INSIDE THE MINDS

New Developments in Securities Litigation

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The Changing Landscape of Securities Litigation

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Introduction

There has been a shift in the nature of the most significant securities cases from the traditional "stock-drop" litigation that dominated the early 2000s, to asset-backed securities (ABS) litigation following the financial crisis. ABS cases are often brought by sophisticated, individual plaintiffs, rather than the large classes of relatively less-informed shareholders that typically brought stock-drop cases. One important result of this change in the type of securities case is that reliance has become an increasingly contested issue because the presumption of reliance, essentially, does not apply to ABSs. Further, contemporary skepticism about the economic rationale underlying the theory of presumption of reliance may weaken its availability even in stock-drop litigation. A weaker presumption of reliance is likely to entrench the changes we are seeing in the types of plaintiffs bringing securities cases, because the presumption was critical to the survival of large shareholder class actions.

The first part of this chapter discusses changes in the nature of big-ticket securities litigation as a result of the new wave of ABS cases that followed the financial crisis and the accompanying decline in stock-drop litigation. The second part addresses how the analysis of reliance has changed in the past decade. The chapter concludes with some thoughts about what these changes could mean for the future of securities litigation.

The Changing Factual Landscape of Securities Litigation

In the mid-1990s, many securities class action claims were relatively modest in size, and the defendants' available insurance was adequate to cover any possible award to the plaintiffs. As a result, these cases tended not to progress very far, settling with insurance proceeds following a motion to dismiss or mediation.[1] By contrast, there have always been "big-ticket" cases, where the damage claims far exceed any available liability insurance

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[1] *See* Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 760-61 (2009); *see also* James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 512 (1997) (noting that in the 1990s, "approximately 96% of securities class action settlements [were] within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds").

and early settlement is rare. Since the burst of the Internet bubble in the early 2000s, we have seen an increasing number of these big-ticket securities cases that are intensely litigated, receive a good deal of publicity, and tend to progress far beyond the initial stages of litigation. This part explores how big-ticket securities litigation has changed over the last decade, examining both the shift in the underlying securities involved and the new type of plaintiffs asserting securities claims.

"Stock-Drop" Litigation in the First Half of the 2000s through Today

During the first half of the 2000s, we saw an increase in big-ticket securities class actions. The claims were brought by shareholder classes, alleging that the defendant corporation had experienced a decline in its share price after it was revealed that the corporation had allegedly made prior misrepresentations or fraudulent statements. Some of these cases were brought against Internet companies whose share prices fell when the Internet bubble burst, while other well-known cases asserted claims of fraudulent misstatements that were unrelated to the Internet bubble, such as *In re Enron Corp. Securities, Derivative & ERISA Litigation*,[2] *In re Lucent Technologies, Inc.*, *Securities Litigation*,[3] and *In re Tyco International, Ltd., Securities Litigation.*[4]

Following the collapse of Lehman Brothers and the ensuing financial crisis, one might have expected an increase in the number of such cases, but instead we saw fewer securities claims brought against public corporations based on declines in their share price.[5] This was, in fact, not surprising because stating this type of claim had become far more difficult. In *Dura Pharmaceuticals, Inc. v. Broudo*, the Supreme Court rejected the proposition that plaintiffs can satisfy the loss causation requirement simply by establishing that the price of the security was inflated on the date of the purchase because of the misrepresentation.[6] Instead, a successful securities

[2] MDL-1446, 2008 WL 4178151 (S.D. Tex. Sept. 8, 2008) (court order approving $7 billion settlement fund for the class).
[3] 307 F. Supp. 2d 633 (D.N.J. 2004) (court order approving the settlement).
[4] 185 F. Supp. 2d 102 (D.N.H. 2002) (court order granting the motion to dismiss).
[5] *See generally* Daniel Tyukody & Gerald Silk, *Understanding the Dip in Class-Action Securities Settlements*, N.Y. TIMES DEALBOOK (Apr. 2, 2012), http://dealbook.nytimes.com/2012/04/02/understanding-the-dip-in-class-action-securities-settlements/?_r=0.
[6] 544 U.S. 336, 338 (2005).

claim requires showing both economic loss and loss causation. In a stock-drop case, the plaintiff must show that (1) it purchased the stock at an artificially inflated price due to the alleged misrepresentations *and* (2) the inflation came out as the truth was revealed to the market.[7]

During the financial crisis, stock prices fell sharply across the board; the Dow Jones industrial average dropped to almost 6,500 in the first quarter of 2009.[8] This nearly universal drop in stock prices made it much more difficult to demonstrate a company-specific price decline. Under *Dura*, plaintiffs have to remove market movement from the equation and show a causal link between the alleged misrepresentation that subsequently came to light, and the alleged decline in share price. However, during this turbulent time, a corporation's share price was far more likely to drop as a result of a triggering event that affected the entire market, such as a statement issued by the Federal Reserve or new unemployment data, than as a result of a company-specific event. As a result, we saw fewer traditional stock-drop securities actions during the economic downturn.

Following the financial crisis, the trend away from stock-drop litigation continued. While the economy has slowly recovered, the stock market rebounded rather quickly, with the Dow Jones industrial average reaching 15,000 by the beginning of 2013.[9] On average, the stock prices of public companies have risen significantly since 2008.[10] This upward trend in stock prices across the market has once again made it difficult for plaintiffs to demonstrate loss causation. Plaintiffs may have to show that the current share price, which is already higher than the purchase price, would have been even higher, if not for the misrepresentation that was later revealed to the market. It is far easier to show loss causation where the stock price declines following purchase than where the price increases but not by as much as the plaintiff alleges it ought to have increased absent the alleged misrepresentation. For this reason, the stock market recovery has led to a continuing trend of fewer stock-drop cases.

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[7] *See Dura*, 544 U.S. at 344.

[8] *See Dow Jones Industrial Average (2000 – Present Daily)*, STOCKCHARTS.COM, http://stockcharts.com/freecharts/historical/djia2000.html.

[9] *See id*.

[10] Obviously, there are exceptions to this general increase in stock prices.

The Financial Crisis and the Rise of Asset-Backed Securities Litigation

The decline in stock-drop cases during and following the financial crisis was accompanied by a rise in securities claims involving more complex financial instruments called ABS. In particular, claims involving a specific type of ABS, mortgage-backed securities, have increased significantly since 2008, spurred by the mortgage crisis. Mortgage-backed securities cases are less likely to be brought as large class actions than are stock-drop cases because these assets are not traded on an exchange, they are less widely traded, and certain courts have required that claims be about investment in a particular security.[11]

Unlike stock-drop cases that are typically class actions brought by thousands of shareholders, mortgage-backed securities cases almost always involve either individual plaintiffs or small plaintiff classes. There is a high level of uniformity with respect to the ordinary shares involved in stock-drop cases that lends itself to class-based litigation. One ordinary share of Company X is exactly the same as every other ordinary share of Company X. Many thousands of these shares may be traded every day on the New York Stock Exchange. They are easy to buy and sell, and are traded widely by investors with varying levels of sophistication. The market sets a price for these shares and the price is uniform throughout the market.

Because mortgage-backed securities are "bespoke," they trade too infrequently to support exchange trading. In a mortgage-backed security, many mortgages from a pool are bundled into a trust.[12] A stream of payments comes from those mortgages, which is distributed among the investors who buy the mortgage-backed securities.[13] While two mortgage-backed securities may be based on the same general types of underlying mortgages—for example, mortgages on two-bedroom houses in California—there are key differences between them because every mortgage is distinct in some way. An investment in these securities is predicated on individualized factors such as the ability of the borrowers to make payments

[11] As discussed below, some courts even require that claims be specific to a particular tranche of a security.
[12] *See* U.S. Sec. & Exchange Commission, *Mortgage-Backed Securities*, http://www.sec.gov/answers/mortgagesecurities.htm (last modified July 23, 2010).
[13] *Id*.

and the quality of the underlying properties. The ability to make payments differs significantly among borrowers because it depends on the borrower's credit profile, unforeseen expenses, employment status, and many other factors. Similarly, the value of the underlying property varies based on factors such as the property's neighborhood, size, and proximity to schools, to name just a few. Unlike homogenous ordinary shares, mortgage-backed securities are not so fungible.

Investment in mortgage-backed securities requires a careful analysis of the factors that impact the ability of borrowers to repay their mortgages and the value of the underlying mortgaged property. As a result, mortgage-backed securities are not widely held by the public at large. Instead, they tend to be purchased by sophisticated financial institutions at issuance and are thinly traded over the counter after their initial purchase. Mortgage-backed securities cases are therefore less likely to be brought as large class actions than as individual claims brought by the financial institutions that invest in mortgage-backed securities. For instance, several lawsuits have been filed by insurance conglomerates like the Massachusetts Mutual Life Insurance Company[14] and Prudential Life Insurance Company[15] against banks that issued mortgage-backed securities. Government entities have brought claims of their own in this area, including the Federal Housing Finance Agency (FHFA), which supervises Fanny Mae and Freddie Mac.[16] Foreign banks that purchased mortgage-backed securities from U.S.-based financial institutions or were purportedly assigned claims involving mortgage-backed securities have also filed a number of large securities claims in recent years.[17]

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[14] *See, e.g.*, *Mass. Mut. Life Ins. Co. v. J.P. Morgan Chase Bank, N.A.*, No. 3:11-cv-30094 (D. Mass. filed Apr. 8, 2011); *Mass. Mut. Life Ins. Co. v. Goldman Sachs Mortg. Co.*, No. 3:11-cv-30126 (D. Mass. filed May 5, 2011); *Mass. Mut. Life Ins. Co. v. Impac Funding Corp.*, No. 3:11-cv-30127 (D. Mass. filed May 6, 2011); *Mass. Mut. Life Ins. Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 3:11-cv-30285 (D. Mass. filed Dec. 29, 2011).

[15] *Prudential Ins. Co. v. J.P. Morgan Sec. LLC*, No. ESX-L-3085-12 (N.J. Super. Ct. filed Apr. 25, 2012).

[16] *Fed. Hous. Fin. Agency v. J.P. Morgan Chase & Co.*, No. 11-Civ-6188 (S.D.N.Y. filed Sept. 2, 2011).

[17] *See, e.g.*, Chad Bray, *German Bank Sues Barclays Over Mortgage Securities*, WALL ST. J. (Apr. 2, 2012), http://online.wsj.com/news/articles/SB10001424052702 30475040457732

The use of tranches as a risk-management tool for mortgage-backed securities may further hinder class certification in mortgage-backed securities cases. Purchasers of mortgage-backed securities receive a payment stream deriving from thousands of mortgage payments.[18] Over time, some of these borrowers will miss mortgage payments because, for example, ordinary life events—such as illness or loss of employment—will impede payments by otherwise responsible borrowers. This risk of borrower default, also known as "credit risk," is managed through the use of "tranches." Tranches establish which investors will be paid first in the event of borrower default.[19] Investors can protect against the risk of default by selecting senior tranches of a given security. In exchange for this low credit risk, however, those senior tranches provide lower interest payments. The greatest risks, and the highest payout opportunities, lie in the bottom tranches of securitizations with the investors who get paid last in the event of borrower default.[20] Different tranches of a particular security are not necessarily fungible because they have different risk profiles and payouts.

There is currently a split in the jurisprudence over whether investment in a particular tranche is required for that tranche to be included in a mortgage-backed securities class action. The general rule for most securities claims is that plaintiffs only have standing to sue if they actually purchased a particular security.[21] A split has arisen between courts in different circuits regarding whether investment in one tranche of a particular security

0103510326074; *see also Dexia SA/NV Holdings, Inc. v. Bear, Stearns & Co., Inc.*, No. 12-cv-4761 (S.D.N.Y. removed June 18, 2012); *Landesbank Baden-Württemberg v. Bear, Stearns & Co. Inc.*, No. 652680/2011 (N.Y. Sup. Ct. filed Sept. 29, 2011).

[18] *See* Chris Wilson, *What Is a Mortgage-Backed Security?*, SLATE (Mar. 17, 2008), http://www.slate.com/articles/news_and_politics/explainer/2008/03/what_is_a_mortgage backed_security.html.

[19] *Introduction to Asset-Backed and Mortgage-Backed Securities*, FORBES (Jan. 18, 2013),http://www.forbes.com/sites/investopedia/2013/01/18/introduction-to-asset-backed-and-mortgage-backed-securities/.

[20] *See id*. ("The subordinate or junior tranches will absorb all of the losses, up to their value before senior tranches begin to experience losses.").

[21] *See, e.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 723 (1975) ("A private damages action under [the SEC's anti-fraud provision,] Rule 10b-5 [,] is confined to actual purchasers or sellers of securities . . . ."); *In re Gentiva Sec. Litig.*, 932 F. Supp. 2d 352, 390 (E.D.N.Y. 2013) (regarding the plaintiffs' claims arising under Section 11 of the Securities Act of 1933, the court stated that "[t]he general rule is that a plaintiff seeking to assert a securities fraud claim must be either a purchaser or seller of the securities at issue").

provides standing to bring a class action that involves multiple different securities or other tranches of that same security. For example, a district court in Seattle ruled that different tranches effectively involve entirely different securities, and so a particular tranche could not be part of the class action if no plaintiff in the lawsuit purchased that tranche.[22] Conversely, the Second Circuit has ruled that a plaintiff "has class standing to assert the claims of purchasers of certificates backed by mortgages originated by the same lenders that originated the mortgages backing plaintiff's certificates, because such claims implicate 'the same set of concerns' as plaintiff's claims."[23] Specifically, on the question of tranches, the court held that despite the fact that some "Certificates may be entitled to cash flows from the loans backing them earlier than others . . . each Certificate-holder within an Offering or Group backed by loans originated by similar lenders has the same 'necessary stake in litigating' whether those lenders in fact abandoned their underwriting guidelines."[24]

During and after the financial crisis, we saw a rise in the number of ABS claims, specifically claims involving mortgage-backed securities. Mortgage-backed securities are sold to a different market of sophisticated, institutional investors than are ordinary shares of company stock because investment in these bespoke securities requires a level of risk analysis that a typical shareholder is usually unable to undertake. As a result, we have seen fewer massive securities class actions and an increasing number of individual claims brought by sophisticated financial institutions. The fact that certain courts require plaintiffs to have invested in particular tranches and securities to assert class-based claims is a further hurdle to broad mortgage-backed securities class actions. Issues involved in proving reliance, discussed in the

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[22] *See In re Wash. Mut. Mortg.-Backed Sec. Litig.*, 276 F.R.D. 658, 664 (W.D. Wash. 2011) ("Plaintiff can show no personal injury arising out of those one-hundred-ten tranches of MBS that they did not purchase, and they lack standing to assert claims arising out of the purchase of those tranches.").

[23] *NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co.*, 693 F.3d 145, 148-49 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 1624 (2013).

[24] *Id*. at 164. Notably, however, the court emphasized: "[I]t is by no means a foregone conclusion that, because plaintiff has standing to assert §§ 11 and 12(a)(2) claims on behalf of Certificate-holders from different tranches of Offerings (or within Offerings) backed by loans originated by the same originators, a putative class comprised of such Certificate-holders should be certified. The district court, after reviewing all of the Rule 23 factors, retains broad discretion to make that determination." *Id*. at 165.

next part, pose yet another challenge to large mortgage-backed securities class actions.

From the Presumption of Reliance to Reliance as a Contested Issue

For years, the presumption of reliance in securities cases has enabled certain plaintiffs to satisfy their initial burden of proving reliance with minimal difficulty. Although the presumption has never been available for securities that do not trade in an efficient market, such as mortgage-backed securities, a recent decision finding that the presumption had been rebutted significantly weakens the presumption for plaintiffs even in the types of securities litigation where the presumption of reliance exists. More significantly, academic criticism of the presumption and jurisprudence from the Supreme Court suggests that we may soon see an end to the presumption of reliance in its entirety.

Reliance-Based Securities Claims and the Basic *Presumption of Reliance*

There are many different types of statutory and common law securities claims, some of which include reliance as an element. Standard Rule 10b-5 securities fraud claims arise under Section 10(b) of the Securities and Exchange Act of 1934, which requires a showing that the plaintiffs relied on the alleged misrepresentation at issue. Federal securities claims may also be brought pursuant to Sections 11 and 12 of the Securities Act of 1933, which cover, respectively, disclosures in registration statements and disclosures in prospectuses or oral communications.[25] Unlike Rule 10b-5, Sections 11 and 12 of the Securities Act do not require a showing of reliance for a successful claim.[26] State securities laws, commonly referred to as "blue sky laws," provide yet another basis for securities fraud liability. Some blue sky laws, like the Massachusetts Uniform Securities Act

[25] *See* Stuart A. Ober, *Due Diligence Defense: Securities Act of 1933 - Sections 11 and 12(a)(2)*, FINANCIALCOUNSEL.COM, http://investor.financialcounsel.com/Articles/Investment/ARTINV0000281-DueDiligenceDefense.asp.

[26] *See Silverstrand Invs. v. AMAG Pharm., Inc.*, 707 F.3d 95, 102 (1st Cir. 2013) *cert. denied*, 134 S. Ct. 174 (2013) ("[U]nlike § 10(b) of the Securities and Exchange Act, § 11 does not have a scienter or reliance requirement . . . ."); *Sanders v. John Nuveen & Co., Inc.*, 619 F.2d 1222, 1225 (7th Cir. 1980) ("It is well settled that [Section] 12(2) imposes liability without regard to whether the buyer relied on the misrepresentation or omission.").

(MUSA), also have no reliance requirement.[27] On the other hand, common law fraud, which may be attractive to securities plaintiffs due to its longer statute of limitations, requires proof of reliance, often by clear and convincing evidence. This part is concerned with the securities laws that do have a reliance requirement, such as Rule 10b-5 and common law fraud.

"Traditionally, purchasers and sellers of securities were required to establish that they were aware of, and directly misled by, an alleged misrepresentation to state a claim for securities fraud under § 10(b) and Rule 10b-5."[28] The "fraud-on-the-market" theory, however, provided plaintiffs with an alternative way to prove reliance in securities fraud cases. Courts presume that because the market price in an efficient market reflects all of the public information about the security, the purchaser relied on all of the information about the security in the public domain, as long as the purchaser paid the market price. When the security is ordinary shares, for example, a purchaser of shares on a publicly traded exchange is presumed to have relied upon all of the public information about the underlying corporation, including statements made by the corporation itself. As a result, where the corporation made a false statement, the price in an efficient market reflects that information, and the investor is presumed to have relied on the misrepresentation in making purchasing decisions. This fraud-on-the-market theory was formalized by the Supreme Court for Rule 10b-5 claims in *Basic v. Levinson*, where the Court held that a presumption of reliance would apply to traditional shareholder class actions involving regularly traded securities.[29]

Reliance and Mortgage-Backed Securities Cases

The presumption of reliance is inapplicable to many contemporary securities actions because mortgage-backed securities do not trade in the same kind of markets as ordinary shares. The factors laid out by the district court in *Cammer v. Bloom* are often used by courts to evaluate whether a

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[27] *Mass. Mut. Life Ins. Co. v. Residential Funding Co., LLC,* 843 F. Supp. 2d 191, 200 (D. Mass. 2012) ("Plaintiff does not need to prove negligence, scienter, reliance, or loss causation" under MUSA.).
[28] *Semerekno v. Cendant Corp.*, 223 F.3d 165, 178 (3d Cir. 2000).
[29] 485 U.S. 224, 225 (1988).

market is efficient.[30] These factors include: (1) a large weekly trading volume, (2) a "significant number of securities analysts" that follow and report on the company's stock, (3) "numerous market makers," (4) the company's eligibility to file an S-3 Registration Statement for public offerings, and (5) "empirical facts showing a cause and effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price."[31]

The *Cammer* factors clearly are not satisfactory for the mortgage-backed securities market. Mortgage-backed securities are likely to be thinly traded over the counter, unlike shares of a company that are regularly traded on the stock exchange.[32] Because mortgage-backed securities do not trade in an efficient market, there is no basis for a presumption of reliance in mortgage-backed securities litigation. As a result, proof of reliance in mortgage-backed securities litigation has always been a heavily contested issue,[33] with plaintiffs bearing the significant burden of demonstrating that they actually read and relied on the alleged misstatements at issue.

Successfully Rebutting the Presumption of Reliance

While the presumption of reliance has never been available for securities that trade in inefficient markets, the presumption has been considerably weakened in recent years, even for those securities thought to trade in efficient markets. The presumption was successfully rebutted by defendants

[30] 711 F. Supp. 1264 (D.N.J. 1989).
[31] *Cammer*, 711 F. Supp at 1286-87.
[32] *See id.*
[33] In cases where the plaintiff was not the original purchaser of the mortgage-backed securities in question, there is also the question of whether litigation rights against the original seller were properly assigned. A decision by Judge Jed Rakoff out of the Southern District of New York recently concluded that a purchasing plaintiff that assigned "all right, title and interest" in certificates had not transferred the tort claims associated with those certificates to the other three plaintiffs, and the purchasing plaintiff had "already recovered the full purchase price" for the majority of the certificates at issue, "negating its claim of injury." *Dexia SA/NV v. Bear, Stearns & Co.*, No. 12-cv-4761, 2013 WL 2136508, at *4 (S.D.N.Y. May 17, 2013) (remanded to state court on other grounds); *see also Dexia SA/NV, Dexia Holdings, Inc. v. Morgan Stanley*, 41 Misc. 3d 1214(A) (N.Y. Sup. Ct. Oct. 16, 2013) (New York State Supreme Court Judge Eileen Bransten's recent order and opinion granting Morgan Stanley's motion to dismiss in a mortgage-backed securities case brought by Dexia and related entities, discussing similar issues regarding assignment of litigation rights).

in recent litigation. In *GAMCO Investors, Inc. v. Vivendi, S.A.*,[34] the court considered whether the defendant had rebutted the presumption for GAMCO Investors, Inc., a sophisticated investment adviser and asset manager for high net-worth individuals. GAMCO alleged that it had relied on fraudulent statements made by the defendant's employees regarding the liquidity of the company in its decision to invest in the defendant's shares. Following a two-day bench trial, the Court ruled that the defendant—the French company, Vivendi Universal, S.A. (Vivendi)—had successfully rebutted the presumption of reliance.[35] In reaching this decision, the Court concluded that GAMCO would have purchased the securities notwithstanding any inflation in the market price caused by the alleged fraud. A sophisticated investor, GAMCO did not rely on the share price as an accurate measure of Vivendi's share value. Rather, GAMCO's decision to purchase was based on its analysts' determinations that the shares traded at a substantial discount to their "private market value." Private market value is the aggregate market value of the divisions of a company if they were each operated independently and had their own stock price; it represents an estimate of what the stock might sell for in an acquisition. Because GAMCO based its decision to invest on its independent view of Vivendi's private market value, any allegedly undisclosed liquidity crisis was irrelevant to GAMCO's decision to purchase Vivendi shares.[36]

The logic of *GAMCO* applies generally to the sophisticated investor plaintiffs—like money managers and large capital management firms—that have become commonplace in securities litigation today. These types of investors do not assume that the market price of the security is correct; instead, sophisticated investors attempt to identify securities that are undervalued or overvalued by the market, to generate greater profits for their clients and themselves. For example, a money manager might choose to invest in a company that could be an acquisition target at some point in the future. The money manager would estimate the private market value, or the company's stock price following an acquisition, and analyze how that price related to the current market price. If the market price was below the potential acquisition price, the money manager would likely make the

[34] 927 F. Supp. 2d 88 (S.D.N.Y. 2013).
[35] *GAMCO*, 927 F. Supp. 2d at 91.
[36] *Id*. at 101-02.

decision to invest in the company. While an ordinary shareholder is presumed to have relied on the market price in making investment decisions, it is implausible that sophisticated investors blindly rely on the market price, adding nothing in the way of investment strategy or analysis. Indeed, such sophisticated investors are paid *not* to rely on the market price. Consequently, the presumption of reliance is weaker, and should be easier to rebut, when the plaintiff is a sophisticated investor.

Even when plaintiffs successfully establish the presumption of reliance at trial, the post-trial claims review process provides the defendants with another opportunity to challenge and rebut the presumption on an individual basis. A verdict of liability against the defendants means that the presumption of reliance was not effectively rebutted as to the entire class. However, the claims review process tests actual reliance by individual class members on specific statements made by the defendants, and defendants may be successful in limiting the number of successful claims, and thereby their liability, at this stage. Recently, two significant securities class actions—*In re Vivendi Universal, S.A. Securities Litigation*[37] and *L Jaffe Pension Plan v. Household International, Inc.*[38]—resulted in liability verdicts against the defendants. Sophisticated claims review processes have been established in both cases, however, to allow the defendants to challenge reliance on an individual basis for particular claimants in the classes.

The Multi-Front Attack on the Presumption of Reliance

Recent developments in the law and in academic thought have called into question the very idea that markets for securities can ever be perfectly efficient, suggesting that the presumption rests on an invalid economic premise. Academics that study market dynamics have become increasingly skeptical of the notion that market efficiency is a binary, yes or no, question.[39] Contemporary scholarship about financial markets in particular suggests that those markets are far from perfectly efficient and

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[37] *See* 284 F.R.D. 144, 155-63 (S.D.N.Y. 2012) (establishing the claims review process).
[38] *See* 756 F. Supp. 2d 928, 930-34 (N.D. Ill. 2010) (establishing the claims review process).
[39] Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 167-68 (2009).

that investor behavior is not always rational.[40] This new understanding of financial markets defeats the central premise of the presumption of reliance theory, that the stock market is perfectly efficient for certain stocks, thereby reflecting all of the information about a company in the company's share price.

Relying on academic research that questions the basis for the presumption of reliance, the Supreme Court has indicated that it may significantly weaken the presumption of reliance in the near future, or possibly eliminate the presumption altogether. The central question in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds* was not about the presumption of reliance, but whether proof of materiality of the alleged misrepresentations was a prerequisite to class certification in a securities fraud action based on a fraud on the market theory.[41] Nonetheless, the justices used *Amgen* as a platform to air their views on the presumption of reliance, with all nine of the justices expressing doubts about its continued validity. Writing for the majority, Justice Ginsburg acknowledged that some of the contemporary research submitted by Amgen demonstrated that market efficiency was not a binary question, as presumed in *Basic*, and that differences in efficiency can exist within a single market.[42] Justice Ginsburg summarized the implications of contemporary economic research about financial markets:

> [T]his research suggests [that] differences in efficiency can exist within a single market. For example, a market may more readily process certain forms of widely disseminated and easily digestible information, such as public merger announcements, than information more difficult to acquire and understand, such as obscure technical data buried in a filing with the Securities and Exchange Commission.[43]

Despite this concession, she concluded that *Amgen* was not a good vehicle for exploring the implications of this research on the holding of *Basic*.[44]

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[40] *See generally* ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (Oxford University Press, 2000).

[41] *Amgen Inc. v. Connecticut Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1188-89 (2013).

[42] *Amgen*, 133 S. Ct. at 1197 n.6.

[43] *Id*.

[44] *Id*.

Both the concurrence and the dissent in *Amgen*, however, suggested that the presumption of reliance ought to be revisited. Justice Alito, although concurring with the majority opinion, stated that reconsideration of *Basic*'s fraud-on-the-market presumption may be appropriate given the recent evidence indicating that the presumption rests on a faulty economic premise.[45] Moreover, Justice Thomas's dissent, which was joined by Justices Kennedy and Scalia, argued that the reasoning of *Basic* was itself questionable—highlighting that in *Basic*, only "four Justices of a six-Justice Court created the fraud-on-the-market presumption from a combination of newly minted economic theories"[46]—and ought to be re-evaluated.[47]

The Supreme Court will reconsider the presumption of reliance in its current term. The Court recently granted *certiorari* in *Halliburton Co. v. Erica P. John Fund, Inc.*, to evaluate these central questions about the presumption of reliance:

> (1) whether [to] overrule or substantially modify the holding of *Basic Inc. v. Levinson*, to the extent that it recognizes a presumption of class-wide reliance derived from the fraud-on-the-market theory; and (2) whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.[48]

If the opinions in *Amgen* are any indication, it seems likely that the presumption of reliance may not survive the Supreme Court's decision in *Halliburton*. The elimination of the presumption of reliance would likely lead to a continuation of the trend away from large securities class actions, because individual reliance issues would predominate over common

[45] *Id*. at 1204 (Alito, J., concurring).
[46] *Id*. at 1212 (Thomas, J., dissenting). Three justices of the Court—Chief Justice Rehnquist, Justice Scalia and Justice Kennedy—took no part in the consideration or decision of *Basic*. *Basic Inc. v. Levinson*, 485 U.S. 224, 225 (1988).
[47] *Amgen*, 133 S. Ct. at 1208 n.4 (Thomas, J., dissenting).
[48] *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423 (5th Cir. 2013) *cert. granted*, 134 S. Ct. 636 (U.S. 2013).

issues.[49] The end result: more individual plaintiffs—likely sophisticated financial institutions—bringing large individual claims.

Conclusion

Over the past decade, we have seen a decline in the number of stock-drop class actions, and a contemporaneous rise in large mortgage-backed securities claims brought by individual investors. Recent developments regarding the presumption of reliance in securities cases suggest that this trend away from massive class actions may well continue. The shift away from classes consisting of ordinary investors toward claims brought by highly sophisticated financial institutions means that issues of sophistication and reliance may come to the fore, and that judges and juries may be less sympathetic to securities plaintiffs. The era of quick and early settlements by defendants who fear significant verdicts against them may also be passing, as practitioners on both the plaintiffs' and defendants' sides begin to adapt to the changing field of securities litigation.

Key Takeaways

- The trend in securities cases has been away from shareholder class actions and toward sophisticated plaintiffs bringing large, individual claims.
- Following the financial crisis, we saw an increase in mortgage-backed securities cases, to which the presumption of reliance is inapplicable.
- The presumption of reliance has recently been rebutted successfully at trial, and post-trial claims review processes in other cases are underway that will provide an opportunity for defendants to challenge reliance for individual claimants.
- Recent developments in the law and academic thought have challenged the very premise of the presumption of reliance.

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[49] "A class action may be maintained if . . . the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members . . . ." FED. R. CIV. P. 23(b)(3).

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