

FIFTH CIRCUIT ERECTS "LOSS CAUSATION" HURDLE TO CERTIFICATION OF SECURITIES CLASS ACTIONS BASED ON FRAUD-ON-THE-MARKET THEORY

The Fifth Circuit last week reversed a district court order certifying a securities fraud class action, holding in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, No. 05-10791, 2007 U.S. App. LEXIS 11525 (May 16, 2007), that loss causation must be established *before* class-wide reliance can be presumed under a fraud-on-the-market theory for purposes of certifying a class. The decision places the burden on plaintiffs who rely on the fraud-on-the-market theory to skirt past individual reliance issues that are generally fatal to class certification to prove loss causation as a prerequisite to certification. *Allegiance Telecom* dramatically changes the manner in which fraud-on-the-market class action cases proceed toward certification in the Fifth Circuit.

Generally, securities fraud plaintiffs must show a causal link between the alleged fraud and their alleged loss. Courts refer to this causation requirement as "loss causation." The fraud-on-the-market theory is a judicially-created doctrine under which investors are presumed to have relied on all publicly available information affecting the market price of a security, including any public misrepresentations. The fraud-on-the-market presumption of reliance, therefore, allows class-wide proof of reliance. Without that presumption, questions of individual reliance would predominate and preclude class certification.

The issue in *Allegiance Telecom* did not concern whether to apply the fraud-on-the-market reliance presumption, but rather, whether proof of loss causation, i.e., proof that a misstatement actually materially affected the market price of a security, is a prerequisite to invoking the fraud-on-the-market presumption of reliance at the class certification stage. Previously, securities fraud plaintiffs could delay proof of loss causation until after class certification. The Fifth Circuit, however, jettisoned that approach in *Allegiance Telecom* and established a new procedural rule requiring proof of causation at the class certification stage before presuming class-wide reliance. In adopting this new rule, the court explained, "a district court's certification order often bestows upon plaintiffs extraordinary leverage, and its bite should dictate the process that precedes it." The ruling erects an additional hurdle to class certification, and consequently, changes the procedural posture for securities class action litigation in the Fifth Circuit.

The facts of *Allegiance Telecom* are unremarkable, but the court's ruling most certainly portends significant changes for securities class action litigation in at least the Fifth Circuit. In reversing the certification, the Fifth Circuit explained that it has undertaken efforts in past decisions to "tighten the requirements for plaintiffs seeking a presumption of reliance," citing *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988); *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir. 2001); *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657 (5th Cir. 2004). The court explained:

We now require more than proof of a material misstatement; we require proof that the misstatement *actually moved* the market. That is, 'the plaintiff [may] recover under the fraud on the market theory if he [can] prove that the defendant's non-disclosure materially affected the market price of the security.' Essentially, we require plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption.

Relying principally on its prior decision in *Greenberg*, where it held that in order to “trigger the presumption [of reliance] plaintiffs must demonstrate that . . . the cause of the decline in price is due to the revelation of the truth and not the release of [any] unrelated negative information,” the court concluded that securities fraud plaintiffs must satisfy the *Greenberg* loss causation test at the class certification stage. Notably, the court held, “[w]e cannot ignore the *in terrorem* power of certification” and continue to “abide the practice of withholding until ‘trial’ a merit inquiry central to the certification decision”

The court’s decision in *Allegiance Telecom* significantly changes the playing field for securities class actions in the Fifth Circuit. The ruling provides defendants with additional opportunities to defeat certification.



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