LATHAM & WATKINS

Number 1481 March 5, 2013

Client Alert

Latham & Watkins Litigation Department

US Supreme Court Holds That Proof Of Materiality Is Not A Prerequisite To Certifying A Securities Fraud Class Action Under § 10(b) Of The Securities Exchange Act And Rule 10b-5

> "The decision will have a significant impact on defendants in securities fraud class actions at the class certification stage, in particular in the Second Circuit. In practice, defendants no longer will be able to raise issues of materiality — by either requiring plaintiffs to prove materiality, or rebutting that proof — until the summary judgment stage of the proceeding."

On February 27, 2013, the US Supreme Court in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds* cleared the way for shareholder plaintiffs to obtain class certification without proving the materiality of allegedly false or misleading disclosures or omissions in a securities fraud class action under § 10(b) of the Securities Exchange Act and Rule 10b-5. Writing for the six-justice majority, Justice Ruth Bader Ginsburg reasoned that, while proof of materiality ultimately is required to establish a substantive violation of § 10(b) and Rule 10b-5, proof of materiality is not needed to establish the threshold issue under Rule 23(b)(3) of the Federal Rules of Civil Procedure: whether questions of law or fact common to the class will "predominate over any questions affecting only individual members."[1]

The decision in this closely watched securities class action represents a departure from the Court's recent trend of mostly defense-friendly opinions on class action issues. For corporate defendants, and their officers and directors who are frequently the targets of securities class actions, the decision means that more cases likely will survive class certification, placing additional pressure on corporate defendants to settle before summary judgment or trial when important issues about materiality can be adjudicated on the merits. Some broader and important lessons, however, may be gleaned from the Justices' fractured views regarding the fraud-on-the market theory underlying the issues before the Court; this is an area that must be watched closely going forward.

Background

In *Amgen*, the plaintiff alleged that the biotechnology company made false statements about the safety and marketing of two of its leading drugs. The plaintiff brought a securities fraud class action lawsuit under § 10(b) of the Securities Exchange Act and Rule 10b-5 in the US District Court for the Central District of California. Amgen moved to dismiss the complaint on the grounds that the plaintiff failed to plead an actionable false or misleading statement or scienter.[2] With respect to falsity, Amgen argued that, *inter alia*, investors could not have been misled by Amgen's public statements regarding a meeting with the Food and Drug Administration (FDA) and the Oncology Drug Advisory Committee, because the

agenda for the meeting was available to the public.[3] The District Court rejected this argument, finding that, although not labeled as such, Amgen appeared to be asserting a "truth on the market" defense, a fact-specific inquiry that could not be resolved at the pleading stage.[4] The Court granted Amgen's motion to dismiss certain individual defendants, but otherwise allowed the case to proceed.[5]

The plaintiff subsequently moved to certify an alleged class of investors who purchased Amgen stock. To obtain certification under Rule 23, a plaintiff must first satisfy all of the prerequisites of Rule 23(a), including that: (1) the class is so numerous that joinder of all members is impracticable; (2) there are questions of law or fact common to the class; (3) the claims or defenses of the class representatives are typical of the claims or defenses of the class; and (4) the class representative will fairly and adequately protect the interests of all members of the class.[6] In addition, to maintain a class action under Rule 23(b)(3), a plaintiff is required to establish that common legal questions predominate over issues unique to individual shareholders. Opposing class certification, Amgen argued that the plaintiff failed to meet this showing because individual questions regarding reliance on the alleged misrepresentations and omissions would predominate over common questions. The plaintiff countered that reliance can be presumed and thus was a common question, invoking the fraud-on-the-market theory endorsed by the Supreme Court twenty-five years ago in *Basic Inc. v. Levinson*. Under *Basic*, a rebuttable presumption of reliance by investors arises if a misrepresentation or omission is material and the company's shares were traded on an efficient market, *i.e.*, one in which the price of the shares reflects all publicly available information about the company.[7] The District Court agreed and granted plaintiff's class certification motion, relying on the fraud on the market presumption and disregarding Amgen's evidence in rebuttal.[8] The Ninth Circuit granted an interlocutory appeal and affirmed the District Court's decision.[9]

On appeal, Amgen argued that the plaintiff could not avail itself of the fraud-on-the-market presumption at class certification because it had not proved that Amgen's allegedly false statements were material.[10] Amgen also argued that the District Court erred by not affording it an opportunity to present evidence rebutting the presumption.[11] The Ninth Circuit disagreed, holding that because materiality was a substantive element of the plaintiff's § 10(b) claim, proof of materiality was required for every putative class member to succeed on the merits, and therefore was a common question for all shareholders.[12] Because proof of materiality was not necessary to ensure that the question of reliance is common among the class, the plaintiff did not need to prove materiality to invoke the fraud-on-the-market presumption at the class certification stage.[13] In effect, the Ninth Circuit took materiality out of the equation at class certification.

The Supreme Court's Decision

The Supreme Court granted Amgen's petition for certiorari to resolve a conflict among several federal circuits over whether plaintiffs must prove — and defendants may rebut — materiality before certifying a class action under § 10(b). In support of its argument that materiality must be proved at class certification to satisfy Rule 23(b)(3)'s predominance requirement, Amgen made two chief arguments. *First*, relying on the Court's holding in *Erica P. John Fund, Inc. v. Halliburton Co.*,[14] Amgen argued that materiality should not be treated differently than other fraud-on-the-market predicates (market efficiency, misrepresentations publicly known, and relevant securities transaction taking place between the time the misrepresentations were made and the truth was revealed), which must be established at the class

certification stage.[15] *Second*, Amgen urged that policy considerations militate in favor of requiring precertification proof of materiality. Otherwise, Amgen reasoned the issue may never be addressed on the merits given that an order granting class certification may often exert substantial pressure on defendants to settle to avoid the expense and risks of litigation against a class.[16]

Plaintiffs Are Not Required To Prove Materiality At The Class Certification Stage

In her majority opinion, Justice Ginsburg rejected Amgen's argument that Connecticut Retirement was required to prove materiality in order to meet the predominance requirement under Rule 23(b)(3). The Court noted that the only issue before the Court at this stage was whether "Connecticut Retirement ha[d] satisfied Rule 23(b)(3)'s requirement that 'questions of law or fact common to class members predominate over any questions affecting only individual members.'"[17] The pivotal inquiry, therefore, was whether proof of materiality was needed to ensure that questions of law or fact common to the class would "predominate over any questions affecting only individual members."[18]

The Court concluded that proof of materiality is not necessary to establish the predominance prong under Rule 23(b)(3), citing two reasons. First, because the question of materiality in the context of a securities fraud claim "is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor, materiality can be proved through evidence common to the class.'"[19] Thus, materiality is a common question for purposes of Rule 23(b)(3).

Second, there is no risk that the failure of proof on the common question of materiality would result in individual questions of reliance predominating, because materiality is an essential element of a Rule 10b-5 claim. Thus, "the failure of proof on the element of materiality would end the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate."[20]

The Court was not persuaded by Amgen's argument that materiality should be treated the same as other fraud-on-the-market predicates that must be proved for class certification. The Court reasoned, in summary, that unlike materiality, those predicates are not substantive elements of a Rule 10b-5 claim. Thus, the failure to prove the other fraud-on-the-market predicates at the class certification stage would not necessarily be fatal to an individual plaintiff's Rule 10b-5 claim.

In addition to holding that the plaintiff is not required to prove materiality prior to class certification, the Court held that Amgen is not permitted to offer evidence to show that the alleged misstatements or omissions were immaterial. The complaint alleged that Amgen downplayed to investors the significance of an impending FDA meeting by suggesting that the FDA would not focus on one of Amgen's leading drugs. At the motion to dismiss stage and at class certification, Amgen sought to rebut that allegation by presenting public documents — including the committee's meeting agenda which was published in the Federal Register prior to the meeting — which indicated that the safety concerns associated with the drug would be discussed at the meeting. The Court explained that by offering such evidence, Amgen attempted to prove that the alleged misstatements were immaterial — a point that Amgen did not dispute.

Relying on its analysis from earlier in the opinion, however, the Court held that "the potential immateriality of Amgen's alleged misrepresentations and omissions is no barrier to finding that common questions predominate."[21] Connecticut Retirement

either will be able to prove materiality on a class-wide basis, or it will fail to prove materiality or have its proof rebutted by Amgen, either of which would be fatal to the plaintiff's claims. In the Court's view, declining to require a plaintiff to prove materiality at the class certification stage — or to permit a defendant to disprove the materiality allegation — does not create a risk that individual issues will predominate in adjudicating class wide claims.

The Supreme Court Rejected Amgen's Policy Arguments That Pressure On Defendants To Settle Post-Class Certification Militates In Favor Of Precertification Proof Of Materiality

Amgen also offered policy considerations in favor of requiring pre-certification proof of materiality. As Amgen explained, an order granting class certification can exert substantial pressure on a defendant to settle a securities fraud lawsuit due to the cost of defending against class-wide claims and the risk of substantial liability. If materiality is not considered at the class certification stage, Amgen argued, the issue probably will never be adjudicated in court.

The majority was not persuaded by these arguments. The Court reasoned that materiality is no different from other elements of a Rule 10b-5 claim — such as falsity or loss causation — which, the Court has held previously, need not be adjudicated before a class is certified. Defendants thus face pressure of having to litigate these issues on a class-wide basis. The Court noted that Congress could have further alleviated pressure to settle securities class actions when it enacted the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Securities Litigation Uniform Standards Act of 1998 (SLUSA), by undoing the fraud-on-the-market presumption endorsed in *Basic*, or requiring plaintiffs to prove elements of securities fraud claims prior to class certification, but Congress did not do so.

In their dissents, Justices Thomas and Scalia were swayed by Amgen's policy-based arguments. In his dissenting opinion, Justice Scalia observed that "[c]ertification of the class is often, if not usually, the prelude to a substantial settlement by the defendant because the costs and risks of litigating further are so high."[22] Justice Scalia further opined that the fraud-on-the-market theory created by *Basic* envisioned proof of materiality for class certification as well as the merits of a Rule 10b-5 claim, pointing to the *Basic* Court's statement that it "granted certiorari … to determine whether the courts below properly applied a *presumption of reliance in certifying the class*."[23] Justice Thomas (joined by Justice Kennedy and in part by Justice Scalia) similarly reasoned that absent proof of materiality at class certification, plaintiffs could not avail themselves of the fraud-on-the-market presumption, without which individualized questions of reliance would predominate and defeat certification under Rule 23(b)(3). Justice Thomas also found Amgen's policy-based arguments persuasive, stating that the majority's "assertion that materiality will be resolved on the merits presumes that certification will not bring in terrorem settlement pressures to bear, foreclosing any materiality inquiry at all."[24] The enactment of the PSLRA while leaving Basic intact, he argued, said nothing about the proper interpretation of *Basic* before the Court.[25]

In his short concurrence, Justice Alito — while asserting that the Court had not been asked to revisit *Basic* — agreed with Justice Thomas that reconsideration of the fraud-on-the-market presumption may be appropriate, as discussed below.[26]

The Impact Of The Decision

The *Amgen* decision resolves a conflict that has emerged over the past several years among the Courts of Appeals. While the Seventh and Ninth Circuits held that materiality need not be proved at the class certification stage, the Second and Fifth Circuits held that a plaintiff must prove, and a defendant may present evidence rebutting, materiality before class certification, complicating the process of class certification for shareholder plaintiffs.[27] The Third Circuit fell in between these two competing views, holding that a plaintiff need not prove materiality before class certification, but that a defendant may present evidence to rebut the plaintiff's allegation of materiality.[28] *Amgen* resolves that split, and now subjects securities fraud class action litigants in the United States to a uniform rule that plaintiffs are not required to prove materiality at the class certification stage.

The decision will have a significant impact on defendants in securities fraud class actions at the class certification stage, in particular in the Second Circuit. In practice, defendants no longer will be able to raise issues of materiality — by either requiring plaintiffs to prove materiality, or rebutting that proof — until the summary judgment stage of the proceeding. Given the longer period of time that will ensue between the inception of such actions and the point when defendants will be able to raise issues of fact concerning materiality, this decision will likely increase the costs of defending many securities fraud class actions, and may exert more pressure on defendants to settle at an earlier point in the case.

While the *Amgen* opinion departs from a trend of recent Supreme Court decisions that have been favorable to defendants in securities class actions, the opinion offers some opportunities for development of new defense arguments in future cases. To the extent that some members of the Court may be rethinking the fraud-on-the-market theory recognized in *Basic*, this may open the door for defendants in securities fraud class suits to mount new challenges to the presumption of reliance established in *Basic*. Amgen cited modern economic research suggesting that market efficiency is not "a binary, yes or no question," but rather that differences in efficiency can exist within a single market.[29] According to the research, a market may more readily process certain forms of widely disseminated and easily digestible information than information that is more difficult to acquire and understand, such as obscure data buried in an SEC filing.[30] Thus, different types of public information have different effects on the market. Justice Alito, in his concurring opinion, indicated that in light of this research, reconsideration of the *Basic* presumption may be appropriate.[31] The majority noted, however, that *Amgen* was not a suitable vehicle to explore the implications of that research, given that Amgen conceded in its answer that the market for its securities is efficient. Going forward, corporate defendants in securities fraud class actions may wish to consider whether or not to concede that a market for their securities is efficient (a concession investors often request prior to class certification), so as to take advantage of this new research, and challenge the fraud-on-the-market theory.

Some members of the Court — in particular, Justices Scalia and Thomas — also appeared to be sympathetic to the policy implications that the decision will have, namely, that more securities fraud class actions are likely to survive class certification, resulting in increased costs to defend and ultimately settle such actions. As noted, the Court declined to accept the policy arguments because Congress had the opportunity to address this issue when it enacted the PSLRA and SLUSA, but opted not to. Conceivably, this opinion may serve as a catalyst for Congress to revisit this issue.

It appears likely that *Amgen* will change the landscape for litigants in securities fraud class actions. These issues, especially regarding the future viability of the fraud-on-the-market theory, should continue to be monitored by public companies, and parties and practitioners involved in securities fraud class action lawsuits.

Endnotes

[1] *Amgen Inc. v. Conn. Retirement Plans and Trust Funds*, slip op. at 10, 568 U.S. __ (2013) (citing Fed. R. Civ. P. 23(b)(3)). Justice Ginsburg was joined in the majority by Chief Justice Roberts and Justices Breyer, Alito, Sotomayor and Kagan. Justice Alito filed a concurring opinion, and Justices Scalia, Thomas and Kennedy dissented.

[2] *In re Amgen Inc. Sec. Litig.*, 544 F. Supp. 2d 1009 (C.D. Cal. 2008).

[3] *Id*. at 1025.

[4] *Id*.

[5] *Id*. at 1038. The Court dismissed five individual director and/or non-speaker defendants.

[6] Fed. R. Civ. P. 23(a).

[7] *Basic v. Levinson*, 485 U.S. 224, 245 (1988).

[8] *Conn. Retirement Plans and Trust Funds v. Amgen, Inc.*, No. 07-2536, 2009 WL 2633743 (C.D. Cal. Aug. 12, 2009).

[9] *Conn. Retirement Plans and Trust Funds v. Amgen, Inc.*, 660 F.3d 1170 (9th Cir. 2011).

[10] *Amgen, supra* note 9, 660 F.3d at 1175.

[11] *Id*. at 1177.

[12] *Id*. at 1175 ("Either way, the plaintiffs' claims stand or fall together – the critical question in the Rule 23 inquiry.").

[13] *Id*. at 1177.

[14] *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. __ (2011).

[15] *Amgen, supra* note 1, slip op. at 15.

[16] *Amgen, supra* note 1, slip op. at 18.

[17] *Amgen, supra* note 1, slip op. at 9.

[18] *Amgen, supra* note 1, slip op. at 10 (quoting Fed. R. Civ. P. 23(b)(3)).

[19] *Amgen, supra* note 1, slip op. at 11 (quoting *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976)).

[20] *Amgen, supra* note 1, slip op. at 11.

[21] *Amgen, supra* note 1, slip op. at 25.

[22] *Amgen, supra* note 1, *post* at 4 (Scalia, J., dissenting).

[23] *Amgen, supra* note 1, *post* at 3, n.* (Scalia, J., dissenting) (emphasis in original).

[24] *Amgen, supra* note 1, *post* at 11, n. 9 (Thomas, J., dissenting).

[25] *Id*.

[26] *Amgen, supra* note 1 (Alito, J., concurring).

[27] *Compare Amgen, supra* note 9, 660 F.3d 1170 (plaintiff need not prove materiality at class certification stage); *and Schlicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010) (same), *with In re Salomon Analyst Metromedia Sec. Litig.*, 544 F.3d 474 (2d Cir. 2008) (plaintiff must prove, and defendant may present evidence rebutting, materiality before class certification); and *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 265 (5th Cir. 2007) (plaintiff required to offer proof of a material misstatement in order to trigger the fraud-on-the-market presumption). The First and Fourth Circuits also stated, in *dicta*, that a plaintiff must prove materiality at the class certification stage. *See In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 7 n. 11 (1st Cir. 2005); *Gariety v. Grant Thornton, LLP*, 368 F.3d 356, 364 (4th Cir. 2004).

[28] *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 631-32, 637-38 (3d Cir. 2011).

[29] *Amgen, supra* note 1, slip op. at 14 n. 6 (quoting Langevoort, Donald C., Basic at Twenty: Rethinking Fraud on the Market, 2009 Wis. L. Rev. 151, 167). According to Professor Langevoort, "[p]erfect efficiency is just a theoretical ideal."

[30] *Amgen, supra* note 1, slip op. at 14 n. 6 (citing Macey & Miller, Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory, 42 Stan. L. Rev. 1059, 1083-87 (1990); Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 J. Corp. L. 635, 653-656 (2003)).

[31] *Amgen, supra* note 1 (Alito, J., concurring).

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

Robert J. Malionek
+1.212.906.1816
robert.malionek@lw.com
New York

Kevin H. Metz
+1.202.637.2338
kevin.metz@lw.com
Washington, D.C.

Lori Alvino McGill
+1.202.637.2319
lori.alvino.mcgill@lw.com
Washington, D.C.

H. Gregory Baker
+1.212.906.2941
gregory.baker@lw.com
New York

Sarah A. Greenfield
+1.202.637.2335
sarah.greenfield@lw.com
Washington, D.C.