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U.S. Supreme Court Holds Materiality Is Not a Prerequisite to Class Certification in Fraud-on-the-Market Cases

Yesterday, in *Amgen Inc.* v. *Connecticut Retirement Plans & Trust Funds*, No. 11-1085, 2013 WL 691001 (Feb. 27, 2013), the Supreme Court of the United States decided a significant issue concerning the requirements for class certification in actions based on alleged misrepresentations in violation of the federal securities laws. Under *Amgen*, a plaintiff in such an action is not required to prove the materiality of the alleged misrepresentation in order to obtain class certification. The *Amgen* decision will make it at least marginally easier for plaintiffs to obtain class certification in some Circuits.

Amgen is likely to be influential in ways that go well beyond its immediate holding. For example, the various opinions in *Amgen* debate the continuing vitality of the Supreme Court's decision in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), which established the fundamental structure enabling claims under the federal securities laws to be litigated as class actions. These and other implications of the decision are discussed below. Readers not requiring a summary of the framework established in *Basic* may wish to go directly to section 2.

1. The Supreme Court's 1988 Decision in *Basic*

Basic addressed the problem of establishing reliance in class actions under the federal securities laws. Reliance is an element of a claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Traditionally, reliance required proof that a particular investor in fact knew of and relied on a particular alleged misrepresentation in purchasing or selling a security. Evidence of historical reliance in this sense is necessarily different and individual for each investor.

In most class actions involving securities claims, the plaintiff class seeks certification under Rule 23(b)(3) of the Federal Rules of Civil Procedure. Under Rule 23(b)(3), certification is available only if "questions of law or fact common to class members predominate over any questions affecting only individual members." As the Supreme Court acknowledged in *Basic*, if each class member must prove that he or she individually relied on the misrepresentations at issue, common questions would not "predominate" for purposes of Rule 23(b)(3). In that event, the class could not satisfy the requirements for certification.

Basic resolved this difficulty for plaintiffs by establishing the fraud-on-the-market doctrine. Under that doctrine, the plaintiff class in an action under Section 10(b) and Rule 10b-5 can establish indirect reliance through class-wide proof. The *Basic* Court focused on situations where (i) a defendant's misrepresentation has distorted the market price of a security, and (ii) an investor then buys or sells a

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security in reliance on the supposed integrity of a market price that, unknown to the investor, has been distorted by the misrepresentation. In such circumstances, according to *Basic*, the investor's direct reliance on a distorted market price may constitute indirect reliance on the underlying misrepresentation. Founded on this reasoning, the *Basic* Court created a rebuttable presumption leading to a finding of indirect reliance. If a plaintiff class successfully invokes the presumption, the plaintiff class can prove indirect reliance through class-wide proof in a way that is consistent with the predominance requirement for class certification.

2. *Amgen*

Amgen involved the relationship between the *Basic* presumption and materiality. As the Supreme Court explained in *Basic*, proof of materiality requires proof of "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." 485 U.S. at 231-32.

In order to invoke the *Basic* presumption, an investor must prove, among other elements, that the defendant's alleged misrepresentation was material. That is so because *Basic* depends on a presumption that the defendant's alleged misrepresentation distorted the market price of the relevant security. This assumption makes sense only if the misrepresentation was material. As *Amgen* noted, "immaterial information, by definition, does not affect market price." 2013 WL 691001, at *7.

Amgen concerned whether, *at the class certification stage*, a plaintiff who relies on the *Basic* presumption must prove materiality. The *Amgen* defendants argued that the answer was yes, for the following reasons. In order to obtain class certification, the plaintiff class must prove that common questions predominate. Common questions do not predominate if each member of the plaintiff class must prove actual reliance on an individual basis. Consequently, in order to prove predominance, the plaintiff class must demonstrate that it can prove reliance through class-wide proof under the *Basic* presumption. And the *Basic* presumption applies only if the alleged misrepresentation is material. Thus, according to the *Amgen* defendants, proof of materiality should be an essential prerequisite to class certification.

In an opinion written by Justice Ginsburg, the Supreme Court rejected the *Amgen* defendants' argument. The Court held that a plaintiff class, in order to obtain class certification in a securities action, need not prove materiality. The Supreme Court's fundamental reasoning was straightforward. Materiality, the Court explained, is not merely a requirement for application of the *Basic* presumption. Materiality is also an essential independent element of a claim under the federal securities laws. Thus, if the plaintiff class ultimately cannot prove materiality, the result will not be that reliance must be litigated as an individual issue. The result will instead be dismissal of the claims asserted by the plaintiff class for failure to prove materiality as an independent element. So in all events, the Court concluded, the claims of the plaintiff class will be resolved up or down on a class-wide basis. If, in all events, the claims of the class will be resolved on a class-wide basis, common questions predominate.

Justice Alito wrote a brief separate concurrence stating his view that reconsideration of the *Basic* presumption in another case might be appropriate. Justice Thomas, joined by Justice Kennedy and in part by Justice Scalia, dissented. Justice Scalia wrote a separate dissent.

3. Some Implications of the *Amgen* Decision

A. Class Certification Decisions. By holding that a plaintiff class need not prove materiality in order to obtain class certification, Amgen makes class certification somewhat easier to obtain. Justice Scalia's dissent complained that *Amgen* expanded the consequences of *Basic* "from the arguably regrettable to the unquestionably disastrous." 2013 WL 691001, at *18. It is not clear, however, that the effect of *Amgen* will be as dramatic as that language implies. Even in Circuits where the law had previously required proof of materiality as a prerequisite to class certification, defendants often faced substantial challenges to prevailing on the issue.

Defendants, of course, will remain able to deploy appropriate materiality arguments on a motion for summary judgment. Those arguments are often most effective when coupled with arguments that the plaintiff class cannot prove loss causation and economic loss. That is so because arguments that a misrepresentation was not material are closely linked to arguments that neither the misrepresentation, nor disclosures allegedly correcting the misrepresentation, affected the price of the security in the way claimed by the plaintiff class.

B. Will the Court Reconsider *Basic*? *Amgen* may foreshadow a battle over the continuing vitality of *Basic*. Justice Ginsburg's opinion for the Court, which was joined by five other Justices, did not expressly reaffirm *Basic*, but the tone of the opinion did not suggest grave doubts about the continuing force of *Basic*. On the other hand, Justices Scalia, Thomas, and Kennedy wrote or joined dissents in *Amgen* containing language disparaging *Basic*. Justice Alito's separate concurrence endorsed Justice Thomas's suggestion that the *Basic* presumption "may rest on a faulty economic premise." 2013 WL 691001, at *15. But the dissenters and Justice Alito are only four votes; perhaps tellingly, the Chief Justice joined the Court's opinion and did not join Justice Alito's concurrence. The *Amgen* opinions do not appear to signal any imminent likelihood that *Basic* will be overruled.

Much of the conversation between the opinion for the Court and the dissents concerned whether Congress or the Supreme Court is the proper forum to evaluate major potential changes to the *Basic* framework. The Court noted that Congress enacted the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998 to limit perceived abuses of class actions alleging securities fraud. Congress, however, has not altered *Basic*. *See id.* at *12. In part for that reason, the Court was unwilling either to read *Basic* restrictively (as Justice Scalia advocated) or to apply Rule 23(b)(3) in an especially demanding way (as Justice Thomas arguably advocated).

The dissenters, however, were concerned by the frequently onerous consequences of *Basic* for defendants, and would have been willing to shape the law in response to that concern. Justice Scalia's decision not to join the key section of Justice Thomas's dissent reflects an interesting divide. Justice Scalia, who wrote

the Court's recent exposition of class-certification doctrine in *Wal-Mart Stores, Inc.* v. *Dukes*, evidently wanted to respond to perceived problems with *Basic* by limiting *Basic* itself.

C. The Court's Uncertain Commitment to the Economic Theories Underlying Basic. The Court's opinion in *Amgen* seems to contain conflicting indications concerning the strength of the Court's continuing adherence to the efficient market hypothesis that underlies *Basic*. Much of the *Amgen* opinion summarizes *Basic* with confidence. The opinion also tends to assume that a material misrepresentation is a misrepresentation that affects the price of a security traded in an efficient market. That assumption is consistent with the efficient market hypothesis and may influence the understanding of materiality in the lower courts. The Third Circuit, in particular, has tested materiality by looking to whether and how the price of a security changed in response to disclosures correcting the supposed misrepresentation. *E.g.*, *Oran* v. *Stafford*, 226 F.3d 275, 282 (3d Cir. 2000) (Alito, J.). Justice Alito, during his tenure on the Third Circuit, was important in developing this strand of doctrine, which remains controversial outside the Third Circuit. The Court's opinion in *Amgen* does not endorse it, but generally appears to be consistent with it.

In footnote 6, however, the Court's opinion veers in a somewhat different direction by acknowledging economic evidence that market efficiency may not be "a binary, yes or no question." 2013 WL 691001, at *10 n.6. According to the Court, that evidence purports to suggest, for example, that even in a generally efficient market, the market may less readily assimilate publicly available information that is more difficult to acquire and understand. Footnote 6 appears to suggest that in another case, the economic evidence in question might conceivably support modified approaches to the *Basic* presumption, as applied either at the class certification stage or the merits. Judges in the lower courts are likely to hear further from litigants about the very disputable implications of this footnote.

D. *Amgen* and the Contested Borders of *Basic*. *Amgen*'s extended discussion of the *Basic* presumption will reverberate in future decisions by lower courts addressing the many contested aspects of the presumption. For example, *Amgen* explained why most investors rely on the integrity of the market price in the following way: most investors, the Court observed, "know[ ] that they have little hope of outperforming the market in the long run based solely on their analysis of publicly available information," and therefore "will rely on the security's market price as an unbiased assessment of the security's value in light of all public information." 2013 WL 691001, at *5. Many professional investors, however, believe that their strategies may enable them to outperform the market by identifying mispriced securities. Defendants sometimes contend that such investors do not rely on the market price as necessarily measuring value, and therefore should not be entitled to invoke the *Basic* presumption. *Amgen* may intensify that fight.

E. *Amgen* and Non-Securities Cases. *Amgen* implicated issues that go beyond securities cases concerning the extent to which evidence relevant to the merits may be considered on a motion for class certification. On that point, *Amgen* adhered to the line drawn in *Wal-Mart Stores, Inc.* v. *Dukes*: "Merits questions may be considered to the extent—but only to the extent—that they are relevant to determining

whether the Rule 23 prerequisites for class certification are satisfied." 2013 WL 691001, at *7. The Court appears to have viewed Justice Thomas's dissent as edging away from the balance struck in *Wal-Mart*.

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