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Loss Causation: A New Hurdle for Class Certification

Class certification under Rule 23 functions as a critical milestone in any securities fraud class-action lawsuit. The legal and practical consequences of class certification are enormous. Success or failure in securing class certification necessarily drives litigation and settlement strategies of both plaintiffs and defendants.

A recent U.S. Court of Appeals for the Fifth Circuit case, *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 2007 WL 1430225 (5th Cir. May 16, 2007), acknowledged the significance of the class-certification decision and significantly increased plaintiff's burden at the class-certification stage.

Oscar, observing that a "certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that proceeds it," held that class plaintiffs must establish loss causation at the class-certification stage by a preponderance of evidence in order "to trigger" *Basic's* fraud-on-the-market presumption.[1]

Fraud-on-the-Market Doctrine

In most actions involving a claimed violation of §10(b) and Rule 10b-5, plaintiffs use the reliance presumption arising from application of the fraud-on-the-market doctrine, as articulated in the Supreme Court's decision in *Basic Inc. v. Levinson*, 485 US 224 (1988). Under that doctrine, each plaintiff's reliance on the alleged material misrepresentation (transaction causation) is presumed and thus common to all putative class members. Once the requisite showing for application of the doctrine has been made, classwide reliance is presumed, albeit subject to the possibility of rebuttal.

The fraud-on-the-market doctrine assumes that, in an efficient market, the market price of a stock is a direct reflection of all material information known to the market relating to the issuer. Accordingly, to invoke the doctrine to establish reliance, the putative class plaintiff must show that the defendant made material misrepresentations, that the shares were traded in an efficient market, and that plaintiff traded shares during the class period.[2]

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The rationale underlying the fraud-on-the-market analysis is that purchasers and sellers of securities rely upon the integrity of the market price, and thus rely (indirectly) upon any material misrepresentations. By presumptively establishing classwide reliance on material misinformation, the fraud-on-the-market doctrine supports the conclusion, as required by Rule 23, that common questions of fact and law predominate.[3]

Tighter Presumption Requirements

In *Oscar,* the Fifth Circuit observed that *Basic* allows each of the circuits room to develop its own fraud-on-the-market rules and that the Fifth Circuit had used that leeway "to tighten the requirements for plaintiffs seeking a presumption of reliance."[4] Oscar overruled the trial court finding that the class certification stage is not the proper time for defendants to rebut a fraud-on-the-market presumption. The court found that the refutation of loss causation relates to the element of reliance because it speaks to the efficient market hypothesis upon which classwide reliance depends. And, concluding that the "assumption that every material misrepresentation will move a stock in an efficient market is unfounded," the Court held the plaintiffs must demonstrate loss causation—that an alleged misstatement "actually moved the market"—before triggering the presumption of reliance.[5]

The court rejected the plaintiffs' argument that full consideration of loss causation is inappropriate at the class-certification stage because it goes to the merits of the case, citing U.S. Court of Appeals for the Second Circuit Judge Newman's recent decision in *Miles v. Merrill Lynch,* 471 F3d 24, 27 (2d Cir. 2006). In *Miles,* the Second Circuit concluded that district courts must resolve all factual disputes relevant to every Rule 23 requirement in considering class certification, regardless of any overlap with a merits issue.

The Fifth Circuit also rejected the plaintiffs' argument that the court was improperly shifting the burden "from a defendant's right of rebuttal to a plaintiff's burden of proof."[6] The court cited to *Basic,* which "plainly states" that the presumption of reliance may be rebutted by "any showing that severs the link" between the alleged misrepresentation and the plaintiffs' loss.

The Fifth Circuit concluded: "to do so rebuts on arrival the plaintiff's fraud-on-the market theory."[7] Pointing to the multiple items of positive information released together with the alleged inflating misrepresentation and multiple items of negative information released together with the corrective disclosure, the court found that, at least in such a "multi-layered loss-causation" case, it is not sufficient to rely upon a post-correction price drop alone; rather, plaintiffs are required to prove that the corrective disclosure caused the price decline and was related to the earlier false positive statement.[8]

The court next addressed the proof required to make the requisite loss causation showing. The district court, although apparently not believing itself legally bound to do so, had weighed all the evidence, both for and against loss causation, and concluded that it was more likely than not that a significant part of the price decline was attributable to the corrective disclosure. Purporting to apply an abuse of discretion standard of review, the Fifth Circuit reversed, finding this factual conclusion "untenable." In instances of multiple negative disclosures, plaintiffs' proof must be "empirically based," (demanding "a peek at the plaintiffs' damages model"), and cannot consist of "speculation about materiality alone."[9] The plaintiffs' evidence consisted mostly of analyst commentary which the court referred to as "little more than well-informed speculation."[10] Plaintiffs' expert failed to offer any empirically based showing that some portion of the decline was attributable to the disclosure. The court concluded: "[a]t least when multiple negative items are contemporaneously announced, we are unwilling to infer loss causation without more."[11] Since plaintiffs' expert had noted that further analysis (which counsel had advised was

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not appropriate at this stage of the litigation) would be able to identify the portion of the decline caused by the corrective disclosure, the court concluded "this is less of a dispute over what showing must be made, and more a dispute over when."[12]

The Dissent

Judge James L. Dennis alone dissented, characterizing the majority's decision as a drastic departure from Supreme Court precedent and "a breathtaking revision of securities class action procedure…."[13] Commenting upon the majority's apparent belief that private securities class action procedure is in need of drastic change and revision, Judge Dennis observed that "judicially enacted reform" is "ill-advised" and that even well-intentioned policy considerations "do not give this court the authority to overrule the Supreme Court's decisions or to change the recognized elements of a §10(b) claim, both of which the majority effectively does today."[14]

The majority incorrectly deprived plaintiffs of the benefit of *Basic's* fraud-on-the-market presumption of reliance, according to Judge Dennis, and "inexplicably" required them to prove the separate element of loss causation at the class certification stage. Under the majority's approach, "*Basic's* fraud on the market presumption is essentially a dead letter…."[15] Disagreeing with the court's holding that loss causation is part of the fraud-on-the-market presumption, the dissent observed that neither *Basic* nor any authority supports the decision to conflate the elements of reliance and loss causation. Judge Dennis noted that loss causation is an entirely distinct element from reliance, the latter requiring only a showing of market movement, either up at the time of the alleged misrepresentation or down at the time of the corrective disclosure.[16] Judge Dennis further disagreed with the court's analysis of the *Basic* presumption, referring to the majority's characterization of it "as a sort of 'bursting bubble' presumption," one which "evaporates as soon as a defendant simply introduces a mere possibility the defendant's material misrepresentation might not have affected the market price."[17] Finally, Judge Dennis noted that the majority "does not and cannot" show the district court abused its discretion by its finding of loss causation but rather had engaged in a de novo review of the district court's decision which had been made after a careful review of all the evidence.[18]

Early Decision-Making Trend

Both *Oscar* as well as the Second Circuit's *Miles* decision, in wrestling with the issues and proof required to certify a class, noted the significance of the 2003 amendments to Rule 23.[19] The provision that class certification "may be conditional" has been removed; the Advisory Committee notes expressly approve "controlled discovery into the merits" of Rule 23 issues and state that if a court is not satisfied that the Rule 23 requirements have been met, it should refuse certification until they have been met; and, the certification decision is no longer to be made "as soon as practicable," but rather "at an early practicable time."[20] These changes led the Second Circuit to decide in *Miles* that it "obviously" could no longer permit a "some showing" standard to suffice to meet Rule 23 requirements: a determination must be made that all Rule 23 requirements have been met, and all necessary facts established.[21]

In *Oscar*, the Fifth Circuit noted that the "subtle" Rule 23 changes and the "less-subtle" PSLRA recognize the power of the certification order and were "the product of years of study. …. This collective wisdom must not be brushed aside."[22] Separately, both courts also joined the majority of circuits, which now hold that Rule 23 determinations must be made even when consideration of Rule 23 elements overlap with the merits.

By presumptively establishing classwide reliance on material misinformation, the fraud-on-the-market doctrine supports the conclusion, as required by Rule 23, that common questions of fact and law predominate.

As a consequence of these rulings and others, it is now fair game to seek to obtain an early adjudication of as many merits issues as can be found within the requirements of Rule 23. *Oscar's* holding that a determination of loss causation is required at the class certification stage, is one such early test of a plaintiff's case, although the Fifth Circuit suggested its decision may be limited. In a footnote, the majority criticized the dissent for being "a bit enthusiastic" in characterizing the extent of their holding. Explaining that their holding was limited to circumstances involving the simultaneous disclosure of multiple negatives, the majority observed that "applying the fraud-on-the-market theory to such complex circumstances by rote would yield a victory of habit over reason."[23] Whether the *Oscar* holding is limited or not, challenging market efficiency is a good way to test the merits of a plaintiff's case at the early class certification stage of a litigation.[24]

Conclusion

Reaction to the majority's holding in *Oscar* has been rather divergent and wide. Not surprisingly, the plaintiffs' bar agrees with the dissent, seeing the case as a giant step away from the Supreme Court's class-certification jurisprudence. The defense bar, by contrast, can identify in *Oscar* elements that place it at the end of a line of developing class-action cases and legislation that have considered the legal, economic and practical considerations that bear upon class-action litigation in general and Rule 23 class certification in particular.

In that vein, *Oscar* is a perfectly logical extension of the Supreme Court's decision in *Dura Pharm., Inc. v. Broudo* which, in defining loss causation and requiring that a complaint set forth the basis for loss causation, emphasized both a plaintiff's burden of proof on the issue as well as Congress' desire to end abusive securities litigation which proceeds "with only faint hope that the discovery process might eventually lead to some plausible cause of action." 544 US 336, 347 (2005).

In *Dura*, the court noted the need to stop plaintiffs with a "largely groundless claim" from taking up people's time "with the right to do so representing an in terrorem increment of the settlement value." Id., quoting *Blue Chip Stamps v. Manor Drugstores*, 421 US 723, 741 (1975). Far from undercutting *Dura*, as Judge Dennis said in his dissent, the Fifth Circuit in *Oscar* echoed *Dura* in its decision: "We cannot ignore the in terrorem power of certification, continuing to abide the practice of withholding until 'trial' a merit inquiry central to the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification…."[25]

Thus, although the Fifth Circuit's decision in *Oscar* can be construed as nothing more than a decision limited to a fact pattern calling into question the trustworthiness of market efficiency as a gauge of reliance and leading the court to interject loss causation as a class-certification requirement, it more likely portends the wave of the future: early merits-based consideration of plaintiffs' class action complaints.

1. *Oscar*, 2007 WL 1430225 at *3, 5-6.
2. *Basic*, 485 US at 247, n.27. The fraud-on-the-market doctrine presumes that, when a company's stock is purchased in an efficient market, the purchaser relied "on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price…." *Blackie v. Barrack*, 524 F2d 891, 907 (9th Cir. 1975).
3. FedRCivPro 23(b)(3).
4. *Oscar*, 2007 WL 1430225 at *3.
5. Id. at *3, 7.
6. Id. at *3.
7. Id.
8. Id.
9. Id. at *7.
10. Id. at *8.
11. Id. at *9.
12. Id. at *8.
13. Id. at *9.
14. Id. at *15.
15. Id. at *15, 17.
16. Id. at *10-11.
17. Id. at *13.
18. Id. at *17.
19. See id. at *5; *Miles*, 471 F3d at 39.
20. See id.
21. *Miles*, 471 F3d at 42.
22. *Oscar*, 2007 WL 1430225 at *5.
23. Id. at n.22.
24. See, e.g., *Polymedica Corp. Securities Litigation*, 432 F3d 1 (1st Cir. 2005).
25. *Oscar*, 2007 WL 1430225 at *4.