RECENT CASES

SECURITIES LITIGATION — CLASS CERTIFICATION — FIFTH CIRCUIT HOLDS THAT PLAINTIFFS MUST PROVE LOSS CAUSATION BEFORE BEING CERTIFIED AS A CLASS. — *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007).

With average settlements rising from under $28 million in 2004 to approximately $62 million in 2006,[1] securities class actions have become "the 800-pound gorilla that dominates and overshadows other forms of class actions."[2] Commentators have thus begun to question not only the efficacy of reforms such as the Private Securities Litigation Reform Act of 1995[3] (PSLRA), but also the underlying rationales of securities class actions.[4] Perhaps in response to these criticisms, courts have erected additional barriers to class certification in securities actions. Recently, in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[5] the Fifth Circuit held that plaintiffs relying on the "fraud on the market" theory[6] to obtain certification in class actions must first show that correction of an alleged misrepresentation, and not other simultaneously released news, reduced the price of the relevant security.[7] This decision reflects a pragmatic and emerging trend in Fifth Circuit jurisprudence after the PSLRA: increasing willingness to restrict class certification in securities cases and, in particular, to limit the scope of the fraud-on-the-market presumption in order to mitigate underlying problems with securities actions.

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[1] JONATHAN C. DICKEY, CURRENT TRENDS IN FEDERAL SECURITIES LITIGATION 3 (2007), http://www.gibsondunn.com/publications/Documents/Dickey-SecuritiesLitigationAndEnforcementInstitute2007.pdf.

[2] John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

[3] Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

[4] *See, e.g.*, Coffee, *supra* note 2. For a description of the PSLRA, see Stephen J. Choi & Robert B. Thompson, *Securities Litigation and Its Lawyers: Changes During the First Decade After the PSLRA*, 106 COLUM. L. REV. 1489, 1490–94 (2006). For evidence that the PSLRA has been relatively ineffective in reducing the number of securities class actions, see *id.* at 1496–97.

[5] 487 F.3d 261 (5th Cir. 2007).

[6] "The fraud on the market theory is based on the hypothesis 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. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." Basic Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (omission in original) (quoting Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)) (internal quotation mark omitted).

[7] *Oscar*, 487 F.3d at 266.

Allegiance Telecom, Inc. (Allegiance) was a publicly traded, national telecommunications company founded in 1997.[8] By 2001, its market capitalization exceeded $2.3 billion,[9] but like many other telecommunications companies, it fell on hard times later that year.[10] On April 24, 2001, Allegiance released its first quarter results for fiscal year 2001, which indicated that the company had outperformed analysts' estimates and installed 126,200 new cable lines.[11] Afterwards, "Allegiance's stock rose 9%, from $14.90 to $16.20, but soon declined again."[12] Similarly, in the second and third quarters, Allegiance released results indicating that it had surpassed earnings expectations and added new subscribers, but its stock price experienced only temporary gains before continuing to decline.[13] On February 19, 2002, Allegiance released its fourth quarter results, which were predominantly negative; in addition to falling short of analysts' earnings estimates, Allegiance restated its total installed-line count, lowering the number from 1,140,000 to 1,015,000.[14] Allegiance explained the restatement as resulting from a switch in billing systems, but its stock nevertheless fell 28%, from $3.70 to $2.65 per share, after the announcement.[15]

Oscar Private Equity Investments and two other purchasers of Allegiance stock filed suit in the U.S. District Court for the Northern District of Texas, alleging that Allegiance had violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934[16] and SEC Rule 10b-5[17] by fraudulently misrepresenting its line-installation count in its first three quarterly announcements of fiscal year 2001.[18] The plaintiffs asserted that they had purchased Allegiance shares at an artificially inflated price due to Allegiance's misrepresentations and had thus been damaged when Allegiance's correction of the inflated line

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[8] *Id.* at 262.

[9] Amended Class Action Complaint for Violations of Federal Securities Laws at 4, Oscar Private Equity Inv. v. Holland, No. 3:03-CV-2761H (N.D. Tex. Apr. 15, 2005), 2004 WL 2655993 [hereinafter Complaint].

[10] *See Oscar*, 487 F.3d at 263. The price of Allegiance's stock dropped by 90% in 2001. *See id.* Overall, by the end of 2002, the telecommunications market had lost "$2 trillion dollars of capital value, double the losses suffered in the dot-com crash and eight times the losses . . . in the savings and loan crisis of the late '80s." Dale A. Oesterle, *Year 2002: The Year of the Telecom Meltdown*, 2 J. ON TELECOMM. & HIGH TECH. L. 413, 415 (2003).

[11] *Oscar*, 487 F.3d at 263.

[12] *Id.* Because Allegiance did not turn a profit, measures of its growth potential played an important role in its valuation, and its line count was arguably "the Company's key operational metric." Complaint, *supra* note 9, at 1; *see also id.* at 5.

[13] *See Oscar*, 487 F.3d at 263.

[14] *Id.*

[15] *See id.*

[16] 15 U.S.C. §§ 78j(b), 78t(a) (2000).

[17] 17 C.F.R. § 240.10b-5 (2007).

[18] *See Oscar*, 487 F.3d at 262–63.

count caused the price of its stock to fall.[19] The plaintiffs moved to certify a class consisting of all individuals who had purchased Allegiance shares between its first and fourth quarter releases.[20] The district court certified the class, concluding that the plaintiffs satisfied the requirements of Federal Rule of Civil Procedure 23.[21] Relying on *Basic Inc. v. Levinson*,[22] the court allowed the plaintiffs to use the fraud-on-the-market theory to establish a rebuttable, class-wide presumption of reliance on Allegiance's representations[23] and thereby to fulfill Rule 23(b)(3)'s requirement that common issues of law or fact "predominate over any questions affecting only individual members."[24] The court rejected Allegiance's efforts to rebut the presumption of reliance and concluded that the plaintiffs had presented sufficient evidence to show that "a significant part of the stock price decline was more likely than not caused by [Allegiance's] line count adjustment."[25]

The Fifth Circuit vacated the district court's certification of the proposed class. Writing for the panel, Judge Higginbotham[26] held that "loss causation must be established at the class certification stage by a preponderance of all admissible evidence."[27] Ultimately, the plaintiffs' "certification fail[ed] for [want] of any showing that the market reacted to the corrective disclosure."[28] Although the plaintiffs had presented expert testimony linking the drop in Allegiance's stock with the "*entire bundle* of negative information contained in the 4Q01 announcement," they lacked any empirical evidence "showing that the corrective disclosure was more than just present at the scene."[29]

In support of this holding, Judge Higginbotham noted that *Basic* "allows each of the circuits room to develop its own fraud-on-the-market rules."[30] He reasoned that the "*in terrorem* power of certifica-

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[19] *See* Complaint, *supra* note 9, at 1, 9. The plaintiffs contended that Allegiance corrected its misrepresentation to "clean up [its] books in anticipation of engaging a new outside auditor or because it was coming under increasing scrutiny from its existing auditor, Arthur Andersen." *Id.* at 52.

[20] *See* Oscar Private Equity Inv. v. Holland, No. 3:03-CV-2761H, 2005 WL 877936, at *2 (N.D. Tex. Apr. 15, 2005) (order certifying class).

[21] *Id.* at *15.

[22] 485 U.S. 224 (1988).

[23] *Oscar*, 2005 WL 877936, at *7–14.

[24] FED. R. CIV. P. 23(b)(3). The court noted that, without the fraud-on-the-market theory, the plaintiffs would have to demonstrate individual reliance by each class member, a practically impossible task. *See Oscar*, 2005 WL 877936, at *7.

[25] *Oscar*, 2005 WL 877936, at *14.

[26] Judge Jolly joined Judge Higginbotham's opinion.

[27] *Oscar*, 487 F.3d at 269; *see also id.* at 265 ("Essentially, we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption.").

[28] *Id.* at 262.

[29] *Id.* at 271.

[30] *Id.* at 264 (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1117–18 (5th Cir. 1988)) (internal quotation marks omitted).

tion"[31] justified using this flexibility to "tighten the requirements for plaintiffs seeking a presumption of reliance."[32] Judge Higginbotham also rejected the dissent's characterization of his decision as inappropriately injecting considerations of merit into the class certification stage and thus conflicting with the Supreme Court's statement in *Eisen v. Carlisle & Jacquelin*[33] that "nothing in either the language or history of Rule 23 . . . gives a court any authority to conduct a preliminary inquiry into the merits."[34] Judge Higginbotham concluded that an analysis of causation was appropriate given recent cases clarifying *Eisen*[35] and given the wording of Rule 23, which requires the court to "'find'" rather than "assume" the facts favoring certification.[36]

Judge Dennis dissented, raising three overarching concerns. First, he characterized the majority's decision as conducting "what appears to have been a *de novo*, rather [than] an abuse of discretion, review of the evidence."[37] In his opinion, the plaintiffs had presented sufficient evidence to establish that the restatement of Allegiance's line count, and not other negative news released in its fourth quarter results, caused the decline in Allegiance's share price. Second, Judge Dennis argued that requiring plaintiffs to demonstrate loss causation effectively reversed the burdens established by the Supreme Court in *Basic* — plaintiffs would now bear the burden of proving the fraud-on-the-market presumption whereas *Basic* had given defendants the burden of rebutting it.[38] Finally, Judge Dennis criticized the majority for requiring the court to decide issues of merit at the certification stage, stating that "the decision contradicts both this circuit's Rule 23 case law and the decisions of other circuits concerning the scope of the class certification inquiry."[39]

The differences between Judge Higginbotham's and Judge Dennis's opinions stem from a basic disagreement about the scope of the Su-

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[31] *Id.* at 267.

[32] *Id.* at 265.

[33] 417 U.S. 156 (1974).

[34] *Oscar*, 487 F.3d at 268–69 (quoting *Eisen*, 417 U.S. at 177).

[35] *See id.* at 268–70 (discussing Unger v. Amedisys Inc., 401 F.3d 316, 321 (5th Cir. 2005)).

[36] *See id.* at 267 (quoting *Unger*, 401 F.3d at 321 (quoting FED. R. CIV. P. 23(b)(3))). Judge Higginbotham also pointed to a post-*Eisen* amendment to Rule 23 requiring certification decisions to take place "at an early practicable time" rather than "as soon as practicable," *see* FED. R. CIV. P. 23(c) advisory committee's note to 2003 amendment, and to the Advisory Committee's endorsement of a limited analysis of merits related to the certification, *see id.*, as supporting his position. *See Oscar*, 487 F.3d at 267 & n.26.

[37] *Oscar*, 487 F.3d at 272 (Dennis, J., dissenting). The majority responded to this contention by emphasizing that "[a] district court that premises its legal analysis on an erroneous understanding of the governing law has abused its discretion." *Id.* at 264 (majority opinion).

[38] *See id.* at 273 (Dennis, J., dissenting) ("The *Basic* court . . . made it plain that the defendant bears the burden of establishing that the [fraud-on-the-market] presumption should not apply.").

[39] *Id.* at 277.

preme Court's holding in *Basic*. Whereas the dissent contended that *Basic* mandated a presumption that material misstatements always affect stock prices,[40] the majority interpreted *Basic* as giving circuits room to rearrange the burdens inherent in the fraud-on-the-market theory.[41] But even if the majority was right on this issue, *Oscar* still posed the broader question of whether to restrict or expand the fraud-on-the-market presumption. In choosing to restrict, the court may have wanted to limit the use of securities class actions to coerce settlements, or it may have been responding to perceived weaknesses in the assumptions underlying the fraud-on-the-market theory itself. These two rationales are ultimately complementary and have been mirrored in a series of Fifth Circuit decisions. By pressing further in this direction, *Oscar* provides a practical means of mitigating many of the inefficiencies of securities class actions.

The *Oscar* majority's portrayal of class certification exhibits an explicit desire to limit the device's power. The court, noting that the fraud-on-the-market presumption "facilitates an extraordinary aggregation of claims," concluded it could not "ignore the *in terrorem* power of certification [by] continuing to abide the practice of withholding until 'trial' a merit inquiry central to the certification decision."[42] These descriptions reflect a genuine fear that maintaining early class certification will allow plaintiffs' lawyers to extract large settlements in frivolous cases, a problem widely recognized in academic literature.[43] Earlier Fifth Circuit cases have expressed similar concerns: In *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*,[44] for example, the court noted that "class certification may be the backbreaking decision that places 'insurmountable pressure' on a defendant to settle, even where the defendant has a good chance of succeeding on the merits."[45] Moreover, in *Unger v. Amedisys Inc.*,[46] the Fifth Circuit defended "rigorous" standards of proof in securities cases

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[40] *See id.* at 274 ("Under *Basic*, the court is to *presume* that the defendant's material misstatement distorted the market price of the stock at issue.").

[41] *See id.* at 264–65 (majority opinion).

[42] *Id.* at 267. Judge Higginbotham further reinforced this point by stating that "a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it." *Id.*; *see also id.* at 262 (characterizing the result as required by "fairness" in light of certification's "lethal force").

[43] *See, e.g.*, Marilyn F. Johnson et al., In Re Silicon Graphics Inc.*: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act's Pleading Standard*, 73 S. CAL. L. REV. 773, 782–83 (2000) ("Filing numerous cases is profitable for plaintiffs' attorneys because of the incentives that defendants face. If plaintiffs can withstand a motion to dismiss, defendants generally will find settlement cheaper than litigation.").

[44] 482 F.3d 372 (5th Cir. 2007).

[45] *Id.* at 379 (quoting Castano v. Am. Tobacco, 84 F.3d 734, 746 (5th Cir. 1996)).

[46] 401 F.3d 316 (5th Cir. 2005).

because "given the realities of litigation costs, [class] certification can compel settlements without trial."[47]

The *Oscar* court's actions may have also stemmed from dissatisfaction with the fraud-on-the-market presumption itself. The efficient market hypothesis, which underlies the presumption, has recently faced criticism for failing to account for both market anomalies[48] and developments in behavioral economics.[49] Although Judge Higginbotham did not directly criticize the hypothesis in *Oscar*, other Fifth Circuit decisions have displayed less restraint. In *Unger*, for example, the court referenced literature "criticiz[ing] the efficient market theory adopted in *Basic* as out of step with current economic analysis and inconsistent with the thrust of recent legislation."[50] Accordingly, the Fifth Circuit's language regarding the dangers of certification may amount to little more than a boilerplate policy argument deployed to justify its emasculation of the fraud-on-the-market presumption.

Regardless of its underlying motivation, the Fifth Circuit has historically used its leeway under *Basic* to constrain the fraud-on-the-market theory's power. The origins of this trend can be traced to the Fifth Circuit's 1988 decision in *Abell v. Potomac Insurance Co.*,[51] in which the court refused to apply the fraud-on-the-market theory to a nonefficient bond market.[52] In so doing, the court noted the presence of "strong policy reasons to reject the [plaintiffs'] contentions," which would "attenuate the fraud-on-the-market presumption of reliance far beyond its proper bounds and almost entirely extinguish reliance as a legitimate element of a rule 10b-5 claim."[53] The PSLRA accelerated this trend: in *Nathenson v. Zonagen Inc.*,[54] a post-PSLRA case, the court held that plaintiffs must show that the alleged misrepresentation "actually affected the market price of the stock" in order to demonstrate reliance.[55] The court expanded this requirement in *Greenberg v.*

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[47] *Id.* at 322.

[48] *See, e.g.*, Alon Brav & J.B. Heaton, *Market Indeterminacy*, 28 J. CORP. L. 517, 518 (2003); Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1060 (1990) (concluding that the fraud-on-the-market theory "suffers from analytic flaws that threaten to undermine its usefulness").

[49] *See, e.g.*, Frederick C. Dunbar & Dana Heller, *Fraud on the Market Meets Behavioral Finance*, 31 DEL. J. CORP. L. 455, 491–97 (2006) (noting that market inefficiencies frequently emerge due to factors such as cognitive biases, herd-like behavior, and information cascades).

[50] *Unger*, 401 F.3d at 322 n.4 (citing Jeffrey L. Oldham, *Taking "Efficient Markets" out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995 (2003)).

[51] 858 F.2d 1104 (5th Cir. 1988).

[52] *Id.* at 1122.

[53] *Id.*

[54] 267 F.3d 400 (5th Cir. 2001).

[55] *Id.* at 415.

Crossroads Systems, Inc.,[56] holding that plaintiffs must specifically demonstrate "that the cause of the decline in price is due to the revelation of the truth and not the release of unrelated negative information."[57] *Oscar* represents yet another restriction of the fraud-on-the-market presumption: it requires that plaintiffs satisfy the *Greenberg* requirements *before* class certification, thus allowing the court to examine the "merits" of plaintiffs' attempts to gain class certification at an earlier stage.[58]

Oscar pushes the Fifth Circuit's restriction on class actions to a new extreme, but not inadvisably so; the decision limits a type of suit that is particularly susceptible to abuse by entrepreneurial plaintiffs' attorneys. Requiring loss causation at the certification stage reduces the likelihood that such attorneys can extract a quick settlement by alleging loss causation even though the case is unlikely to prevail at trial.[59] Accordingly, *Oscar* creates financial incentives for plaintiffs' attorneys to screen out non-meritorious, or "frivolous," cases.

Although these incentives clearly favor under- as opposed to over-prosecution of securities claims, this preference is justified in light of the limited ability of such actions to fulfill their intended goals of compensation and deterrence.[60] Securities class actions generally fail to compensate, as victims' recoveries after plaintiffs' fees are small or even negative after accounting for expenses paid by shareholders to subsidize "defense counsels' fees and expenses, Directors' and Officers' . . . insurance premiums, and the possible costs of disruption, stigma, and adverse publicity."[61] That large, institutional investors generally decline to participate in these suits despite standing to gain the most from them is compelling proof of this point.[62]

Given these shortcomings, the utility of securities class actions depends on their ability to deter undesirable corporate behavior. However, even if SEC and criminal law mechanisms are inadequate to accomplish this objective, evidence suggests that securities class actions

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[56] 364 F.3d 657 (5th Cir. 2004).

[57] *Id.* at 665.

[58] Closer scrutiny of the merits makes certification less likely. *See* Gariety v. Grant Thornton, LLP, 368 F.3d 356, 365 (4th Cir. 2004) ("If it were appropriate for a court simply to accept the allegations of a complaint at face value in making class action findings, every complaint asserting the requirements of Rule 23(a) and (b) would automatically lead to a certification order . . . .").

[59] For a discussion of incentives to initiate frivolous suits, see Lucian Arye Bebchuk, *Suing Solely To Extract a Settlement Offer*, 17 J. LEGAL STUD. 437 (1988); and Joseph A. Grundfest, *Why Disimply?*, 108 HARV. L. REV. 727, 735 (1995).

[60] *See, e.g.*, Coffee, *supra* note 2, at 1545–56.

[61] *Id.* at 1546. When combined, these costs "approach[] and may exceed the aggregate recovery." *Id.*

[62] *Id.* at 1547; *see also* James D. Cox & Randall S. Thomas, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions To Participate in Securities Class Action Settlements*, 58 STAN. L. REV. 411, 413 (2005).

fail to deter fraud. Corporate officials are often shielded by insurance, reducing their responsiveness to the threat of lawsuits.[63] There is especially little deterrence with respect to smaller corporations, which are unlikely to be sued because they provide smaller rewards for plaintiffs' attorneys.[64] Finally, the deterrent effects of securities actions are misplaced. Because most suits target the corporation itself rather than the culpable executives (who have shallower pockets), the costs of settlements and verdicts are largely borne by shareholders.[65] Executives, who suffer none of the downside, thus have imperfect incentives to refrain from committing fraud.[66]

Judge Higginbotham's decision in *Oscar* represents a practical response to the growing recognition of these problems. By requiring plaintiffs to demonstrate loss causation before they may be certified as a class, *Oscar* functions as a means for screening out frivolous claims while at the same time protecting businesses from coerced settlements. Groups of victimized investors will still be able to organize as classes — *Oscar*'s requirements are neither insurmountable nor arduous.[67] But its loss causation requirement, combined with the Fifth Circuit's tendency to restrict access to class certification, promises to mitigate the inefficiencies of securities actions and deter plaintiffs' lawyers from bringing frivolous suits with the aim of extracting quick settlements.

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[63] *See* Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1499 (1996) (noting that "[i]ndividual defendants almost never contribute personally to settlements"); Cox & Thomas, *supra* note 62, at 512 ("Perhaps the greatest condemnation of the securities class action is the evidence that approximately 96% of securities class action settlements are within the typical insurance coverage, with the insurance proceeds often being the sole source of settlement funds.").

[64] *See* Coffee, *supra* note 2, at 1544 ("[T]here is a cutoff level in terms of market capitalization below which private enforcement appears not to work.").

[65] *See id*. at 1534, 1556–66; *see also* Johnson et al., *supra* note 43, at 783–84 (noting that management's incentives to quickly settle in order to avoid personal liability reduce the deterrent capability of securities fraud suits). Stock prices generally decline following the initiation of such suits, demonstrating this effect. *See* Coffee, *supra* note 2, at 1537 ("[T]he market reacts adversely to the filing of the action because it expects that the eventual settlement of the action will be borne by the shareholders as a group.").

[66] Furthermore, because the corporation itself does not benefit from misrepresentations that increase its share price, "[t]o punish the corporation and its shareholders in such a case is much like seeking to deter burglary by imposing penalties on the victim for having suffered a burglary." Coffee, *supra* note 2, at 1537. But for a defense of securities class actions, see James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497 (1997). Professor Cox advances both compensatory- and deterrence-based justifications for securities actions. *See id.* at 509–15. However, the court in *Oscar* was attempting not to nullify the class action device but rather to limit its application to truly meritorious cases so that the system's marginal costs of coercing settlements would no longer outweigh its marginal deterrent benefits.

[67] The *Oscar* majority noted that event studies, a common econometric tool, will frequently be sufficient to demonstrate loss causation. *See Oscar*, 487 F.3d at 265 n.22.