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FRAUD NOT ON THE MARKET: REBUTTING THE PRESUMPTION OF CLASSWIDE RELIANCE TWENTY YEARS AFTER BASIC INC. v. LEVINSON

Matthew L. Mustokoff

I. INTRODUCTION

To establish securities fraud under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, a plaintiff must allege reliance upon a material misstatement or omission of fact in connection with the purchase or sale of a security. Plaintiffs that are unable to allege that they actually relied upon the statements at issue regularly invoke the rebuttable presumption of reliance based on the "fraud-on-the-market" theory. This doctrine presumes that all publicly available information concerning a security has been incorporated into that security’s price, thereby enabling investors to rely on the integrity of the market price when making an investment decision. The fraud-on-the-market presumption, which derives from an economics theory dubbed the “efficient market hypothesis,” was first recognized by the U.S. Supreme Court in Basic Inc. v. Levinson1 almost two decades ago. Ever since, the district and circuit


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courts have grappled with the applicability of the presumption at various stages of securities fraud litigation, including class certification, particularly in cases involving securities that are not heavily traded or listed on prominent exchanges.

In a wave of recent decisions, the courts have made it tougher for plaintiffs to demonstrate that a particular security trades in an efficient market for purposes of triggering the classwide presumption of reliance. There are two principal reasons for this trend.

First, the courts have interpreted Federal Rule of Civil Procedure 23, which governs the requirements for class certification, more stringently in recent years. Among Rule 23’s prerequisites is the so-called “predominance” requirement of Rule 23(b)(3) which requires class plaintiffs to demonstrate that “questions of law or fact common to the members of the class predominate over any questions affecting only individual members.” In the majority of cases discussed in this article, the courts engaged in extensive fact-finding on the question of market efficiency in determining whether the Basic presumption applied for purposes of satisfying the rigorous requirements of Rule 23(b)(3).

Second, the expert evidence that has been permitted at the class certification stage in these proceedings has become exponentially more sophisticated and complex. Expert analyses of market movements, trading patterns among arbitrageurs, and the assimilation of market information by analysts and the investing public have provided an enormous benefit to issuers and other defendants in fraud-on-the-market cases by supplying the courts with the empirical proof of an inefficient market required to rebut the Basic presumption.

This article explores several recent decisions in which class certification was denied on the basis of the plaintiffs’ failure to establish an efficient market for the security underlying the fraud claim. These decisions serve as reminders to shareholder plaintiffs eager to invoke the fraud-on-the-market presumption as a means of establishing reliance through common, generalized proof that application of the presumption is not automatic and may be rebutted by an evidentiary showing of market inefficiency. They also highlight the critical role of expert reports and testimony in Rule 23 proceedings, particularly when the security at issue is not a familiar or heavily traded security and presents a borderline case for the applicability of Basic.

II. THE Basic Presumption

As explained by the Supreme Court in Basic, the “efficient market hypothesis” — from which the fraud-on-the-market theory stems — posits that, “‘in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business . . . .’” The Court concluded that investors that buy or sell stock at the price set by the market do so “in reliance on the integrity of that price,” and because all publicly available information has been reflected in that price, “an investor’s reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action.”

Application of the fraud-on-the-market presumption, however, is not mechanical and may be rebutted by “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price.” As one federal appeals court interpreting Basic has explained,

[T]he presumption of reliance may be rebutted by showing that the market did not respond to the alleged misrepresentations, or that the plaintiff did not actually rely on the market price when making his or her investment decision . . . . a defendant may [also] defeat the presumption of reliance by showing that the plaintiff’s reliance on the market price was actually unreasonable.

One of the most common methods of rebutting the presumption is by demonstrating that the relevant security did not trade in an efficient market during the contested period — i.e., that the alleged misrepresentations which caused the stock’s price to fall were not assimilated into the price of the security. By way of example, the courts have refused to recognize the presumption in cases involving securities traded over-the-counter or on “pink sheets,” newly issued municipal bonds, and mutual funds. In each

3. Basic, 485 U.S. at 241 (quoting Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986)).
4. Id. at 247.
5. Id. at 248.
7. See Bender v. Gillespie, 184 F.3d 1059, 1065 (9th Cir. 1999) (decertifying class; market for stock traded on “pink sheets” that circulate daily and contain “bid” and “ask” process, but do not include trading information such as sales volume on actual prices paid, is not efficient); Krogman v. Sterritt, 202 F.R.D. 467, 478 (N.D. Tex. 2001) (presumption did not apply because over-the-counter bulletin board market was not an efficient market).
8. See Freeman v. Laventhal & Horwath, 915 F.2d 193, 199 (6th Cir. 1990) (“We hold in the instant case that a primary market for newly issued municipal bonds as a matter of law is not efficient.”).
9 See Clark v. Nevis Capital Mgmt., LLC, No. 04 Civ. 2702, 2005 U.S. Dist. LEXIS 3158, at *56-57 (S.D.N.Y. Mar. 2, 2005) (“A plaintiff who has allegedly acquired shares in a mutual fund, the price for which is unaffected by alleged misrepresentations and omissions concerning the fund itself,
case, the court either dismissed the complaint or denied class certification on the ground that the security at issue did not (or could not) trade in an efficient market.

In *Cammer v. Bloom*, a decision issued one year after *Basic*, the District Court of New Jersey adopted a practical, five-factor test for determining whether an efficient market exists for purposes of presuming reliance under *Basic*. These factors include:

- the security's average weekly trading volume expressed as a percentage of total outstanding shares;
- the number of securities analysts reporting on the security;
- the extent to which market makers and arbitrageurs trade in the security;
- the issuer's eligibility to file SEC registration Form S-3 (as opposed to Form S-1 or S-2); and
- the existence of empirical facts demonstrating a cause and effect relationship between unpredicted corporate events or releases of financial data and an immediate reaction in the security's price.

The courts have come to rely on *Cammer* as a guidepost for fraud-on-the-market analysis. And inevitably, the analysis tends to focus on what several judges have identified as the "most important" *Cammer* factor: the cause and effect relationship between market news and market price.

III. BOMBARDIER: A CASE STUDY FOR THE APPLICATION OF THE CAMMER FACTORS

In a 2006 decision by District Judge Shira A. Scheindlin of the Southern District of New York, the court found that the fraud-on-the-market presumption did not apply in a case involving certificates of mortgage-backed securities. In *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc.*, the court found that the plaintiff pension fund was unable to establish that the certificates underlying the

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11. Id. at 1287.
12. E.g., *In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 512 (1st Cir. 2005).
fraud claims traded in an efficient market and, therefore, the putative class did not satisfy the requisites for class certification under Federal Rule of Civil Procedure 23.14 While the Bombardier decision does not forge any new law or depart from established principles, the court’s exploration of the contours of the fraud-on-the-market-theory and methodical balancing of the various, judicially crafted factors used to ascertain market efficiency provides an instructive precedent to guide courts in future cases.

Lead plaintiff Teamsters Local 445 Freight Division Pension Fund ("Teamsters") brought section 10(b) claims on behalf of open market purchasers of certain certificates ("the Certificates") offered by defendants Bombardier Capital Mortgage Securitization Corporation and Bombardier Capital, Inc. ("Bombardier"). Teamsters alleged that Bombardier misrepresented the integrity of mobile home installment sales contracts and mortgage loans serving as the collateral for the Certificates. Teamsters sought an order to certify the action as a class action pursuant to Rule 23. In arguing that the putative class satisfies the "predominance" requirement of Rule 23(b)(3), Teamsters maintained that the market for the Certificates was efficient and, thus, the putative class could rely on the fraud-on-the-market presumption.

At the outset, Judge Scheindlin noted that while the Second Circuit has not adopted a test for determining whether the market for a security is efficient, courts have historically looked to the five factors enunciated by the court in Cammer, as well as three additional factors — the issuer’s market capitalization, the bid-ask spread for stock sales, and the “float,” or the security’s trading volume excluding insider-owned stock — that are applicable when the security at issue is an equity.15 Judge Scheindlin explained that “[c]ourts should use these factors as an analytical tool rather than as a checklist.”16

In noting that the Cammer factors are not exhaustive, the court emphasized that the analysis under Basic must also take into account the definition of “market efficiency.” The court highlighted the First Circuit Court of Appeals’ 2005 decision in In re PolyMedica Corp. Sec. Litig.,17 in which the First Circuit adopted what it characterized as the “prevailing definition of market efficiency.”18

Under this definition, an “efficient market” is “one in which market price fully reflects all publicly available information.”19 As the First

14. Id. at *57-59.
15. Id. at *21-22 (citing Cammer, 711 F. Supp. at 1286-87).
16. Id. at *22 (citing Cammer, 711 F. Supp. at 1286-87; Krogman, 202 F.R.D. 467, 474-78 (N.D. Tex. 2001)).
17. 432 F.3d 1 (1st Cir. 2005).
18. Id at 10.
19. Id (emphasis added). In PolyMedica Corp., the First Circuit rejected the district court’s
Circuit explained, in an efficient market, the ""ordinary investor"" can never ""beat the stock market"" or ""make trading profits on the basis of new information"" because ""the market price already reflects the new information.""20 The PolyMedica Court's definition of market efficiency adopts what is known in the literature as the ""semi-strong"" form of the efficient market hypothesis. As explained by the First Circuit:

There are three competing forms of [the efficient market] hypothesis — weak, semi-strong, and strong — each of which makes a progressively stronger claim about the kind of information that is reflected in stock price. Under the weak form, an efficient market is one in which historical price data is reflected in the current price of the stock, such that an ordinary investor cannot profit by trading stock based on the historical movements in stock price. Under the semi-strong form, an efficient market is one in which all publicly available information is reflected in the market price of the stock, such that an investor's efforts to acquire and analyze public information (about the company, the industry, or the economy, for instance) will not produce superior investment results. Finally, under the strong form, an efficient market is one in which stock price reflects not just historical price data or all publicly available information, but all possible information — both public and private. Based on this form of an efficient market, not even an inside trader can outperform other investors because all such information is reflected in the market price.21

The PolyMedica Court essentially concluded that the ""semi-strong"" form of the efficient market hypothesis is the ""one most consistent with the understanding of market efficiency espoused by the Supreme Court in Basic when it adopted and defined the contours of the fraud-on-the-market presumption.""22

Having adopted the PolyMedica definition of market efficiency, the Bombardier Court turned to its analysis of the parties' experts' arguments concerning whether the Certificates traded in an efficient market, systematically applying each of the Cammer factors to determine whether Teamsters demonstrated the efficiency of the market by a ""preponderance of the evidence"" — the applicable standard of proof in Rule 23 certification proceedings.

With respect to the first factor, trading volume, the court found that

holding that ""the 'efficient' market required for [the] 'fraud on the market' presumption of reliance is... one in which market professionals generally consider most publicly announced material statements about companies,"" as opposed to a market in which ""a stock price rapidly reflects all publicly available material information."" Id. (quoting In re PolyMedica Corp. Sec Litig., 224 F.R.D. 27, 41 (D. Mass 2004)) (emphasis added).

20. Id. at 8.
21. Id. at 10 n.16 (emphasis added).
22. Id. at 11-15.
the Certificates' weekly "turnover," or average weekly trading volume as a percentage of outstanding shares, of 8.5 percent supports a finding that the Certificates traded in an efficient market. In so finding, the court relied on Cammer, which held that a turnover of two percent or more of outstanding shares "would justify a strong presumption that the market for the security is an efficient one."

The court found that the second factor, the extent of analyst coverage of the security, militates in Bombardier's favor. The court rejected Teamsters' argument that because forty-four financial analysts actively covered Bombardier, Inc. ("BI") — the parent company of the Bombardier entity responsible for servicing the collateral on the Certificates — these same analysts can be said to have followed the Certificates as well. As the court explained, "Teamsters has presented no evidence that analysts specifically followed the Certificates, the value of which is tied to the performance of the underlying mobile homes, and only incidentally to the performance of BI or its subsidiaries." The third factor, the existence of market makers, was also found to tilt in Bombardier's favor. In applying this factor, the court relied on the SEC's regulations which define "market maker" as one who,

with respect to a particular security, (i) regularly publishes bona fide, competitive bid and offer quotations in a recognized interdealer quotation system; or (ii) furnishes bona fide competitive bid and offer quotations on request; and, (iii) is ready, willing and able to effect transactions in reasonable quantities at his quoted prices with other brokers or dealers.

As the court explained, because Teamsters could not establish that any firm regularly published bids and quotes for the Certificates or would furnish bids and quotes on request and effect transactions for the Certificates, this factor supports a finding that the Certificates traded in an inefficient market.

There was no dispute as to the fourth factor, the filing of an SEC Registration Form S-3. For each class of Certificates, Bombardier filed a Form S-3, a fact supporting a finding that the Certificates traded in an efficient market.

The court found that the fifth factor, causation, supported a showing of an inefficient market. The court rejected Teamsters' expert's event study of Certificate price movement which purported to show that numerous positive and negative announcements corresponded with anomalous

25. Id at *51-52 (citing 17 C.F.R. §240.15c3-1(c)8 (2006)).
movements in the Certificates' prices. As the court explained, Teamsters' event study was deficient insofar as it relied on Bloomberg prices — as opposed to transaction prices — which take into account transaction prices as well as current news concerning the issuer. To that end, the court credited Bombardier's expert, who maintained that the Bloomberg prices for the Certificates are not as reliable as the transaction prices in that they (i) experienced greater variation over time than the transaction prices, and (ii) reacted much more significantly to unanticipated news than the transaction prices.

The court was not persuaded by Teamsters' response that the price indications provided by proprietary pricing services such as Bloomberg constitute a "reasonable proxy" for transaction prices when there are no publicly available prices. As Judge Scheindlin reasoned, because Bloomberg and other proprietary services "presuppose" that security prices reflect information about the issuer (or, in the instant case, the Certificate collateral) these so-called "prices" "assume market efficiency." The court found that "[t]o use prices that assume market efficiency in an event study designed to determine whether or not that market is efficient is circular reasoning" and stated that because of the material discrepancy between the Bloomberg prices and the transaction prices, the transaction prices are the more meaningful indicator of market efficiency. As there were no material price drops in the Certificates after they were unexpectedly downgraded below investment grade, the Court concluded that the causation factor cuts in favor of a finding that the Certificates did not trade in an efficient market.

In weighing the totality of the circumstances — and in particular, the lack of a causal relationship between unforeseen news and a direct, immediate reaction in the price of the Certificates — the Bombardier court found that the market for the Certificates was inefficient and refused to certify the class.

26. Id. at *55.
27. The court also found that Teamsters could not rely upon the presumption of reliance based on the doctrine of Affiliated Ute Citizens v United States, 406 U.S. 128, 153-54 (1972), in which the Supreme Court held that in securities fraud cases "involving primarily [allegations of] a failure to disclose, proof of reliance is not a prerequisite to recovery," but rather reliance may be presumed. Judge Scheindlin quickly disposed of Teamsters' argument that the Affiliated Ute presumption applies. As the court explained, Teamsters' Section 10(b) claims are premised, not on an alleged failure to disclose, but rather on "affirmative misstatements" allegedly made by Bombardier regarding its purported adherence to underwriting standards and the causes of the Certificates' poor performance; thus Affiliated Ute does not avail Teamsters with a presumption of reliance. Teamsters, 2006 U.S. Dist. LEXIS 52991, at *45-46
Less than two months after the Bombardier decision came down, District Judge William G. Young of the District of Massachusetts resolved the class certification dispute in In re Polymedica Securities Litigation\(^\text{28}\) that was the subject of the appeal discussed above in which the First Circuit adopted the “semi-strong” definition of an efficient market, i.e., one in which the market price of the stock fully reflects all publicly available information.

By way of background, in 2005 the First Circuit vacated District Judge Robert Keeton’s order granting the original certification motion in which the district court had held that “the ‘efficient’ market required for [the] ‘fraud on the market’ presumption of reliance is ... ‘one in which market professionals generally consider most publicly announced material statements about companies.’”\(^\text{29}\) In addition to adopting semi-strong definition of market efficiency, the First Circuit held that a district court may properly go beyond the pleadings when deciding a Rule 23 class certification motion, explaining that there must be a “rigorous analysis of the prerequisites established by Rule 23 before certifying a class.”\(^\text{30}\)

On remand, Judge Young was faced with the question of whether PolyMedica shares traded on an efficient market during the class period in light of the First Circuit’s newly adopted definition of market efficiency. The court first focused on the Cammer factors, finding that the first four factors — average trading volume, number of analysts, presence of market makers and eligibility to file a Form S-3 registration — favored the plaintiffs and militated toward a finding of market efficiency for PolyMedica stock. “As for the ‘most important’ Cammer factor,’ however, the court found that the plaintiffs’ expert’s analysis left “much to be desired.”\(^\text{31}\) PolyMedica’s expert sharply criticized plaintiffs’ assertion that because PolyMedica’s stock price reacted in the marketplace on significant news days, the stock’s market was demonstrably efficient for fraud-on-the-market purposes. The plaintiffs’ expert’s analysis relied solely on a listing of five price movements during the contested time period, each of which corresponded to a major news event. On cross-examination, PolyMedica’s expert testified as follows:

\[\text{[Y]ou went and searched for the largest price drops. That’s not a scientific study. A scientific study is one where you draw a sample and}\]
then you compare a test statistic from that sample to another sample... All you did was went and picked the largest stock price drops and said, oh, gee, that just shows that it’s informationally efficient. You picked five days out of about 160 trading days. What you should do is look at all 160 trading days and do a scientific study to see if there’s a difference between the news days and the non-news days. And if you would have done that you would have found that there wasn’t any difference between them.32

Essentially, PolyMedica, through its expert, established that the fluctuations in the company’s stock during the contested period occurred as much on days when significant market news was announced as on days when there were no big news announcements. As the court explained, the plaintiffs’ expert’s “mere listing of five days on which news was released and which exhibited large price fluctuations proves nothing.”33 The court also concluded that the plaintiffs’ expert analysis failed to demonstrate “not only that news caused price movements, but also that those movements were ‘fully’ and ‘quickly’ reflected in PolyMedica’s stock price. Nothing in Miller’s [expert] analysis tends to show that all reactions to any news event were regularly complete within any given time frame, let alone ‘quickly.’”34 As a result, the court expressed its doubts that plaintiffs could meet the standard set forth by the First Circuit, and in referring to an oft-quoted baseball legend, noted that, “[i]t may be true, as Miller suggests, that one ‘can observe a lot just by watchin,’ but Yogi Berra is hardly a competent expert in market efficiency.”35

As if the plaintiffs’ failure to establish market efficiency under the Cammer test was not enough, the court, in denying the plaintiffs’ bid for class certification, underscored PolyMedica’s expert’s demonstration of “fundamental value efficiency,” or the ability of a particular security to be accurately valued by the market. The court explained that fundamental value efficiency is separate, but related, to the concept of “information efficiency” which underlies the First Circuit’s definition of market efficiency. As the court elucidated,

Information efficiency must be distinguished from fundamental value efficiency. An information efficient market need not accurately respond to information such that “market prices mirror the best possible estimates, in light of all available information, of the actual economic values of securities in terms of their expected risks and returns. A market that is fundamental value efficient is both information efficient and accurate in its valuation of stocks. Thus, it is possible for a market

32. Id at 269. The court found PolyMedica’s expert to be “particularly credible and informative. His responsiveness to the Court’s questions was both helpful and impressive.” Id at 269 n.7.
33. Id. at 270.
34. Id.
35. Id.
to be information efficient but not fundamental value efficient.

The First Circuit requires only that a market be information efficient, not fundamental value efficient. Still, 'as a matter of logic,' evidence related to fundamental value efficiency may be relevant because fundamental value efficiency incorporates information about information efficiency.\textsuperscript{36}

The \textit{PolyMedica} court thus went beyond the First Circuit's analysis, taking into consideration not only whether the price of PolyMedica stock \textit{did} quickly and fully respond to news, but also whether the structure of the market for PolyMedica stock was such that it \textit{could} do so.\textsuperscript{37} In recognizing that its analysis must be guided by the First Circuit's emphasis on the information efficiency test, the court explained that it "will tie itself to the mast of information efficiency, but loosen the bindings when considerations of fundamental value efficiency proves beneficial to the analysis."\textsuperscript{38}

The court then turned to the defendant's expert's observation that short selling\textsuperscript{39} of PolyMedica stock was notably difficult, a factor tending to demonstrate a lack of fundamental value efficiency. PolyMedica's expert proffered evidence that compared to the average 1.9 trading days required to cover a short sale of securities listed on the NASDAQ exchange, for PolyMedica stock it took an average of ten days during the same period and at one point took as many as twenty days.\textsuperscript{40} It was further demonstrated that as a result of this inability to find short sellers for PolyMedica stock that, the transaction costs for short selling the company's stock became prohibitively high.

The court rejected the plaintiffs' contention that PolyMedica's short sales analysis addresses the fundamental value efficiency of the company's stock, but not the information efficiency which is required by the First Circuit standard. Noting that the role of market arbitrage, including short sales, is significant in determining the efficiency of a security's market, the court found that the constraints on short selling for PolyMedica stock demonstrated a lack of fundamental value efficiency which, as the First

\textsuperscript{36} Id at 271-72 (quoting Lynn A. Stout, \textit{The Mechanisms of Market Efficiency: An Introduction to the New Finance}, 28 J. CORP. L. 635, 640 (2003)).

\textsuperscript{37} Id at 273.

\textsuperscript{38} Id.

\textsuperscript{39} The Second Circuit recently described short selling as follows:

An investor sells short when he sells a security that he does not own by borrowing the security, typically from a broker. At a later date, he 'covers' his short position by purchasing the security and returning it to the lender. A short seller speculates that the price of the security will drop. If the price drops, the investor profits by covering for less than the short sale price.

\textit{ATSI Communications, Inc. v. Shaar Fund, Ltd.}, 493 F.3d 87, 96 n.1 (2d Cir. 2007).

\textsuperscript{40} \textit{In re PolyMedica Corp. Sec. Litig.}, 453 F. Supp. 2d at 273-74.
Circuit observed, "may be relevant to the [information] efficiency determination as, for example, circumstantial evidence that arbitrageurs are not trading in the market, with the result that securities prices do not fully reflect all publicly available information."^41

Finally, the PolyMedica court relied on evidence put forth by the defendant’s expert that the price of PolyMedica’s stock, perhaps as a result of the limitations on short selling, exhibited what is known as "positive serial correlation" — a continual delay in the processing of market information into the stock price — for a five-month period.42 As the court explained, this phenomenon is not present in efficiently traded securities which can assimilate market news within a short, if not instantaneous, time frame. The court held that the First Circuit’s definition of market efficiency, which stated that stock price must "quickly and fully reflect the release of public information such that ordinary investors cannot profitably trade on the basis of it, requires that the reaction to news be fully completed on the same trading day as its release — and perhaps even within hours or minutes."^43 The court concluded that the positive serial correlation of PolyMedica stock precluded a finding of market efficiency: "Such a condition is fundamentally incompatible with the standard the First Circuit announced."^44

V. In re IPO: The Second Circuit Ratchets Up Rule 23

In Miles v. Merrill Lynch & Co. (In re Initial Public Offering Sec. Litig.) ("In re IPO"),^45 the Second Circuit held that in deciding a class certification motion under Rule 23, district courts must consider sufficient evidence to reach a proper "determination" of whether the purported class has satisfied the requirements for certification, even though such determination may intersect with, or indeed encompass, the actual merits of the case.46 In clarifying the framework for Rule 23 inquiry in the Second Circuit — and in particular, in emphasizing a district court’s obligation to undertake a thorough examination of the competing evidence on market efficiency at the class certification stage — the In re IPO decision is in many respects a loud avowal of the district courts’ methods and processes in Bombardier and PolyMedica. As the Second Circuit held, "the district judge must receive enough evidence, by affidavits, documents, or

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41. Id. at 276 (quoting In re PolyMedica Corp. Sec. Litig., 432 F.3d 1, 16 (1st Cir. 2005)).
42. See id. at 276-278.
43. Id. at 278.
44. Id.
45. 471 F 3d 24 (2d Cir. 2006)
46. Id. at 41.
testimony, to be satisfied that each Rule 23 requirement has been met.\textsuperscript{47}

In certifying the shareholder class below, District Judge Scheindlin declined to weigh the parties’ dueling expert reports addressing, among other things, whether the initial public offering shares underlying the plaintiffs’ fraud claims traded in an efficient market. The district court applied a “some showing” standard in finding that the purported class had satisfied the predominance requirement of Rule 23(b)(3) by invoking the Basic presumption.

On appeal, the Second Circuit rejected Judge Scheindlin’s “some showing” standard as too lenient.\textsuperscript{48} In defining the contours of a district court’s scope of review on a Rule 23 class certification motion, the Second Circuit explained that a district court, in determining whether all Rule 23 requirements have been met, should not be constrained in its factual inquiry even if there is some overlap between the issues raised by the class certification motion and issues which go directly to the merits. Nevertheless, the Second Circuit cautioned that district courts should avoid an examination of the merits with respect to issues that are “unrelated” to the Rule 23 inquiry.\textsuperscript{49}

Before turning to the parties’ competing evidence on whether the IPO shares at issue traded in an efficient market, the IPO court set forth the following conclusions of law:

(1) a district judge may certify a class only after making determinations that each of the Rule 23 requirements has been met;
(2) such determinations can be made only if the judge resolves factual disputes relevant to each Rule 23 requirement and finds that whatever underlying facts are relevant to a particular Rule 23 requirement have been established and is persuaded to rule, based on the relevant facts and the applicable legal standard, that the requirement is met;
(3) the obligation to make such determinations is not lessened by overlap between a Rule 23 requirement and a merits issue, even a merits issue that is identical with a Rule 23 requirement;
(4) in making such determinations, a district judge should not assess any aspect of the merits unrelated to a Rule 23 requirement; and
(5) a district judge has ample discretion to circumscribe both the extent of discovery concerning Rule 23 requirements and the extent of a hearing to determine whether such requirements are met in order to assure that a class certification motion does not become a pretext for a partial trial of the merits.\textsuperscript{50}

The Second Circuit stated that these conclusions “necessarily

\textsuperscript{47} Id. at 42.
\textsuperscript{48} Id.
\textsuperscript{49} See id. at 41.
\textsuperscript{50} Id. (emphasis added).
preclude" the application of a "some showing" standard at the Rule 23 stage and that the district judge must assess "all of the relevant evidence admitted at the class certification stage . . . just as the judge would resolve a dispute about any other threshold prerequisite for continuing a lawsuit." 

Turning to the particular facts of the case, the IPO court explained that while in some circumstances, it would be appropriate to remand a class certification dispute to the district court for reconsideration, in this case remand was not necessary because "the Plaintiffs' own allegations and evidence demonstrate that the Rule 23 requirement of predominance of common questions over individual questions cannot be met under the standards as we have explicated them." With respect to plaintiffs' fraud-on-the-market argument, the Second Circuit held that plaintiffs could not avail themselves of the presumption of reliance because shares of initial public offerings cannot trade on an efficient market. Citing to the Sixth Circuit's decision in Freeman v. Laventhol & Horwath — a case holding that newly issued, non-exchange traded municipal bonds do not trade in an efficient market — the IPO court explained that "'a primary market for newly issued [securities] is not efficient or developed under any definition of these terms.'" The court noted that an efficient market for the IPO shares cannot be demonstrated because during the 25-day "quiet period" imposed by SEC regulations, analysts cannot report on securities trading as part of an IPO, thus negating one of the hallmarks of an efficient market — significant analyst coverage. The Second Circuit also found that plaintiffs' own allegations with respect to how slow the market was to correct the price inflation of the IPO shares allegedly caused by the defendant-underwriters "indicate[s] the very antithesis of an efficient market." Having failed to trigger the Basic presumption through a showing of market efficiency, plaintiffs, the court held, could not satisfy the predominance requirement for class certification.

VI. ENRON AND STONERIDGE: "SCHEME" LIABILITY FOR "NON-SPEAKING" DEFENDANTS IS INCOMPATIBLE WITH BASIC

In March 2007, the U.S. Court of Appeals for the Fifth Circuit denied a bid for class certification by Enron shareholders as they attempted to hold three investment banks liable for their alleged participation in Enron's
accounting machinations. In *Regents of Univ. of California v. Credit Suisse First Boston (USA), Inc.* ("Enron"), the Fifth Circuit found that the shareholder plaintiffs could not invoke the *Basic* presumption as they were unable to establish that the banks owed the purported class a duty to disclose material information about Enron’s financial condition. As the court reasoned, because the banks did not owe an affirmative duty to Enron shareholders to disclose misstatements in Enron’s financial reports, the plaintiffs could not presume reliance in accord with *Basic*. This decision reversed District Judge Melinda Harmon’s certification order with respect to the defendant banks which was premised on the lower court’s view that a showing of an efficient market was not required to invoke the *Basic* presumption at the class certification stage in a case involving allegations of “scheme” liability under Rule 10b-5(a) and (c) for fraudulent conduct that is distinct from written or verbal misrepresentations to the marketplace.

Central to the Fifth Circuit’s reversal of the district court’s certification order was its rejection of scheme liability under Rule 10b-5(a) and (c). Scheme liability is a doctrine which arose in the wake of *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, in which the U.S. Supreme Court held that a plaintiff in a private damages action under Section 10(b) cannot recover against an aider and abettor of another party’s fraud. In an effort to evade *Central Bank*’s bar on aider and abettor liability, plaintiffs have sought to ensnare underwriters, lenders, broker-dealers and other “secondary actors” for their roles in alleged financial frauds by relying on the “scheme” liability prongs of Rule 10b-5:

- subsections (a) and (c). These subsections, which prohibit the employment of a “device, scheme, or artifice to defraud,” and an “act, practice or course of business which operates or would operate as a fraud or deceit,” address a category of “non-verbal” or “non-representational” fraudulent conduct that is analytically distinct from the more familiar, garden-variety misrepresentations and omissions of material fact proscribed by subsection (b) of the rule. The underpinning of the scheme liability doctrine is that while these secondary actors may not themselves have, either by misstatement or omission, made actionable representations, they are nevertheless liable for primary violations of section 10(b) through their manipulative or deceptive acts.

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58. 482 F.3d 372 (5th Cir. 2007).
59. 511 U.S. 164, 188 (1994) (holding that Section 10(b) does not reach parties “who do not engage in the proscribed activities at all, but who give a degree of aid to those who do”).
60. Before *Central Bank*, plaintiffs rarely invoked subsections (a) and (c), because, as District Judge Kaplan has surmised, during the pre-*Central Bank* era of aiding and abetting liability, the "path of least resistance" for a plaintiff alleging a fraud involving multiple actors was to plead that one defendant misrepresented or omitted a material fact and that the other defendants aided and abetted the making of that misrepresentation or omission. *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005).
In rejecting scheme liability, the *Enron* court stated that "[t]he appropriate starting point is the text of the statute"  — Section 10(b) — which prohibits a "manipulative or deceptive" act. The court relied heavily on the Eighth Circuit's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* ("Charter Communications"), 62 a decision which was appealed to, and recently upheld by, the U.S. Supreme Court. 63 The Eighth Circuit in *Stoneridge* was the first circuit court following *Central Bank* to address — and reject — scheme liability. In endorsing the reasoning of *Stoneridge* and refusing to follow the Ninth Circuit position that a defendant can be liable under Rule 10b-5(a) or (c) if he is found to have "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of [a fraudulent] scheme," 64 the *Enron* court stated:

The Eighth Circuit, unlike the Ninth, has correctly taken [post-*Central Bank*] decisions collectively to mean that "deceptive" conduct involves either a misstatement or a failure to disclose by one who has a duty to disclose." That court quoted the technical definition of "manipulation" from *Santa Fe [Indus., Inc. v. Green]* and stated that "any defendant who does not make or affirmatively cause to be made a fraudulent statement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10b-5.

Applying this framework, the Fifth Circuit reasoned that the three defendant investment banks could not be primary violators under Section 10(b) because they engaged in neither a "manipulative" nor "deceptive" act within the meaning of the statute. The court explained that "manipulation" is a term of art that has the narrow contextual meaning ascribed by the Supreme Court in *Santa Fe Indus., Inc. v. Green*, namely, unlawful trading practices such as "wash sales, matched orders, or rigged prices, that are

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61. *Enron*, 482 F.3d at 387.
62. 443 F.3d 987 (8th Cir. 2006).
65. *Enron*, 482 F.3d at 388 (quoting *Stoneridge*, 443 F.3d at 992).
intended to mislead investors by artificially affecting market activity—none of which were alleged by the Enron plaintiffs. With respect to establishing a "deceptive" act under section 10(b), the court explained that in the case of a defendant not alleged to have made an affirmative misstatement, a section 10(b) plaintiff must demonstrate alternatively that the defendant had a duty to disclose material facts and breached that duty. As the court held, because the defendant banks owed no fiduciary or contractual duty of disclosure to shareholders of Enron, the purported class could not demonstrate the existence of a deceptive act on the part of the banks:

The district court's conception of "deceptive act" liability is inconsistent with the Supreme Court's decision that § 10 does not give rise to aiding and abetting liability. An act cannot be deceptive within the meaning of § 10 where the actor has no duty to disclose. Presuming plaintiffs' allegations to be true, Enron committed fraud by misstating its accounts, but the banks only aided an abetted that fraud by engaging in transactions to make it more plausible; they owed no duty to Enron's shareholders.67

Having found that the investment banks owed no classwide duty of disclosure to the purported class, the Fifth Circuit held, by extension, that the plaintiffs could not invoke the Basic presumption of reliance with respect to these defendants. The court concluded essentially that the notion of Rule 10b-5 liability for "non-speakers" on whom the market does not presumptively rely for information is fundamentally incompatible with the fraud-on-the-market doctrine which is premised on market efficiency. As the court stated:

Without its broad conception of liability for "deceptive acts," the district court could not have found that the entire class was entitled to rely on Basic's fraud-on-the-market theory, because the market may not be presumed to rely on an omission or misrepresentation in a disclosure to which it was not legally entitled. The plaintiffs are likely correct that the market for Enron securities was efficient and that inherent in that conclusion is the fact that the market price reflected all publicly available information. But the factual probability that the market relied on the banks' behavior and/or omissions does not mean that plaintiffs are entitled to the legal presumption of reliance.68

In this regard, the court explained that "[m]arket efficiency was not the sole condition that the Court in Basic required plaintiffs to prove existed to qualify for the classwide presumption," and that plaintiffs must also establish that the defendant made "public and material

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66 Enron, 482 F.3d at 387 (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977)).
67 Id. at 386.
68 Id. at 382-83.
misrepresentations." Applying this tenet from *Basic*, the *Enron* court reasoned that “if the banks’ actions were non-public, immaterial, or not misrepresentative because the market had no right to rely on them (in other words, the banks owed no duty), the banks should be able to defeat the presumption.”

On January 22, 2008, the U.S. Supreme Court denied the *Enron* plaintiffs’ petition for certiorari, dealing a major blow to those who view scheme liability as a valid subset of primary liability under section 10(b). The Court’s order came just a week after affirming the Eighth Circuit’s decision in *Stoneridge* on which the *Enron* Court so heavily relied. The Supreme Court affirmed *Stoneridge* by a 5-3 decision. Though *Stoneridge* is not a class certification case, the decision is directly pertinent to the evolving doctrine under *Basic* discussed in this article.

In *Stoneridge*, the plaintiffs alleged that Scientific-Atlanta and Motorola, suppliers and customers of Charter Communications, entered into sham transactions with Charter that allowed Charter to book fictitious revenues from the transactions. The *Stoneridge* Court, echoing the reasoning of *Enron*, placed cardinal emphasis on the reliance element, concluding that the plaintiff-investors could not trigger the fraud-on-the-market presumption because the transactions — as opposed to Charter’s false financial statements — were not disclosed to the public, thereby precluding reliance. The Court, however, did not hold — as the Fifth Circuit in *Enron* and the Eighth Circuit in *Stoneridge* had — that a “deceptive” act for purposes of section 10(b) necessarily entails a specific oral or written misstatement. Rather, the Court reasoned that, even assuming the truth of the allegations that Scientific-Atlanta and Motorola — neither of whom were the issuer of the security in question — engaged in deceptive acts by participating in sham transactions with Charter, the respondents’ deceptive acts were not “communicated to the public,” and thus plaintiffs could not establish reliance by way of *Basic*. As the Court stated:

In effect petitioner contends that in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect. Were this concept of reliance to be adopted, the implied cause of action [under Section 10(b)] would reach the whole marketplace in which the issuing company does

69. Id. at 383 (citing *Basic*, 485 U.S. at 248 n. 27).
70. Id.
73. Id. at 766-67.
74. Id. at 769.
75. Id. at 769-70.
business; and there is no authority for this rule . . . . [T]he investors cannot be said to have relied upon any of the respondents' deceptive acts in the decision to purchase or sell securities; and as the requisite reliance cannot be shown, respondents have no liability to petitioner under the implied right of action.76

Although Stoneridge essentially reaffirms the rule of Central Bank, the Stoneridge Court's underscoring of reliance to clarify the contours of primary liability under section 10(b) is a departure from much of the post-Central Bank jurisprudence, where the principal question weighing on the district and circuit courts was whether non-representational conduct, such as structuring or financing fraudulent transactions (as opposed to misrepresenting or failing to disclose the true nature of those transactions to the market), falls within section 10(b)'s definition of a "deceptive" act. In Stoneridge, the Supreme Court relegated this question to ancillary status, focusing predominantly on the role of reliance in a securities fraud. The Stoneridge Court invoked the fraud-on-the-market doctrine to demarcate the line between primary and secondary liability under section 10(b), effectively drawing a boundary between the sphere of the "efficient" market in which securities are bought and sold through reliance on prospectuses, financial statements, proxy statements and other publicly available sources of information, and a sphere of secondary actors — the contractors and suppliers in Stoneridge, the investment banks in Enron — whose deceptive acts, while beyond the reach of a private section 10(b) action, are within the ambit of regulation by the Securities and Exchange Commission (SEC) and state law.77 And by denying review of the Fifth Circuit's Enron ruling a week later, the Supreme Court made clear that there is no exception to Stoneridge's limitation on primary liability for financial institutions such as the banks that allegedly facilitated Enron's fraud on the market.

76. Id. at 770, 774 (emphasis added).
77. The Stoneridge Court reasoned that, while Central Bank prohibits private Section 10(b) claims against secondary actors who may have participated in a fraudulent scheme, such actors remain subject to enforcement actions by the SEC pursuant to Section 104 of the Private Securities Litigation Reform Act, which expressly granted the SEC with enforcement power over aiders and abettors. Id. at 768-69. In that regard, the Court placed great weight on the fact that Congress opted to "restor[e] aiding and abetting liability in certain cases but not others" and noted its reluctance to expand the implied private right of action under Section 10(b) in a way that would "undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants." Id. at 771-72. The Court further noted that state law provides remedies for private litigants injured by "secondary" conduct, explaining that "the realm of ordinary business operations" that exists beyond the securities markets is an area "already governed by functioning and effective state-law guarantees." Id. at 770-71; see also id. at 773 ("In addition some state securities laws permit state authorities to seek fines and restitution from aiders and abettors.").
VII. ALLEGIANCETELECOM: LOSS CAUSATION AS AFRAUD-ON-THE-MARKET PREREQUISITE

Because the *Enron* court found that the absence of a classwide duty was dispositive of the *Enron* plaintiffs' class certification motion, the court declined to reach another question briefed by the parties: whether the banks' alleged acts could have been viewed as a "unitary scheme giving rise to common issues of loss causation among the class members." However, just eight weeks after the Fifth Circuit handed down the *Enron* decision, the court took up the loss causation issue in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, another decision vacating a class certification order.

In *Allegiance Telecom*, the Fifth Circuit — incited by "the lethal force of certifying a class of purchasers of securities enabled by the fraud-on-the-market doctrine" became the first circuit court to require plaintiffs to establish a direct causal link between defendants' alleged misrepresentations and plaintiffs' losses to trigger the fraud-on-the-market presumption of reliance and qualify for class certification. In so holding, the court focused on how the question of loss causation is inextricably linked — as a matter of doctrine, theory and precedent — to the presumption of classwide reliance as established by *Basic*. The Fifth Circuit also echoed the Second Circuit's *IPO* decision in its emphasis on the necessity of a rigorous judicial inquiry at the class certification stage that goes beyond the pleadings, addresses the merits (if necessitated by the Rule 23 inquest), and which may require sufficient fact-finding for the court to render a certification decision on an "informed basis."

The plaintiffs in *Allegiance Telecom* claimed that Allegiance, a telecommunications provider, fraudulently misrepresented its line-installation count in the company's first three quarterly announcements of 2001. The plaintiffs claimed that after the company restated the line-installation count in its fourth quarter (4Q01) announcement on February 19, 2002 — (a restatement from 1,140,000 to 1,015,000 lines, or a difference of 125,000 lines) — the company's stock dropped from $3.70 to $2.65 per share. Allegiance filed for bankruptcy the following year. The defendants argued that the 4Q01 restatement of the line-installation count did not cause the stock price to drop. Rather, the defendants contended, Allegiance's restatement of the line-installation count was just one of several negative announcements made by Allegiance on February 19, 2002.

78. *Id.* (emphasis added).
79. 487 F.3d 261 (5th Cir. 2007).
80. *Id.* at 262.
81. *Id.* at 267.
including (i) missed analysts' expectations on 2001 earnings per share, (ii) a greater EBITDA loss than expected, and (iii) a very thin margin of error for meeting revenue covenants for 2002. The defendants asserted that the plaintiffs could not establish that the decline in Allegiance stock on February 19, 2002 was the result of the line-installation restatement, as opposed to these other pieces of bad news.

In certifying the class below, the district court had concluded that “the class certification stage is not the proper time for defendants to rebut lead Plaintiffs' fraud-on-the-market presumption,” reasoning that while Basic held that the presumption of classwide reliance was rebuttable, such rebuttal had to await a summary judgment motion. On appeal, the defendants maintained that the district court erroneously declined to consider all evidence on the question of loss causation at the class certification stage. The Fifth Circuit agreed, holding that “loss causation must be established at the class certification stage by a preponderance of all admissible evidence” and rejecting the plaintiffs’ argument that such a requirement “improperly shifts the burden, from a defendant’s right of rebuttal to a plaintiff’s burden of proof.”

In holding that plaintiffs must show that the alleged misrepresentation proximately caused plaintiffs’ losses in order to trigger the fraud-on-the-market presumption, the Fifth Circuit focused on the evolution of Rule 23. The court noted that Rule 23(c)(1)(A), amended in 2003, no longer requires a district court to rule on class certification “as soon as practicable,” but now requires a ruling “at an early practicable time.” As the court explained, under the old rule, class certification was viewed by district courts as a “light step along the way, divorced from the merits of the claim” — i.e., a threshold procedural analysis that needed to be undertaken quickly after commencement of the proceeding without the benefit of adequate discovery and one which, it was understood, would yield a “tentative” decision that could be reconsidered on summary judgment or at trial when the court is called upon to rule on the merits. However, as the court noted, the new Rule 23 “no longer characterizes the class certification order as ‘conditional’” and, as the Advisory Committee Notes to the 2003 amendments instruct, “[a] court that is not satisfied that the requirements of Rule 23 have been met should refuse certification until they have been met” — an inquiry which may require “controlled discovery into the ‘merits,’ limited to those aspects relevant to making the certification

82 Id. at 263.
83. Id. at 265.
84. Id. at 263.
85. Id. at 267 (quoting Fed. R. Civ. P. 23(c)(1)(A) (2003)).
86. See id. (quoting Fed. R. Civ. P. 23(c)(1)(A) (2003)).
87. Id. at 266.
decision on an informed basis."

The Fifth Circuit stated that the “collective wisdom” of the Advisory Committee on Civil Rules which sponsored the 2003 amendments to Rule 23 “must not be brushed aside” and applies with particular force to securities fraud claims, especially where, as in the instant case, the plaintiffs’ allegations of loss causation are tenuous:

[T]he efficient market doctrine facilitates an extraordinary aggregation of claims. 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, at least in the instance of simultaneous disclosure of multiple pieces of negative news. Nor is there sound reason for an early “tentative” certification, which leaves loss causation for later more focused examination.

The Fifth Circuit then stressed that the loss causation inquiry at the class certification stage requires little by way of discovery, explaining that “little discovery from defendants is demanded by the fraud-on-the-market regimen. Its ‘proof’ is drawn from public data and public filings, as in this case. It is largely an empirical judgment that can be made then as well as later in the litigation.” To that end, the court criticized district courts that “tread too lightly on Rule 23 requirements that overlap with the [Rule] l0b-5 merits, out of a mistaken belief that merits questions may never be addressed at the class certification stage.”

Having established the appropriateness of taking up the merits at the class certification stage as necessitated by the Rule 23 inquiry, the Fifth Circuit then sought to explain the doctrinal nexus between loss causation and the requirements for invoking the fraud-on-the-market presumption. Beginning with the premise that the Supreme Court’s decision in “Basic ‘allows each of the circuits room to develop its own fraud-on-the-market rules,’” the court stated that it would now require more than just proof of a material misstatement and evidence that the relevant security traded in an efficient market: “we require proof that the misstatement actually moved the market.” In so holding, the Fifth Circuit noted that “this requirement was not plucked from the air,” but in fact derives from Basic, in which the Supreme Court stated that the presumption of classwide reliance may be rebutted by “[a]ny showing that severs the link between the alleged

88. Id. at 267, n.26 (quoting Fed. R. Civ. P. 23 Advisory Committee Notes to the 2003 Amendments).
89. Id. at 267.
90. Id.
91. Id. at 268 Accord In re IPO Sec. Litig., 471 F.3d 24, 41 (2d Cir. 2006).
92. Oscar, 487 F.3d at 264-65 (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1117-18 (5th Cir 1988)).
misrepresentation and . . . the price received (or paid) by the plaintiff," including ""a showing that the market price would not have been affected by the alleged misrepresentations . . . ." 

The Fifth Circuit observed that this requirement — that the alleged fraud caused the stock price to fall — is complicated in this case by the fact that the corrective disclosure regarding the installation-line restatement was one of several items of negative information that were announced on the same date. At oral argument, the plaintiffs suggested that the loss causation issue presented by Allegiance’s multiple disclosures on February 19, 2002 did not affect the class certification analysis and should be addressed at a later stage in the litigation “because loss causation necessarily predominates, unlike individualized questions of reliance.” The court rejected this characterization of the loss causation issue, stating that it “might agree, if loss causation were only empirical proof of materiality, unmoored from the question of classwide reliance,” but that the question of loss causation speaks directly to the “semi-strong efficient market hypothesis on which classwide reliance depends.”

The Fifth Circuit explained that, contrary to the plaintiffs’ assertion, the notion that any disclosure of a material misrepresentation relating to a security traded in an efficient market inevitably affects the security’s price is unsubstantiated. To that end, the court offered two explanations, in addition to the immateriality of an alleged misrepresentation, for why a disclosed misrepresentation might not move the stock price, both of which are “relevant” to the issue of “classwide reliance” confronting the court:

- First, while the market for a particular security might be “efficient” according to the “usual indicia” (e.g., average weekly trading volume, the extent to which securities analysts follow the stock, the cause and effect relationship between public releases of information and an immediate reaction in the stock price), the market may be inefficient with respect to the particular type of information being transmitted by the misstatement. For example, telecommunications analysts may not necessarily digest line-installation count information. As the court explained, this observation “gives effect to information-type inefficiencies, recognizing that ‘the market price of a security will not be uniformly efficient as to all types of information.’”

- Second, a misrepresentation might not affect stock price if the market was “strong-form efficient” with respect to particular

93. Id. at 265 (quoting Basic Inc. v. Levinson, 485 U.S. 224, 248 (1988)).
94. Id. at 269 (emphasis added).
95. Id. (emphasis added).
96. Id.
information, such as the line-installation count information in this case. The court surmised that "due to insider trading, the restated line count [may have been] reflected by the stock price well before the 4Q01 corrective disclosure."  

The Fifth Circuit reasoned that both of these explanations "resist application of the semi-strong efficient-market hypothesis, the theory on which the presumption of classwide reliance depends." As an extension of this analysis, the court concluded that the plaintiffs were required to establish loss causation before availing themselves of the fraud-on-the-market presumption.

The court next turned to the competing expert reports and other evidence proffered by the parties on the loss causation issue. As an initial matter, the court, relying on Fifth Circuit precedent, noted that in a case of multiple, contemporaneous public disclosures by the corporate defendant, a plaintiff must demonstrate that it is "more probable than not" that the disclosure that corrected the alleged misstatement, and not the other unrelated disclosures, proximately caused "a significant amount" of the stock price decline. The court explained that proof of a corrective disclosure's "significant contribution" must be based on empirical evidence, not an expert's mere speculation as to the materiality of the various concurrent disclosures.

Applying these guideposts, the court found the plaintiffs' evidence of loss causation to be insufficient, noting that the evidence consisted primarily of commentary by research analysts who identified Allegiance's line-installation count restatement as a "red flag" with respect to the company's management and overall financial picture. Specifically, the court found that this evidence was negated by the defendants' submission of analyst commentary that attributed the precipitous drop in Allegiance stock to other factors, including concerns about a revenue covenant violation, a hostile regulatory environment and customer turnover. Ultimately, the court dismissed the analyst reports pointing to the line-count restatement introduced by plaintiffs as "little more than well-informed speculation."

The Fifth Circuit also faulted the plaintiffs' expert report, explaining that while the report includes event studies establishing that Allegiance's stock price reacted to the "entire bundle" of negative disclosures contained in the company's 4Q01 announcement, such a reaction "suggests only market efficiency, not loss causation, for there is no evidence linking the

98.  Id.
99.  Id.
100  Id. at 270 (quoting Greenberg v. Crossroads Systems, Inc., 364 F.3d 657, 666 (5th Cir. 2004)).
101  Id.
102.  Id. at 271.
culpable disclosure to the stock-price movement.”103 At bottom, the court stated that in order to establish loss causation for purposes of invoking the presumption of reliance, plaintiffs must offer “some empirically-based showing that the corrective disclosure was more than just present at the scene.”

The class certification decision bears due-process concerns for both plaintiffs and defendants, and an empirical inquiry into loss causation better addresses these concerns than an impenetrable finding akin to a reasonable man assessment. And analyst speculation about materiality, while better informed than a layman, more closely resembles the latter. At least when multiple negative items are contemporaneously announced, we are unwilling to infer loss causation without more. In sum, only a medical doctor who has either conducted a post-mortem or reviewed the work of another who did so, may credibly opine about the cause of death. We do not insist upon event studies to establish loss causation, helpful though they may be. We hold only that the opinions of these analysts, without reference to any post-mortem data they have reviewed or conducted, is insufficient here.104

The Allegiance Telecom decision marks a major development in the jurisprudence of Rule 10b-5 class certification. The decision — the first of its kind by a circuit court — holds that in order for securities fraud plaintiffs to avail themselves of the fraud-on-the-market presumption of classwide reliance, establishing the existence of an efficient market and a material misrepresentation is not enough; a showing of loss causation is also required — at least in the case of multiple, contemporaneous and ostensibly unrelated disclosures of negative information.

VIII. CONCLUSION

The recent decisions discussed in this article mark an important trend in the law of class certification, one which signifies heightened judicial scrutiny of Rule 23 motions — in many cases, going beyond the pleadings and involving extensive fact-finding. These rulings reinforce the principle that when confronted with a motion to certify a shareholder class in a securities action, a district court is now required to address the merits of the underlying fraud claims at the class certification stage to the extent that an examination of the merits is necessitated by the court’s Rule 23 inquiry.

Bombardier and PolyMedica stand as paradigms for the meticulous

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103. Id. (emphasis added); see also id. (“When multiple negative items are announced contemporaneously, mere proximity between the announcement and the stock loss is insufficient to establish loss causation.”).

104. Id
evaluation of contending expert evidence on whether an efficient market is present for purposes of invoking the *Basic* presumption of reliance. The district courts' empirical approach to the dueling expert reports in these two cases was effectively (if not explicitly) endorsed by the Second Circuit in *IPO* and the Fifth Circuit in *Allegiance Telecom*. The *IPO* decision, in refining the Second Circuit standard for the scope of review at the class certification stage, mandates that district judges must receive enough evidence, including expert testimony, to be satisfied that the purported class has complied with Rule 23 which, in securities class actions, requires plaintiffs to show that reliance can be presumed under *Basic* or some other doctrine of classwide reliance (for example, the *Affiliated Ute* presumption applicable in certain "failure to disclose" cases). The *Allegiance Telecom* decision, standing on the shoulders of *IPO*, took *Basic* a step further by holding that in addition to establishing reliance through a showing of an efficient market, plaintiffs seeking to trigger the fraud-on-the-market presumption must also establish loss causation — a separate but inextricably related element of a securities fraud claim. And in *Enron* — a decision in which the fraud-on-the-market analysis did not at all depend on empirical evidence of market efficiency, but rather turned on a purely doctrinal analysis — the Fifth Circuit held that the *Basic* presumption does not apply mechanically to all defendants alleged to have participated in a fraudulent scheme, and will not serve to certify a class against a secondary actor who is not alleged to have committed a manipulative or deceptive act (i.e., a primary violation of section 10(b)) within the meaning of *Central Bank* and *Stoneridge*.

This constellation of recent decisions — which, as a group, impose a more stringent evidentiary standard for invoking the fraud-on-the-market presumption at the class certification stage — certainly, for the time being, signals increased scrutiny by courts in determining whether class certification is warranted. Moreover, should the circuit courts follow the Fifth Circuit's lead in *Allegiance Telecom*, the applicability of the *Basic* presumption for purposes of certifying a shareholder class will not depend solely on whether the relevant security trades in an efficient market, but also whether the alleged misrepresentations (or, more accurately, the disclosure thereof) caused the stock price to drop. The interplay of reliance and loss causation for purposes of establishing Rule 23 predominance through the fraud-on-the-market presumption is sure to be taken up by additional courts in forthcoming class certification disputes.