohibits, among other things, making any "untrue statement of material fact . . . in connection with the purchase and sale of any security." Private plaintiffs must prove six elements under Rule 10b-5: (1) a defendant's material misrepresentation or omission; (2) scienter; (3) in connection with the purchase or sale of securities; (4) plaintiff reliance on the misrepresentation or omission; (5) economic loss; and (6) loss causation. *Matrixx Initiatives, Inc. v. Siracusano*, 131 S.Ct. 1309, 1317 (2011).

The element of "reliance" requires class action litigants to demonstrate that common questions of law or fact predominate to prevail at class certification. Any showing of plaintiffs' individual reliance would render class certification impossible. To address this challenge, the U.S. Supreme Court in *Basic Inc. v. Levinson, Inc.* recognized the "fraud-on-the-market" presumption, which permits courts to presume reliance where plaintiffs show that any misstatements were public and made in a well-developed, efficient market. 485 U.S. 224 (1988).

Since *Basic*, however, the lower courts have struggled over whether plaintiffs seeking to certify a class in reliance on the fraud-on-the-market presumption also bear the burden of showing that any misrepresentation was material, and whether a defendant is entitled to rebut such evidence. The Circuits are split on these issues.

The Ninth Circuit joined the Third and Seventh Circuits in holding that plaintiffs need not show materiality to survive class certification; further, the Ninth Circuit held that defendants are not entitled to present evidence to rebut materiality at class certification.

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Directly to the contrary, the Second and Fifth Circuits require (and the First Circuit noted in dicta the requirement of) plaintiffs to prove materiality at class certification; the Second Circuit also permits defendants to rebut evidence of materiality at class certification.

THE AMGEN CASE

In 2007, Connecticut Retirement Plans and Trust Funds ("Connecticut Retirement") brought suit against biotechnology company Amgen Inc. and several of its officers, alleging that they knowingly and recklessly made materially misleading statements and omissions regarding the safety of two Amgen products in violation of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5.

Connecticut Retirement alleged that Amgen made statements and omissions between April 22, 2004 and May 10, 2007 concerning the safety of its flagship Aranesp and Epogen products, used to stimulate the production of red blood cells. Among other things, Connecticut Retirement alleged that Amgen had downplayed FDA safety concerns about the products prior to an FDA meeting; concealed details about a clinical trial that was canceled because of safety concerns; and exaggerated the safety of the products for approved FDA uses. Allegedly, Amgen's misstatements and omissions had inflated the price of Amgen's stock, which subsequently dropped following corrective disclosures by Amgen.

In the district court, Connecticut Retirement moved to certify its suit as a class action under Rule 23(b)(3). Under Rule 23(b)(3), class certification is permissible where the court finds that "questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy." To defeat an argument that questions of individual reliance by class members predominate over the common question of class reliance, Connecticut Retirement relied on the fraud-on-the-market presumption, which the district court accepted.

The district court observed that Connecticut Retirement had met its fraud-on-the-market burden by showing that (1) Amgen's stock was traded in an efficient market, and (2) the alleged misstatements were public. Notably, the district court held that Connecticut Retirement need not prove the materiality of Amgen's misstatements and that Amgen could not rebut the presumption of materiality at this stage.

On appeal, the Ninth Circuit affirmed the district court's holding. Specifically, the Ninth Circuit held that the question of materiality went to the merits of the plaintiff's Rule 10b-5 claim—not to the question of whether common questions of law or fact predominate among class members under Rule 23. Applying the standard articulated in the Supreme Court's *Dukes v. Wal-Mart Stores* decision, the Ninth Circuit held that the "critical question in the Rule 23 inquiry" to permit class certification was whether plaintiffs' claims would "stand or fall together." 660 F. 3d 1170, 1775 (9th Cir. 2011).

While three Circuits had interpreted *Basic* to require materiality at the class certification stage, the Ninth Circuit was of the view that these courts had misinterpreted *Basic*. According to the Ninth Circuit, *Basic* simply recited the proposition that materiality was

essential, but did not itself adopt materiality as a precondition for class certification. 660 F. 3d at 1176.

"Whether statements [are] false, or whether the effects [are] large enough to be called material, are questions on the merits," Judge Barry Silverman wrote for the Ninth Circuit. 660 F. 3d at 1176. Accordingly, at the class certification stage, a plaintiff need only show that the "security in question was traded in an efficient market . . . [and] that the alleged misrepresentations were public"—and need not prove that alleged misstatements were material. *Id.* at 1170.

Reasoning that the truth-on-the-market defense refuted the materiality of any alleged misrepresentation, the Ninth Circuit also upheld the district court's refusal to give Amgen an opportunity to rebut materiality at the class certification stage.

Petitioners Amgen and its senior officers seek reversal of the Ninth Circuit's decision on grounds that materiality is a "key predicate" to plaintiff's successful invocation of the fraud-on-the-market theory. Amgen contends that because immaterial misstatements, by their very definition, do not affect a stock's price, courts cannot presume that investors relied in common on immaterial statements. Connecticut Retirement, on the other hand, urges that materiality is irrelevant at the class certification stage because a showing of immateriality does not show dissimilarity among the class members that would cause individual questions to predominate.

Both parties have invoked policy arguments. According to Amgen, permitting class certification without evidence of materiality will impose settlement pressure on companies, who would otherwise be forced to defend costly—even if ultimately meritless—class action suits. According to Connecticut Retirement, requiring proof of materiality at the class certification stage would saddle judges with burdensome, fact-intensive inquiries before full discovery, adversely affecting a court's ability to administer securities fraud class actions.

ORAL ARGUMENT HIGHLIGHTS

At oral arguments this week, Amgen argued that the Court should reverse the Ninth Circuit on grounds that the fraud-on-the-market presumption requires materiality. According to Amgen, fraud-on-the-market permits plaintiffs to indirectly prove reliance by showing that "everybody relied on a distorted market price." If a statement is immaterial, no price is distorted, and plaintiffs can only show that each *individually* relied on the misstatement or omission.

But, asked Chief Justice Roberts, wasn't the lack of materiality—where the effect on the market price "just happen[ed] to be zero"— still a question common to all claimants?

Amgen responded that demonstrating commonality alone was not enough to prevail at class certification. Plaintiffs, for example, already must prove other common questions – namely, market efficiency and the public nature of any misstatement—to certify a class.

Justice Sotomayor, Justice Kagan, and Justice Ginsburg questioned whether a finding of immateriality at class certification would effectively eliminate all future claims for

individual members. "When you prove immateriality, the whole class falls together, because it's immaterial for everybody," said Justice Kagan.

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But Amgen argued that finding immateriality would not preclude any individuals from pursuing individual actions under Rule 10b-5. If, at class certification, a district court found a misrepresentation to be immaterial, the defendant would move for summary judgment against the individual plaintiff, arguing that materiality had just been determined in its favor.

Justice Kennedy questioned whether there was a difference between the materiality necessary to prove fraud-on-the-market, and the materiality necessary to show direct reliance. "[I]f there was fraud on the market . . . [and] the class isn't certified, [couldn't] the investor . . . still show that he had direct [reasonable] reliance?"

Furthermore, the possibility of foreclosing issues for future litigants was hardly unique. As Justice Scalia observed, other predicates for class certification—the efficiency of the market, the public nature of the misstatement—were decided conclusively for future individual litigants.

Plaintiffs' burden aside, Justice Sotomayor questioned whether defendants should have the opportunity to rebut materiality to defeat class certification. Following *Basic*, defendants have been permitted to rebut evidence of another fraud-on-the-market predicate, market efficiency. Why "set out efficiency [and not materiality] as the one issue that [could] be rebutted?"

Connecticut Retirement argued that *Basic* had to be read against the backdrop of Rule 23 and the Court's decision in *Wal-Mart*. Because "materiality always generat[ed] a common answer for all class members, it [was] the quintessential common issue."

But Justice Kennedy questioned whether there "[m]ight be instances in which [plaintiffs'] subjective[ly] reli[ed] . . . but [without] . . . fraud on the market."

"[T]he enormous pressure [on defendants] to settle once the class is certified . . . . [provides] a good reason for deciding [materiality] sooner."

- Justice Scalia

Justice Scalia analogized the question of materiality to the determination of market efficiency. If plaintiffs decline to prove an efficient market, the class would fail, but individual claims could go forward. Similarly, if plaintiffs declined to prove the materiality of misstatements, the class would fail, but individual claims could go forward.

Still, Justice Breyer observed that materiality and market efficiency were different. Materiality was both a predicate and an element of the substantive Rule 10b-5 claim, and therefore, unlike market efficiency, "there [was] no special reason to or desirability in or need for litigating [it] at the outset."

Justice Scalia rejoined that the "enormous pressure [on defendants] to settle" provided reason enough to decide materiality earlier.

Further, added Justice Kennedy, Connecticut Retirement had the "burden of justifying class certification." Without a showing of materiality, there was "some real question of whether . . . the causal chain [had been] broken."

"But you can only rely on an efficient market where there has been a material misrepresentation. So maybe we should overrule Basic because it was certainly based upon a theory . . . that simply collapses once you remove the materiality element."

- Justice Scalia

The United States, as amicus curiae, argued that the two questions of materiality—at class certification and on the merits—collapsed into one. "Once [plaintiffs] prove[d] that the market [was] efficient and . . . the [mis]statements [were] public," any question of materiality merged with the element of reliance, which was required at the merits, but not class certification stage.

Justice Roberts questioned whether plaintiffs had to show reliance at all: Once plaintiffs "show that it's an efficient market, and that the information was public, doesn't that show reliance without regard to whether the statement's material or not?"

But Scalia argued that this undermined the fraud-on-the-market theory, which conditions reliance within an efficient market on the presence of a material misrepresentation. Perhaps the Court "should overrule *Basic*," given that it was based upon a theory that "simply collapses" once the materiality element is removed.

Justice Kennedy similarly questioned the foundations of the "efficient market" theory. Some "24 years of economic scholarship" since the Court's decision in *Basic* had "shown that the efficient market theory . . . is really an overgeneralization. It could be much more subtle than that."

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POTENTIAL IMPLICATIONS

If Amgen prevails on one or both issues presented on appeal, defendants opposing class certification in class action suits brought against them under Rule 10b-5 will be able to require courts to address the materiality of alleged misrepresentations prior to certifying a class. Here, defendants will be faced with a dual-edged sword: on one hand, defendants will have the opportunity to dispense with claims that would otherwise be dismissed on the merits, at a much earlier stage in the litigation. But defendants may also no longer benefit from the claim preclusive effect of a later finding of immateriality on the merits, facing the prospect of defending against many individual actions across multiple jurisdictions. Further, requiring a judge to decide the fact-intensive issue of materiality at class certification may shift some discovery earlier in the case.

If oral arguments are any indication, the Justices may also be willing to address the issue of materiality beyond the narrow questions presented. While the Court appears divided, two justices (Justice Scalia and Justice Kennedy) hinted at their willingness to reconsider the very assumptions that underlie *Basic*'s fraud-on-the-market presumption and the theory of an efficient market.

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