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BY JAMIE A. LEVITT AND MICHAEL GERARD

Loss Causation at Class Certification: Illusory Circuit Split

The U.S. Court of Appeals for the Second Circuit's recent decision in *In re: Salomon Analyst Metromedia Litigation*, by Judges John M. Walker Jr., Guido Calabresi and Rosemary Pooler, establishes what may be perceived to be a circuit split.

The "split" pertains to whether proposed class action representatives asserting claims of securities fraud must establish loss causation at the class certification stage to benefit from the fraud-on-the-market presumption.[1]

'Oscar' Compared With 'Salomon'

One year ago, in *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, the Fifth Circuit held that a plaintiff must establish loss causation at the class certification stage in order to trigger the fraud-on-the-market presumption that is necessary to meet the Rule 23(b)(3) predominance requirement for class certification.[2] While the Second Circuit's opinion appears to be inconsistent with the Fifth Circuit's requirement that the plaintiff bear the initial burden of establishing loss causation at the class certification stage, it does cite the Fifth Circuit's decision in *Oscar* to support the proposition that district courts must permit defendants to rebut the fraud-on-the-market presumption at the class certification stage. For litigants, this may be a distinction without a difference, as both *Oscar* and *Salomon* will likely result in battles over loss causation at the class certification stage, as well as an increasing number of interlocutory appeals of class certification decisions under Federal Rule of Civil Procedure 23(f).

Jamie A. Levitt *Michael Gerard*

The decision in *Salomon* is certainly significant for the so-called "analyst cases" (in which analysts rather than issuers are alleged to have made a misstatement) as it clearly establishes that the fraud-on-the-market presumption applies and that heightened proof is unnecessary—an issue with which many district court judges have valiantly struggled.[3] But *Salomon's* significance goes beyond analyst cases alone, as it firmly establishes (1) what a plaintiff alleging securities fraud against any defendant must establish to benefit from the fraud-on-the-market presumption, and (2) that class certification is the appropriate stage for defendants to rebut the presumption. Perhaps, in reality, the Fifth and Second circuits are not as far apart as they may seem.

Fraud-on-the-Market

A court may certify a class under Rule 23 where the proposed class representative meets the standards of Rule 23(a) (numerosity, commonality, typicality, and adequacy) and the proposed class action meets the requirements of one of the subsections of Rule 23(b).[4] Rule 23(b)(3) requires that "the questions of law or fact common to the members of the class predominate over questions affecting only individual members…."[5] Reliance is an essential element of a claim under §10(b) of the Securities Exchange Act of 1934, and in order for plaintiffs asserting such claims to meet the predominance requirement, they must establish that individual questions will not predominate over common questions with respect to whether each member of the proposed class relied on defendants' alleged misrepresentations.[6] To do this, plaintiffs often rely on what is known as the "fraud-on-the-market" presumption, adopted by the Supreme Court in *Basic Inc. v. Levinson*, which creates a rebuttable presumption of reliance when the alleged, material misstatements at issue become public, and the stock is traded on an efficient market.[7] The theory holds that "public information is reflected in the market price of the security," and it can then "be assumed that an investor who buys or sells stock at the market price relies upon the statement."[8] A defendant can rebut this presumption by "sever[ing] the link between the alleged misrepresentation and…[the] market price."[9] Without the presumption, questions of individual reliance would predominate, and the proposed class could not be certified under Rule 23(b)(3).

Fifth Circuit: 'Oscar'

In *Oscar*, the Fifth Circuit raised the bar for plaintiffs seeking the benefit of the fraud-on-the-market presumption, by requiring more than a public material misstatement and efficient market. In *Oscar* the Fifth Circuit decertified plaintiffs' class for failure to establish loss causation, holding that "[g]iven the lethal force of certifying a class of purchasers of securities enabled by the fraud-on-the-market doctrine, we now in fairness insist that such a certification be supported by a showing of loss causation that targets the corrective disclosure appearing among other negative disclosures made at the same time."[10] A plaintiff must provide

Jamie A. Levitt *is a securities litigation partner at Morrison & Foerster and* **Michael Gerard** *is an associate with the firm.*

"proof that the misstatement *actually moved* the market."[11] The Fifth Circuit also held that the "trial court erred in ruling that the class certification stage is not the proper time for defendants to rebut lead plaintiffs' fraud-on-the-market presumption."[12] As the Fifth Circuit explained, proof of loss causation is necessary at the class certification stage because it speaks to the efficient market assumption on which classwide reliance depends, and some material, public misrepresentations may fail to affect the stock price.[13] Plaintiffs argued that the presumption of reliance was rebuttable only at the summary judgment stage as loss causation goes to the merits of a 10(b) claim.

Relying, in part, on the Second Circuit's decision in *In re Initial Public Offering Securities Litigation*, the Fifth Circuit rejected plaintiffs' argument, reasoning that, "a district court must 'resolve[] factual disputes relevant to each Rule 23 requirement'" even where "'a merits issue…is identical with a Rule 23 requirement.'"[14] Thus, the Fifth Circuit held that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence."[15]

In sum, the Fifth Circuit placed the burden on plaintiffs to establish loss causation at the class certification stage in order to establish the fraud-on-the-market presumption, and allowed defendants to rebut the presumption if established at that same stage.

In a dissenting opinion, Judge James L. Dennis described the requirement that loss causation be established prior to certification of the class as "a breathtaking revision of securities class action procedure that eviscerates *Basic's* fraud-on-the-market presumption, creates a split from other circuits by requiring minitrials on the merits of cases at the class certification stage, and effectively overrules legitimately binding circuit precedents."[16]

In practice, however, *Oscar's* application has resulted in litigants relying on expert reports and event studies rather than evidentiary hearings—far from the "mini-trials on the merits" suggested by the dissent.[17] Nonetheless, several judges in the Southern District of New York have agreed with Judge Dennis, and expressly rejected the standard articulated by *Oscar*.[18]

Second Circuit: 'Salomon'

In *Salomon*, plaintiffs brought a putative class action in the U.S. District Court for the Southern District of New York, against defendants Citicorp USA Inc., Salomon Smith Barney Inc., their parent, Citigroup Inc. and research analyst Jack Grubman alleging that they engaged in a scheme to defraud investors in Metromedia Fiber Networks Inc. by issuing and disseminating research analyst reports on Metromedia that allegedly contained materially false and misleading statements and omissions in violation of §10(b).[19] At class certification, the defendants argued that the fraud-on-the-market presumption does not apply to statements by research analysts, as opposed to issuers of securities. The defendants' primary argument against applying the presumption was that "plaintiffs were required to show that misrepresentations had an actual causal effect on the market price of Metromedia shares."[20]

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Judge Gerard E. Lynch certified the class concluding that the "presumption can apply in a case against research analysts," and that "nothing in the language of *Basic* limits its holding to issuer statements alone." Judge Lynch further held that "there is no reason to adopt a higher standard at class certification for plaintiffs alleging securities fraud by research analysts," and that "plaintiffs must make only 'some showing' that the predominance requirement is met." Finally, Judge Lynch held that the defendants would not be permitted to rebut the fraud-on-the-market presumption "until a later stage of the litigation, when it is appropriate to weigh merits-related evidence."[21]

The Second Circuit granted defendants leave under Rule 23(f) for an interlocutory appeal of the class certification to resolve the question of "whether plaintiffs alleging securities fraud against research analysts must make a heightened evidentiary showing in order to benefit from the fraud-on-the-market presumption."[22] On appeal, the Second Circuit refused to adopt a bright-line rule that bars application of the fraud-on-the-market presumption to a suit alleging misrepresentations by research analysts, and agreed that plaintiffs in such cases need not make a heightened evidentiary showing in order to benefit from the fraud-on-the-market presumption.[23] Nonetheless, the Second Circuit vacated the grant of class certification because the district court erred in not permitting defendants to attempt to rebut the presumption prior to class certification.[24]

'Basic's' Test

In *Salomon*, the Second Circuit explained that the Supreme Court in *Basic* "set forth a test of general applicability that where a defendant has (1) publicly made (2) a material misrepresentation (3) about stock traded on an impersonal, well-developed (i.e., efficient) market, investors' reliance on those misrepresentations may be presumed. This is all that is needed to warrant the presumption."[25] "Thus, plaintiffs do not bear the burden of showing an impact on price. The point of *Basic* is that an effect on market price is *presumed* based on the materiality of the information and a well-developed market's ability to readily incorporate that information into the price of securities."[26] The Second Circuit explained that the "burden of showing that there was *no* price impact is properly placed on defendants at the rebuttal stage," and that *Basic* made clear "[a]ny showing that *severs the link* between the alleged misrepresentation and…the price… will be sufficient to rebut the presumption of reliance."[27]

Reaffirming, the Second Circuit's previous holding in *In re IPO*, the court rejected the "some showing" standard and reaffirmed that class certification requires "*definitive assessment* of Rule 23 requirements, and held that all…evidence must be assessed as with any other threshold issue," and that "[s]uch an assessment can be made only if the judge resolves the factual disputes relevant to each Rule 23 requirement and is persuaded to rule…that the requirement is met…."[28] Most significantly, the Second Circuit held that this "definitive assessment" that Rule 23(b)(3) predominance requirement is met "cannot be made without determining whether defendants can successfully rebut the fraud-on-the-market

presumption."[29] *Salomon* notes that *Basic* itself explained "that a successful rebuttal *defeats* certification by defeating the Rule 23(b)(3) predominance requirement."[30]

Citing to 'Oscar'

The Second Circuit then cited to the Fifth Circuit's decision in *Oscar* (along with *In re IPO*) in support of its holding that defendants must be given the opportunity to rebut the fraud-on-the-market presumption at the class certification stage.[31] But the court also made clear that "[i]f defendants attempt to make a rebuttal, the district court will be 'accorded considerable discretion to limit both discovery and the extent of the hearing on Rule 23 requirements' in order '[t]o avoid the risk that a Rule 23 hearing will extend into a protracted mini-trial of substantial portions of the underlying litigation….'"[32]

Two weeks after its decision in *Salomon*, the Second Circuit again reaffirmed a district court's discretion to limit discovery and the extent of the class certification hearing in *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc.*, holding that a district court need not hold a "full blown evidentiary hearing," and "requir[ing] only that a court 'receive enough evidence, by affidavits, documents, or testimony, to be satisfied that each Rule 23 requirement has been met.'"[33] *Bombardier* also resolved any lingering confusion in the Second Circuit about the proper evidentiary standard by holding that "the preponderance of the evidence standard applies to evidence proferred to establish Rule 23's requirements," thus aligning the Second Circuit with the Fifth Circuit's decision in *Oscar*.[34]

Conclusion: Illusory Split

While many litigants will focus on the ostensible "split" between the Second and Fifth circuits with respect to plaintiff's burden of establishing loss causation as part of its motion for class certification, the Second Circuit's pronouncement in *Salomon* that defendants may rebut loss causation at the class certification stage will likely make the practical effect of this split illusory. Although the burden of showing no price impact in the Second Circuit is on defendants, both sides will be forced to address loss causation in detail at the class certification stage. Inevitably, defendants will rely on experts armed with event studies in order to sever the link between the misrepresentation and the price of the security in issue, essentially disproving loss causation as would normally be done at the summary judgment or trial stage.

Faced with such evidence, plaintiffs will clearly need to present their own evidence that the misrepresentations in issue did move the market in order to avoid losing the fraud-on-the-market presumption. Ultimately, with both plaintiffs and defendants presenting evidence on the issue of loss causation at the class certification stage, and the courts applying the preponderance of the evidence standard to all admissible evidence, it is likely there will be little difference between class certification in the Fifth and Second circuits. Together, the Second Circuit's decision in *Salomon* and Rule 23(f), which allows parties to seek interlocutory review of class certification decisions, are certain to increase the costs yet provide defendants an important, additional avenue for defeating securities class actions at an early stage prior to certification.

1. *In re Salomon Analyst Metromedia Litig.*, 06-3225-cv, 2008 WL 4426412 (2d Cir. Sept. 30, 2008).
2. *Oscar Private Equity Investments v. Allegiance Telecom Inc.*, 487 F.3d 261 (5th Cir. 2007).
3. See, e.g., *In re Credit Suisse First Boston Corp. (Lantronix Inc.) Analyst Sec. Litig.*, 250 F.R.D. 137 (S.D.N.Y. 2008) (Preska, J.); *Demarco v. Lehman Bros. Inc.*, 222 F.R.D. 243 (S.D.N.Y. 2004) (Rakoff, J.).
4. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *3.
5. Fed.R.Civ.P. 23(b)(3).
6. "The basic elements of a cause of action for securities fraud under §10(b) and Rule 10b-5 are (1) a material misstatement or omission, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance, 'often referred to in cases involving public securities markets (fraud-on-the-market cases) as transaction causation,' (5) economic loss, and (6) 'loss causation, i.e., a causal connection between the material misrepresentation and the loss.'" *Salomon*, 06-3225-cv, 2008 WL 4426412 at *3 n. 1 (quoting *Dura Pharms. Inc. v. Broudo*, 544 U.S. 336, 341 (2005)).
7. *Basic Inc. v. Levinson*, 485 U.S. 224, 247-248, n. 27 (1988).
8. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S.Ct. 761, 769 (2008).
9. *Basic*, 485 U.S. at 248.
10. *Oscar*, 487 F.3d at 262. While *Oscar* was understood by some to apply only to cases of multiple negative disclosures, the Fifth Circuit has since applied *Oscar's* holding to cases of single disclosures as well. See *Luskin v. Intervoice-Brite Inc.*, No. 06-11251, 2008 WL 104273 at *4 (5th Cir. Jan. 8, 2008) ("There is no reason why the concerns stated in *Oscar* do not equally apply to cases in which only one negative disclosure is at issue.")
11. *Oscar*, 487 F.3d at 265 (emphasis in original).
12. *Oscar*, 487 F.3d at 270.
13. *Oscar*, 487 F.3d at 269.
14. *Oscar*, 487 F.3d at 268 (quoting *In re Initial Public Offering Sec. Litig.*, 471 F.3d 24 (2d Cir. 2006) (*In re IPO*)).
15. *Oscar*, 487 F.3d at 269.
16. *Oscar*, 487 F.3d at 272 (Dennis, J. dissent); see also Samuel H. Rudman, "'Oscar': Misinterpretation of Fraud-on-the-Market Theory" July 17, 2008 NYLJ, 3, (col. 1) (*Oscar* "imposes an unprecedented burden on plaintiffs to prove the merits of their case at the class certification stage, while at the same time it counters objectives of full disclosure established by the Exchange Act").
17. See *Fener v. Belo Corp.*, 560 F.Supp.2d 502 (N.D. Tex. 2008); *Ryan v. Flowserve Corp.*, 245 F.R.D. 560 (N.D. Tex. 2007).
18. *Lapin v. Goldman Sachs & Co.*, No. 04 Civ. 2236 (RJS), 2008 WL 4222850 at *16 (S.D.N.Y. Sept. 15, 2008) (Sullivan, J.) ("*Oscar* should be rejected as a misreading of *Basic*," and "[n]othing in *Basic* or any Second Circuit precedent requires that plaintiff prove loss causation by a preponderance of the evidence in order to invoke the *Basic* presumption and satisfy the requirements of Rule 23."); *Darquea v. Jarden Corp.*, 2008 WL 622811 at * 4 (S.D.N.Y. March 6, 2008) (Brieant, J.) (the standard articulated in *Oscar* was "limited to the Fifth Circuit," and a "Plaintiff in the Second Circuit may benefit from the fraud-on-the-market presumption of reliance at the certification stage based solely on a showing that they made purchases or sales in an efficient market, and need not show that they specifically relied on the allegedly fraudulent conduct, as reliance—an element of a 10(b) claims—is presumed."); *Wagner v. Barrick Gold Corp.*, 2008 WL 465115 at *6 (S.D.N.Y. Feb. 15, 2008) (Berman, J.) ("[W]hile the Second Circuit has not addressed the issue of whether loss causation must be established to trigger the fraud on the market presumption, courts within the Second Circuit…have certified classes despite the lack of evidence of loss causation.")
19. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *1
20. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *4.
21. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *3-4.
22. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *1.
23. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *6.
24. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *10-11.
25. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *6.
26. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *8 (emphasis in original).
27. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *9 (emphasis in original, quoting *Basic*, 485 U.S. at 248).
28. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *9 (internal quotations and citations omitted, emphasis in original, citing *In re IPO*, 471 F.3d at 27, 41).
29. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *10.
30. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *10 (emphasis in original, citing *Basic*, 485 U.S. at 249, n. 29).
31. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *10 (citing *Oscar*, 487 F.3d at 270).
32. *Salomon*, 06-3225-cv, 2008 WL 4426412 at *11 (quoting *In re IPO*, 471 F.3d at 41).
33. *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc.*, No. 06-3794-cv, Slip Op. at 13 (2d Cir. Oct. 14, 2008) (quoting *In re IPO*, 471 F.3d at 41).
34. *Bombardier*, No. 06-3794-cv, Slip Op. at 11.