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Messin' with Texas: How the Fifth Circuit's Decision in Oscar Private Equity Misinterprets the Fraud-on-the-Market Theory

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Messin' with Texas: How the Fifth Circuit's Decision in *Oscar Private Equity* Misinterprets the Fraud-on-the-Market Theory*

Last May, the Fifth Circuit unexpectedly deviated from federal precedent in the realm of class action securities litigation. In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*,[1] the court fashioned a greater hurdle for plaintiffs seeking class certification in an action under the Securities and Exchange Commission's Rule 10b-5.[2] Departing from Supreme Court precedent, *Basic Inc. v. Levinson*,[3] the Fifth Circuit held that, to reach the fraud-on-the-market presumption of reliance and acquire class certification, the plaintiff must prove "that [a] misstatement *actually moved* the market."[4] As a result, the court introduced a new and more difficult standard for materiality, ultimately tying together two separate and distinct elements of a Rule 10b-5 claim—loss causation and reliance—at an early stage in litigation.[5] Yet the court failed to acknowledge that its new standard will likely frustrate the purposes behind Rule 10b-5: promoting honesty and full disclosure in financial markets.[6] Moreover, the holding may usher in a host of negative policy

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1. 487 F.3d 261 (5th Cir. 2007). A summary of the facts of this case may be useful for a better understanding of the issue. In *Oscar*, the Fifth Circuit Court of Appeals addressed whether the trial court's decision to grant the plaintiff's motion for class certification was improper. Plaintiffs brought suit against defendant telecommunication company because of alleged stock investment losses the plaintiffs suffered due to certain misstatements in the defendant's financial statements in the first, second, and third quarters of 2001. *Id.* at 262–63. The quarterly financial statements indicated that the defendant installed a much larger number of telecommunication lines than it had actually installed. *Id.* at 263. In the final quarter of 2001, the defendant released a corrective disclosure restating the year's installations, attributing the misrepresentation to a change in the company's recording process. *Id.* At the same time, defendant released other negative information concerning the company, and the corporation's stock price plummeted. *Id.* Plaintiffs filed suit, moving for class certification, and the United States District Court for the Northern District of Texas granted class certification. *Id.* Defendants filed this interlocutory appeal. *Id.*

2. 17 C.F.R. § 240.10b-5 (2007).

3. 485 U.S. 224 (1988).

4. *Oscar*, 487 F.3d at 265.

5. *See id.* at 264–65 (defining "material" in a manner which ties together the reliance and loss causation elements of Rule 10b-5). For further discussion on how the *Oscar* holding mistakenly ties together these two elements of the claim, see *infra* notes 18–23 and accompanying text.

6. *See Basic*, 485 U.S. at 230.

implications by placing a greater burden on plaintiffs seeking class certification.

This Recent Development will argue that the Fifth Circuit's new limitation on the fraud-on-the-market theory is inconsistent with the stance taken by the Supreme Court and that the new standard will erode the public policy concerns behind Rule 10b-5 and the fraud-on-the-market theory.[7] Specifically, it will begin by demonstrating that the standard for materiality has already been established by both common-law fraud doctrines as well as the Supreme Court and that the Fifth Circuit's requirement that the misstatement actually affect the stock price is inconsistent with the preexisting definition. Second, this Recent Development will illustrate how *Oscar*'s new standard impermissibly shifts the fraud-on-the-market theory from a rebuttable presumption in favor of the plaintiffs to a new burden on the plaintiff class. Finally, it will argue that the Fifth Circuit's holding frustrates the purposes of both the fraud-on-the-market theory and Rule 10b-5 and significantly limits the scope of recovery available for plaintiffs in securities fraud class action lawsuits.

To assert a successful Rule 10b-5 claim,[8] a plaintiff must prove six elements:

(1) a material misrepresentation (or omission);
(2) scienter, i.e., a wrongful state of mind;
(3) a connection with the purchase or sale of a security;

7. These public policy considerations are analyzed in more detail later. *See infra* notes 36–47 and accompanying text (full and honest disclosure and market participation); *infra* notes 48–65 and accompanying text (the allocation of the burden of proving reliance); *infra* notes 66–75 and accompanying text (the availability of class certification).

8. Rule 10b-5 prohibits anyone from "mak[ing] any untrue statement of a material fact or omit[ting] to state a material fact necessary in order to make the statements made ... not misleading ... in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (2007). This regulation provides a remedy for any party injured through a purchase of stock made in reliance upon what is essentially fraud—a material misstatement or omission. As numerous courts have held, "Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public ... if such assertions are false or misleading or are so incomplete as to mislead." SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968) (in banc), *rev'd on other grounds*, 446 F.2d 1301 (2d Cir. 1971); *see, e.g.*, *In re* Cabletron Sys., Inc., 311 F.3d 11, 36 (1st Cir. 2002) (holding that a company owes a duty of disclosure if such disclosure is necessary to prevent prior statements from being misleading); *In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244–47 (3d Cir. 1989) (applying the *Texas Gulf Sulphur* standard to vacate the portion of the lower court's decision dismissing the plaintiff's Rule 10b-5 claim); Colvin v. Dempsey-Tegeler & Co., 477 F.2d 1283, 1286 (5th Cir. 1973) (stating that it is a violation of Rule 10b-5 to make material misstatements or omissions of fact in connection with a purchase or sale of securities).

(4) reliance, often referred to in ... fraud-on-the-market cases as "transaction causation,";
(5) economic loss; and
(6) "loss causation," i.e., a causal connection between the material misrepresentation and the loss.[9]

In a class action lawsuit based on Rule 10b-5, it would be impractical to require each class member to individually prove the reliance element of the claim.[10] Thus, the Supreme Court recognized the fraud-on-the-market theory, which creates a rebuttable presumption that each class member has satisfied the reliance requirement of Rule 10b-5.[11] The plaintiff class may take advantage of this presumption so long as they can demonstrate three conditions: "First, the information in question must have been material. Second, the market must have been sufficiently active to be deemed to be efficient. Third, the misinformation must have been disseminated publicly."[12]

Analyzing the first of these conditions, materiality, the *Oscar* court held that there must be "proof that the misstatement *actually moved* the market."[13] Yet in making this declaration, the Fifth Circuit failed to acknowledge that the Supreme Court has already established

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9. *Oscar*, 487 F.3d at 264 n.5 (quoting Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005)). For the purpose of this Recent Development, the only significant elements of the claim are materiality, reliance, and loss causation. While each of these elements is discussed more fully throughout the paper, it may be useful at this point to analyze loss causation in greater detail. In describing the requirement of loss causation, the Private Securities Litigation Reform Act states that "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78u-4(b)(4) (2000). As analyzed by the most recent Supreme Court case concerning the issue, loss causation is essentially proximate causation linking the defendant's material misstatement or omission to the plaintiff's economic injury. *Dura*, 544 U.S. at 344.

10. *See, e.g.*, *Basic*, 485 U.S. at 242 (Blackmun, J., plurality) ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.").

11. *Id.* at 241–47. Notably a majority of the bench did not endorse the portion of the *Basic* holding concerning the fraud-on-the-market theory. Justice Blackmun authored the Court's opinion, joined by Justices Brennan, Marshall, and Stevens. Justices White and O' Connor concurred in part and dissented in part, agreeing with the Court's analysis of materiality but disagreeing with the discussion of the application of the fraud-on-the-market theory as applied to the facts in *Basic*. *Id.* at 250. Chief Justice Rehnquist, as well as Justices Scalia and Kennedy, took no part in the case.

12. 3 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 12.10[6][A] (5th ed. 2005) (citations omitted); *see Basic*, 485 U.S. at 248 n.27 (Blackmun, J., plurality); Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 661 (5th Cir. 2004).

13. *Oscar*, 487 F.3d at 265.

a definition of materiality in the context of securities fraud litigation.[14] In fact, in the case in which the Supreme Court first recognized the fraud-on-the-market theory, Justice Blackmun noted that "[t]he Court also explicitly has defined a standard of materiality under the securities laws . . . concluding in the proxy-solicitation context that 'an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.' "[15] Thus, "to fulfill the materiality requirement 'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.' "[16] The Court then went on to "expressly adopt" that standard for materiality in regard to Rule 10b-5.[17]

The key difference between the materiality definition established by the Supreme Court and the one employed in *Oscar* is that the Supreme Court's standard did not require proof that the misrepresentation or omission actually affected the stock price.[18] The High Court's standard simply required that the misrepresentation or omission be one that a reasonable investor would find significant in making investment decisions.[19] By adding the additional requirement that the distortion or omission actually change the market price of the security, the Fifth Circuit tied together two elements of the Rule 10b-

14. *See Basic*, 485 U.S. at 231.

15. *Id.* (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)); *see, e.g.*, Prudent Real Estate Trust v. Johncamp Realty, 599 F.2d 1140, 1146 (2d Cir. 1979) (using the test for materiality set forth in *TSC Industries*); Hassig v. Pearson, 565 F.2d 644, 650 (10th Cir. 1977) (employing the "reasonable shareholder" standard established in *TSC Industries*).

16. *Basic*, 485 U.S. at 231–32 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). The Supreme Court continued to expound upon this concept, presumably to ensure that their standard was clear regarding materiality of misstatements. " 'The determination [of materiality] requires delicate assessments of the inferences a "reasonable shareholder" would draw from a given set of facts and the significance of those inferences to him . . . .' " *Id.* at 236 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976)). The Court made clear that "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Id.* at 240.

17. *Id.* at 232, 249.

18. *Compare id.* at 231 (" '[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.' " (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976))), *with Oscar*, 487 F.3d at 265 ("We now require more than proof of a material misstatement; we require proof that the misstatement *actually moved* the market.").

19. *See Basic*, 485 U.S. at 231–32.

5 claim—material misrepresentation and loss causation[20]—together. But even Justices White and O'Connor's partially concurring and partially dissenting opinion in *Basic* recognized that these two elements of the claim are separate and should remain so.[21] The presumption arising from the fraud-on-the-market theory is simply one of reliance.[22] It should neither affect nor involve the loss causation element of a 10b-5 claim, as that is a totally separate requirement of the cause of action.[23]

The *Oscar* court stated that the Supreme Court's opinion in "*Basic* 'allows each of the circuits room to develop its own fraud-on-the-market rules.' "[24] The Fifth Circuit, however, seems to have exceeded the Court's limits. Rather than merely lending its own judgment in the face of ambiguous terms, the *Oscar* court completely disregarded the explicit definition of material misrepresentation as established by the Supreme Court when it adopted the fraud-on-the-market theory.[25] Moreover, in fashioning its own rule, the Fifth Circuit ignored the High Court's warning in *Basic* that no bright-line rules should be established regarding materiality.[26] The *Basic* Court concurred with the Advisory Committee on Corporate Disclosure's advice against such a bright-line test:

> Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and

20. *See Oscar*, 487 F.3d at 264 n.5 (quoting Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005)).

21. *See Basic*, 485 U.S. at 251 (White, J., concurring in part and dissenting in part) ("At the outset, I note that there are portions of the Court's fraud-on-the-market holding with which I am in agreement. Most importantly, the Court rejects the version of that theory, heretofore adopted by some courts, which equates 'causation' with 'reliance' . . . ." (citations omitted)).

22. *See id.* at 245 (Blackmun, J., plurality); 3 HAZEN, *supra* note 12, § 12.10[6][A] ("[A] number of courts fashioned a fraud-on-the-market presumption for proving *reliance*." (emphasis added) (citations omitted)).

23. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005) (listing the elements of a Rule 10b-5 claim).

24. *Oscar*, 487 F.3d at 264 (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1120 (5th Cir. 1988), *vacated on other grounds sub nom.* Fryar v. Abell, 492 U.S. 914 (1989)). Whether or not this statement is true is irrelevant for the purposes of this Recent Development. Still, it is important to note that the *Abell* court did not base its claim—that the circuits may define Rule 10b-5 as they see fit—on any precedent. Moreover, that court did not quote any language in the *Basic* decision indicating such a power in the federal circuits. In light of this, it would seem rather peculiar that the Supreme Court would grant the circuits power to disregard its explicit holding.

25. *Basic*, 485 U.S. at 224.

26. *See id.* at 236.

> unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the [Securities and Exchange Commission] is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as disclosure problems are identified.[27]

The Supreme Court followed its recantation of this quotation with its own guidance: "Courts also would do well to heed this advice."[28]

Yet the Fifth Circuit did not just ignore the explicitly established Supreme Court standard. The *Oscar* court also failed to grasp the basic foundation of the elements of a Rule 10b-5 action—the tort of fraud.[29] In the context of fraud, a "[representation is] material if a reasonable person would want to consider the fact represented in determining whether to enter the transaction in question."[30] Indeed, some early cases analyzing Rule 10b-5 "looked to the Restatement of Torts in defining materiality in terms of whether a reasonable person 'would attach importance [to the act misrepresented] in determining his choice of action in the transaction in question.' "[31] There is, however, an important distinction between the Rule 10b-5 action for fraud and the tort doctrine: Rule 10b-5 was meant to add greater protection than that offered at common law by reducing the standard

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27. *Id.* at 236 n.14 (quoting STAFF OF H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 327 (Comm. Print 1977)); *see also* 3 HAZEN, *supra* note 12, § 12.10[6][A] ("It has repeatedly been held that the concept of materiality cannot be distilled into a bright-line test." (citations omitted)).

28. *Basic*, 485 U.S. at 236.

29. *See* Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 343 (2005) ("Judicially implied private securities fraud actions [such as Rule 10b-5 actions] resemble in many (but not all) respects common-law deceit and misrepresentation actions."); LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 910–18 (5th ed. 2004) (explaining the common-law fraud foundation for Securities and Exchange Commission fraud actions and comparing the two). The elements of common-law fraud include:

> (1) a false representation of (2) a material (3) fact; (4) the defendant must know of the falsity (this kind of knowledge is called "scienter"), but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; and (5) the plaintiff must justifiably rely on it, and (6) suffer damages as a consequence.

LOSS & SELIGMAN, *supra*, at 910. To compare these requirements to those for a Rule 10b-5 action, see *supra* note 9 and accompanying text.

30. 35 DAN B. DOBBS, THE LAW OF TORTS § 476 (2000).

31. 3 HAZEN, *supra* note 12, § 12.9[3] (citing List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965)); *see, e.g.*, LOSS & SELIGMAN, *supra* note 29, at 915–17 (discussing the relationship between common-law fraud and Rule 10b-5).

of proof.[32] Such heightened protection is likely a product of the fundamental difference between common face-to-face transactions and securities market transactions. As the Supreme Court recognized:

> The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences. "In face to face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing

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32. *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. __, __, 128 S. Ct. 761, 777 (2008) (Stevens, J., dissenting) ("[O]ur prior cases explained that to the extent that 'the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud,' it is because common-law fraud doctrines might be too restrictive." (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 388–89 (1983))); *Basic*, 485 U.S. at 244 n.22 (Blackmun, J., plurality) ("Actions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims ... and are in part designed to add to the protections provided investors by the common law ...."). The Supreme Court addressed this issue in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983):

> The Court of Appeals relied primarily on the traditional use of a higher burden of proof in civil fraud actions at common law .... Reference to common-law practices can be misleading, however, since the historical considerations underlying the imposition of a higher standard of proof have questionable pertinence [in a Rule 10b-5 action] .... Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry.

Id. at 388–89 (citations omitted). While the Private Securities Litigation Reform Act of 1995 ("PSLRA"), 15 U.S.C. § 78u-4(b) (2000), seems to impose some heightened pleading requirements in many portions of the Rule 10b-5 action, the PSLRA does not increase the loss causation requirement in pleadings. *See* Teachers' Ret. Sys. v. Hunter, 477 F.3d 162, 185 (4th Cir. 2007). It is true that the plaintiff will ultimately bear the burden of proving loss causation. *Dura*, 544 U.S. at 345–46. However, the plaintiffs should not bear the burden of actually *proving* loss causation at the class certification stage. *Id.* at 346. This is a critical distinction because the *Oscar* court demanded the higher standard of proof in order to allow class certification. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007). For further analysis of why causation proof should not be required at class certification, see *infra* notes 66–75 and accompanying text.

him that given all the information available to it, the value of the stock is worth the market price."[33]

Aside from the differences between face-to-face transactions and financial market transactions, there are at least three additional justifications supporting heightened fraud protections. The first of these, relied upon by the Supreme Court in establishing the fraud-on-the-market presumption, is the Efficient Market Hypothesis. This theory states that, in an active financial market, any material information regarding a company will affect that company's stock price.[34] In fact, the Supreme Court discussed this notion in describing the basis for the fraud-on-the-market theory: " '[I]n 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 ....' "[35] Thus, due to the unique connection of information and security prices, courts should afford greater protection under Rule 10b-5 than is offered in other common-law fraud actions.

A second justification for the heightened level of protection in Rule 10b-5 actions is contained in the legislative purpose behind the Securities Exchange Act of 1934, under which the Securities and Exchange Commission promulgated Rule 10b-5. The *Basic* Court referred to the "legislative philosophy [that] '[t]here cannot be honest markets without honest publicity.' "[36] In fact, the Court " 'repeatedly has described the fundamental purpose of the [Securities Exchange Act of 1934] as implementing a philosophy of full disclosure.' "[37] Thus, to effectuate the legislative purpose of promoting full and

33. *Basic*, 485 U.S. at 243–44 (Blackmun, J., plurality) (quoting *In re* LTV Sec. Lit., 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

34. *See* ZVI BODIE, ALEX KANE & ALAN J. MARCUS, ESSENTIALS OF INVESTMENT 260–87 (International ed. 2003). The text defines this theory as "[t]he hypothesis that prices of securities fully reflect available information about securities." *Id.* at 262. The authors explain that as soon as new information is made available concerning a security, investors will trade on that information to bring "its price to a fair level." *Id.* at 262; *see also* H.R. REP. NO. 73-1383, at 11 (1934) ("The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price.").

35. *Basic*, 485 U.S. at 241–42 (Blackmun, J., plurality) (citing Peil v. Speiser, 806 F.2d 1154, 1160–61 (3d Cir. 1986)).

36. *Id.* at 230 (quoting H.R. REP. NO. 73-1383, at 11 (1934)).

37. *Id.* (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977)).

honest disclosure, courts should increase the level of protection and recourse available to investors who trade based on misrepresentations by lowering the standard of proof necessary to establish materiality of misstatements.

A third justification, which could be viewed as a subset of the second justification, is the facilitation of market participation. By promoting a legislative scheme that insures the information available to investors is as complete and accurate as possible, the legislature will foster an environment that is more welcoming to hesitant and skeptical investors. At least one court has noted the importance of full disclosure in regard to market participation:

> The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.[38]

Thus, by demonstrating increased protections for investors who, to their detriment, trade on inaccurate information, courts foster a more hospitable market, encourage investment, and increase liquidity through enhanced participation.

Yet in spite of the Supreme Court's recognition of heightened protection and lowered standards of proof for materiality in Rule 10b-5 actions, the *Oscar* court seems to have gone in the opposite direction. Rather than looking out for investors, the Fifth Circuit seems to have placed an additional barrier in the path of a claimant alleging securities fraud. In requiring satisfaction of the sort of bright-line test the *Basic* Court cautioned against,[39] the *Oscar* court

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38. *In re* Carnation Co., Exchange Act Release No. 22,214, 33 SEC Docket 1025, 1030 (July 8, 1985). This is also addressed in *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*, 552 U.S. __, 128 S. Ct. 761 (2008):

> "Holding liable wrongdoers who actively engage in fraudulent conduct that lacks a legitimate business purpose ... enhances[] the integrity of our markets and our economy. We believe that the integrity of our securities markets is their strength. Investors, both domestic and foreign, trust that fraud is not tolerated in our nation's securities markets and that strong remedies exist to deter and protect against fraud and to recompense investors when it occurs[.]"

Id. at __, 128 S. Ct. at 778 n.10 (2008) (Stevens, J., dissenting) (quoting Motion for Leave To File Brief Out of Time and Brief Amici Curiae of Former SEC Commissioners in Support of Petitioners at 4, *Stoneridge*, 552 U.S. __, 128 S. Ct. 761 (No. 06-43)).

39. *See supra* notes 26–28 and accompanying text.

has significantly lessened the protection and recourse available for injured investors. The Fifth Circuit questioned the fundamental logic behind the Efficient Market Hypothesis[40] rather than acknowledging the well-recognized theory, thus straying into the dense field of financial theory in which the court has little knowledge or expertise.[41]

Moreover, the court frustrates the basic legislative purpose of full and accurate disclosure that is at the foundation of Rule 10b-5.[42] In fact, the court's new standard for materiality—"proof that the misstatement *actually moved* the market"[43]—creates a loophole for dishonesty. Specifically, the *Oscar* court held that "when unrelated negative statements are announced contemporaneous of a corrective disclosure [of prior positive misrepresentations], the plaintiff must prove 'that it is more probable than not that it was this [corrective disclosure], and not other unrelated negative statements, that caused a significant amount of the decline.' "[44] This standard allows

40. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 269–70 (5th Cir. 2007).

41. In fact, it seems likely that, in this specific instance, the court has botched the financial theory behind the Efficient Market Hypothesis as it applied to the *Oscar* case. The court listed two arguments as to why misrepresentations regarding the security would not affect the price—selective efficiency (implying a semi-strong form efficient market) and strong form efficiency. *Id.* at 269–70. Regarding the court's first argument, "the idea that a share price might be somehow *selectively* efficient would seem to run counter to the basic notion of the semi-strong form." E-mail from William Beedles, Professor of Finance, University of Kansas School of Business, to Tad E. Thompson (Sept. 29, 2007, 11:32 EST) (on file with the North Carolina Law Review). As for the court's contention that the market might be strong form efficient, "we know that stock prices aren't strong form efficient[,] and while the opinion presents an academically interesting hypothesis, it's empirically untrue." E-mail from Laura Tuttle, Professor of Accounting and Finance, American University of Sharjah, to Tad E. Thompson (Sept. 24, 2007, 01:26 EST) (on file with the North Carolina Law Review). It may be true that, to make rulings, courts often have to delve into fields in which they lack expertise. But the *Oscar* court's venture into financial theory seems particularly egregious, as the court chose to deny class certification and keep the merits of the case from reaching trial based largely on a theory the court misunderstood and misapplied. Although granting class certification and allowing the case to reach trial would likely not give the court complete expertise in the matter, this author believes that it would have allowed the court to make a more informed decision founded on greater understanding, as the adversary process would have more adequately explained the theory to the trier of fact. Nevertheless, analysis of the court's management of the hypothesis is outside the scope of this Recent Development and unnecessary for the argument found herein.

42. *See* H.R. REP. NO. 73-1383, at 11 (1934) (noting that the purpose behind the Securities Exchange Act of 1934 is that full disclosure will promote honest markets).

43. *Oscar*, 487 F.3d at 265.

44. *Id.* at 270 (quoting Greenberg v. Crossroads Sys., Inc., 364 F.3d 657, 666 (5th Cir. 2004)). *Oscar* involved a fact pattern where the corporate defendant revealed a prior misrepresentation while releasing other negative information about the company's performance. *See id.* at 263.

corporations that have previously made material misrepresentations a way to avoid liability by shrouding their corrective statements in other concurrently released negative information, thus making it more difficult for injured investors to acquire relief. Such a loophole thwarts the legislative purpose of full disclosure by allowing corporations a way to escape legal accountability for inaccurate statements and material omissions.

Finally, this loophole will not facilitate market integrity and participation. Despite recognizing a state of "Enron-itis"[45] and the "increasingly skeptical market,"[46] the court blazed on with its new heightened standard of proof for materiality. Ordinary logic cautions that, by increasing the standard of proof necessary for a remedy in securities fraud actions, the court will frighten off weary or hesitant investors. This is the exact result courts have cautioned against—that investors fearful of dishonest markets "will be less likely to invest, thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike."[47]

In addition to misinterpreting the standard for materiality, the *Oscar* decision effectively changes fraud-on-the-market from a presumption in favor of plaintiffs to a burden that plaintiffs must prove. The fraud-on-the-market theory creates a rebuttable presumption of reliance.[48] The Supreme Court found that such a presumption "is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the [Securities Exchange Act of 1934]."[49] The Court also instructed "that [defendants] may rebut proof of the elements giving rise to the presumption[] or show that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would

45. *Id.* at 270 (quoting James Ott of Hibernia Southcoast Capital).

46. *Id.*

47. *In re* Carnation Co., Exchange Act Release No. 22,214, 33 SEC Docket 1025, 1030 (July 8, 1985). This statement may seem a bit melodramatic. It is not the author's position that the Fifth Circuit's decision will destroy capital markets as we know them. Nevertheless, there is a strong argument that this decision will have a detrimental impact on risk-averse, borderline investors.

48. 3 HAZEN, *supra* note 12, § 12.10[6][A] (citations omitted).

49. Basic Inc. v. Levinson, 485 U.S. 224, 245 (1988) (Blackmun, J., plurality). The Court supported this proposition, stating, "[i]n drafting that Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets." *Id.* at 245–46. The Court went on to conclude "[t]he presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress's premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Id.* at 246.

have traded despite his knowing the statement was false."[50] As the *Basic* Court noted, "[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, will be sufficient to rebut the presumption of reliance."[51] Thus, under the Supreme Court's standard, once the plaintiff has established the elements necessary for the fraud-on-the-market presumption of reliance,[52] the burden shifts to the defendant to show that the presumption should not stand.[53] A significant part of the Supreme Court's analysis of the ability to rebut this presumption is that the defendant must "*show*" that the presumption should not stand.[54] The Court enumerated several examples of how a defendant can demonstrate the presumption's inapplicability.[55] The important aspect of these examples is that each places the burden on the defendant to overcome the presumption.[56] Thus, the Court's language seems to indicate that the defendant cannot simply rebut fraud-on-the-market by raising the possibility that the presumption should not stand.[57]

Yet the *Oscar* court departs from this standard. In fact, the Fifth Circuit's decision implies that the "presumption evaporates as soon as a defendant simply introduces a mere possibility the defendant's material misrepresentation might not have affected the market price" and places the burden back onto the plaintiffs.[58] This is inconsistent

50. *Id.* at 248.

51. *Id.*

52. Those elements are as follows: (1) the misrepresentation was material, (2) the market was sufficiently active, and (3) the misstatements or omissions were made public. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 264 (5th Cir. 2007); 3 HAZEN, *supra* note 12, § 12.10[6][A].

53. 3 HAZEN, *supra* note 12, § 12.10[6][A] (citations omitted).

54. *Basic*, 285 U.S. at 248 (Blackmun, J., plurality) (emphasis added).

55. *See id.*

56. *See id.*

57. The *Basic* Court explains that, in demonstrating that the fraud-on-the-market presumption should not apply, the defendant may "show that the misrepresentation in fact did not lead to a distortion of price" and may offer a "showing that severs the link between the alleged misrepresentation and either the price" of the security or the plaintiff's reliance. *Id.* The Court's language concerning both methods implies that the defendant must make an affirmative demonstration—a showing—to fight the presumption of reliance.

58. Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 274 (5th Cir. 2007) (Dennis, J., dissenting). The dissent notes that the majority opinion "conspicuously neglects to explain what type of evidence a defendant would have to produce to meet its standard." *Id.* at 274. Likewise, the majority is cryptic as to what kind and amount of proof would be necessary when the burden shifts to the plaintiff. *See id.* at 270–71 (majority opinion) ("[U]nder these circumstances, proof of a corrective disclosure's

with the purpose of the presumption. The Supreme Court recognized that the presumption exists in favor of plaintiffs in class action litigation because, if each class member had to prove individual reliance, certification would always fail as individual questions would overwhelm common ones among the class members.[59] The presumption of materiality was the Court's recognition of the proper "[allocation of] the burdens of proof between parties."[60]

To be sure, there are legitimate reasons why the courts might want to lessen the force of the fraud-on-the-market presumption. If plaintiffs can easily satisfy the requisite elements for class certification in a Rule 10b-5 action, they can create "an extraordinary aggregation of claims," thus putting defendants at risk of tremendous losses should the trial turn against them.[61] The potential of such large losses would heavily incentivize defendants to settle after the class certification. It seems this recognition was critical to the *Oscar* court's holding.[62] Its conclusion, that "a district court's certification order often bestows upon plaintiffs extraordinary leverage," signaled to it " 'important due process concerns of both plaintiffs and defendants inherent in the certification decision.' "[63]

Still, the court acted outside of its authority in eroding the fraud-on-the-market presumption. "Such policy considerations, ... no matter how sincerely interpreted or applied, do not give [the Fifth Circuit] the authority to overrule the Supreme Court's decisions or to change the recognized elements of a [§] 10(b) claim ...."[64] In fact, as the Fifth Circuit has already recognized, "it is the Supreme Court's job to overrule *Basic*."[65] These due process concerns do not give circuit courts the authority to shift the burden of proof established by the Supreme Court. Absent a conflict with current legislation, the *Basic* opinion—establishing a presumption in favor of plaintiffs that the defendant must actively rebut—is binding on the Fifth Circuit. The court acted impermissibly in ignoring this.

significant contribution to a price decline demands a peek at the plaintiff's damages model ...."). Yet the majority suggests that the standard for a plaintiff would be high, as the court rejected the plaintiff's expert opinions and reports as "well-informed speculation." *Id.* at 270–71.

59. *Basic*, 285 U.S. at 242 (Blackmun, J., plurality).

60. *Id.* at 245.

61. *Oscar*, 487 F.3d at 267.

62. *See id.*

63. *Id.* (quoting Unger v. Amedisys Inc., 401 F.3d 316, 321 (5th Cir. 2005)).

64. *Id.* at 276 (Dennis, J., dissenting).

65. Unger v. Amedisys Inc., 401 F.3d 316, 322 n.4 (5th Cir. 2005).

Yet if allowed to stand, the *Oscar* court's holding will have drastic and far-reaching consequences on class action suits brought under Rule 10b-5. As many courts have recognized, "the Federal Rules of Civil Procedure require only a 'short and plain statement of the claim showing that the pleader is entitled to relief' "[66] that "[provides] the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.' "[67] The Fifth Circuit's holding drastically departs from this rule. The court ruled that " 'Rule 23 [of the Federal Rules of Civil Procedure] requires the court to "*find*," not merely assume, the facts favoring class certification.' "[68] As noted above, the court defined "find" to mean that the plaintiff must have proven, by a preponderance of the evidence, an element of his case—"that the misstatement *actually moved* the market."[69] Such analysis and consideration of proof at the class certification stage is not warranted.[70] On the contrary, this depth of examination of proof, at such an early point in the litigation, will push the merits of the case to the certification stage and inevitably lead to "mini-trials" on those merits,[71] as the court will be required to determine whether the plaintiffs will succeed at trial on a material element of their claim.[72] This result breaches long-standing public policy, as numerous courts have recognized that "[c]lass certification hearings should not be mini-trials on the merits of the class or individual claims."[73]

66. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 346 (2005) (quoting FED. R. CIV. P. 8(a)(2)).

67. *Id.* at 346 (quoting Conley v. Gibson, 355 U.S. 41, 47 (1957), *abrogated by* Bell Atl. Corp. v. Twombly, 550 U.S. __, __, 127 S. Ct. 1955, 1969 (2007)).

68. *Oscar*, 487 F.3d at 267 (emphasis added) (quoting *Unger*, 401 F.3d at 321).

69. *Id.* at 265.

70. *See, e.g.*, Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 177 (1974) ("We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of a suit in order to determine whether it may be maintained as a class action.").

71. *Oscar*, 487 F.3d at 272 (Dennis, J., dissenting) (stating that the *Oscar* decision will "[require] mini-trials on the merits of cases at the class certification stage").

72. *See id.* at 269 (majority opinion). Since the majority in *Oscar* held that loss causation required proof "by a preponderance of all admissible evidence" at the class certification stage, the court required the plaintiffs to meet the trial burden of proof on a material element of their claim to get certification. By requiring this strict and searching standard of proof at such an early stage, the court will inevitably invite determination of the probability of success on the merits at certification. This is impermissible. *See, e.g.*, *Eisen*, 417 U.S. at 177; Stastny v. S. Bell Tel. & Tel. Co., 628 F.2d 267, 275 (4th Cir. 1980).

73. Unger v. Amedisys Inc., 401 F.3d 316, 321 (5th Cir. 2005); *see also Eisen*, 417 U.S. at 177–78. Although the *Unger* opinion held that " '[g]oing beyond the pleadings is necessary, as the court must understand the claims, defenses, relevant facts, and applicable substantive law in order to make a meaningful determination of the certification issues,' " *Unger*, 401 F.3d at 321 (quoting Castano v. Am. Tobacco Co., 84 F.3d 734, 744 (5th Cir.

> [S]uch a procedure contravenes [Rule 23] by allowing a representative plaintiff to secure the benefits of a class action without first satisfying the requirements for it. He is thereby allowed to obtain a determination on the merits of the claims advanced on behalf of the class without any assurance that a class action may be maintained .... "In determining the propriety of a class action, the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met."[74]

The Fifth Circuit's decision ignores this policy and pushes aside the considerations for enforcing different standards at class certification than those at trial.

Furthermore, the *Oscar* holding limits the ability of an injured stockholder to obtain relief. By increasing the standard for materiality, shifting the rebuttable presumption in favor of plaintiffs to a burden they must bear, and moving this determination to the class certification stage, the logical conclusion is that the Fifth Circuit's holding will make it much more difficult for plaintiffs alleging securities fraud to succeed in 10b-5 litigation. This increased difficulty will likely frighten off hesitant investors who fear that there will be no recourse for misrepresentations, thus chilling market participation and liquidity. Moreover, the added difficulty for obtaining a remedy will frustrate the purpose of Rule 10b-5—"implementing a 'philosophy of full disclosure' "[75]—by lessening accountability of corporations that have made material misrepresentations regarding their securities.

At the very least, the higher standard established by the *Oscar* decision, applicable at the earlier class certification stage rather than at trial, will logically increase the difficulty of acquiring class certification. This is an especially disadvantageous result for securities fraud litigation. Class action lawsuits often allow individuals, whose claims are too small to pursue standing alone, to

1996)), the court only required the plaintiffs to demonstrate that the stock traded in an efficient market, *id.* at 325. That opinion did not, at the class certification stage, delve so far into the substantive matters of the case as to require proof of actual causation—a separate element of a Rule 10b-5 action from materiality—to allow the fraud-on-the-market presumption. The *Oscar* holding thus goes much further than *Unger*.

74. *Eisen*, 417 U.S. at 177–78 (quoting Miller v. Mackey Int'l, 452 F.2d 424, 427 (5th Cir. 1971)).

75. Basic Inc. v. Levinson, 485 U.S. 224, 230 (1988) (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477–78 (1977)).

band together and establish an economically viable suit.[76] The benefit of enabling litigation where the individual complainants' damages are small is significant in Rule 10b-5 litigation, as many members of a prospective class may have only purchased a few shares in reliance on the misrepresentation and therefore will not have enough damages to bring an action on their own.[77] The result of an opinion like *Oscar*, which significantly raised the bar for class certification, will effectively eliminate any potential for recovery for those investors whose stake in the corporation was insubstantial. Such an outcome stands contrary to one of the principal justifications for class action litigation—enabling suits where the individual class members cannot maintain actions individually[78]—and is detrimental to public policy.

The Fifth Circuit's decision in *Oscar* appears to be a large step away from precedent. Although it was motivated by an admittedly legitimate concern—the massive pressure that class certification creates for settlement[79]—the court was acting outside its authority in fashioning a new standard for Rule 10b-5 actions. Moreover, it could even be argued that the court was more interested in the defendant's cost of litigating a class action suit than in the plaintiffs' ability to acquire remedy for their injuries. The court's drastic revision of the materiality standard, which significantly lessened the investor protection upheld in prior cases, seems to be a large departure from the cases preceding it. Worse, this departure will unfairly disadvantage investors and injured parties in future Rule 10b-5 class actions. First, the decision will interfere with the legislative goals behind the Securities Exchange Act of 1934 and Rule 10b-5—promoting full and honest disclosure—by creating a loophole for

76. *See* FLEMING JAMES, JR., GEOFFREY C. HAZARD, JR. & JOHN LEUBSDORF, CIVIL PROCEDURE § 10.20 (5th ed. 2001); Owen M. Fiss, *The Political Theory of the Class Action*, 53 WASH. & LEE L. REV. 21, 22 (1996).

77. Barbara Ann Banoff & Benjamin S. DuVal, Jr., *The Class Action as a Mechanism for Enforcing the Federal Securities Laws: An Empirical Study of the Burdens Imposed*, 31 WAYNE L. REV. 1, 33 (1984); Jonathan M. Landers, *Of Legalized Blackmail and Legalized Theft: Consumer Class Actions and the Substance-Procedure Dilemma*, 47 S. CAL. L. REV. 842, 845 (1974).

78. *See* JAMES, HAZARD & LEUBSDORF, *supra* note 76, § 10.20; Fiss, *supra* note 76, at 22.

79. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc. 487 F.3d 261, 267 (5th Cir. 2007). The court's statements regarding the "*in terrorem* power of certification" and the "extraordinary leverage" it gives are likely directed toward plaintiffs' increased leverage in settlement negotiations after attaining certification. *Id.* at 267; *see also* LARRY L. TEPLY & RALPH U. WHITTEN, CIVIL PROCEDURE 750–51 (3d ed. 2004) (noting that class certification may often induce defendants to settle class actions to avoid the cost of litigation).

companies to avoid liability for injuries resulting from the corporations' misstatements and omissions.[80] Second, the holding will decrease market participation, thus decreasing market liquidity.[81] Finally, the Fifth Circuit's alteration of fraud-on-the-market, from a rebuttable presumption in favor of injured investors to what is essentially an affirmative burden on plaintiffs,[82] seems to defeat the basic purpose and justifications for the theory,[83] increase the burden on a plaintiff class at the certification stage, and hinder attempts to acquire recovery for injuries.[84]

Still, it is arguable that this case is just one part of a current trend eroding the private right of action under Rule 10b-5, at least as described in *Basic*.[85] In fact, at least one commentator[86] has asserted that the result in *Oscar* is simply the next logical step from the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*.[87] In that case, the High Court permitted a more searching analysis into the adequacy of the plaintiff class's proof of loss causation at trial than in previous cases.[88] Although both the majority[89] and dissent[90] in

80. *See supra* notes 36–37, 42–44 and accompanying text.

81. *See supra* notes 38, 45–47 and accompanying text.

82. *See supra* notes 48–60 and accompanying text.

83. *See supra* notes 10–12, 32–41 and accompanying text.

84. *See supra* notes 76–78 and accompanying text.

85. *See* H. Peter Haveles, *'Oscar': Nearing the End of Fraud-on-Market Theory?*, N.Y. L.J., Sept. 27, 2007, at 4, *available at* http://www.arnoldporter.com (follow "Who We Are"; then follow "Publications"; then search by author "Haveles").

86. *See id.*

87. 544 U.S. 336 (2005).

88. In *Dura*, the defendant pharmaceutical company falsely stated that its new asthmatic spray device would quickly receive U.S. Food and Drug Administration ("FDA") approval, thus causing a rise in its stock price. *Id.* at 339–40. Later, when the company announced that the product had not received FDA approval, its stock price tumbled. *Id.* at 339. Shareholders who had purchased the defendant's stock between the two announcement dates filed a class action suit, seeking to establish the loss causation element of their Rule 10b-5 claim based on the allegation that, "*on the date of purchase*," the stock price "was inflated because of the misrepresentation." *Id.* at 338 (internal quotation marks omitted) (quoting Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003)). The High Court, permitting a more searching analysis into the adequacy of the plaintiff class's proof of loss causation than employed in previous cases, struck down the plaintiff's claim. *Id.* at 342–43. As Justice Breyer's unanimous opinion explained:

> We begin with the Ninth Circuit's basic reason for finding the complaint adequate, namely, that at the end of the day plaintiffs need only "establish," *i.e.*, prove, that "the price *on the date of purchase* was inflated because of the misrepresentation." In our view, this statement of the law is wrong. Normally, in cases such as this one (*i.e.*, fraud-on-the-market cases), an inflated purchase price will not itself constitute or proximately cause the relevant economic loss.

Oscar explicitly state that the *Dura* holding was a narrow one, it can be argued that *Dura* signaled a new view on the availability of class action securities fraud litigation, especially in light of the great incentive class certification gives for settlement. Likewise, the Court's most recent narrowing interpretation of Rule 10b-5, *Stoneridge Investment Partners, L.L.C. v. Scientific-Atlanta, Inc.*,[91] held that private parties could not bring suits under the theory that defendants aided and abetted a violation of the Rule because those plaintiffs could not show reliance on the aider and abettor's conduct.[92]

Id. at 342 (quoting *Dura*, 339 F.3d at 938). The *Dura* Court explained that when investors, such as the plaintiffs in that case, purchase securities with an artificially inflated value due to a material misrepresentation or omission, they have "suffered no loss" because they own a share of stock equal in market value to the price paid. *Id.* After the misrepresentation or omission comes to light, the security's "lower price may reflect, not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, . . . or other events, which taken separately or together account for some or all of that lower price." *Id.* at 343. Thus, the *Dura* Court required the plaintiffs to prove loss causation with greater specificity. *Id.* at 343, 346. Nevertheless, the *Dura* holding was a narrow one that only analyzed the loss causation element of Rule 10b-5. *Id.* at 346. *Dura* did not discuss reliance. Moreover, it differs from both *Basic* and *Oscar*, as the *Dura* Court dismissed the plaintiffs' case for failing to adequately allege economic loss and loss causation in the pleadings. *Id.* The *Dura* analysis does not go beyond the pleadings. Further discussion of the loss causation element of the Rule 10b-5 claim is outside the scope of this Recent Development.

89. *See* Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 n.16 (5th Cir. 2007).

90. *See id.* at 276 (Dennis, J., dissenting).

91. 552 U.S. __, 128 S. Ct. 761 (2008).

92. *Id.* at __, 128 S. Ct. at 769. In *Stoneridge*, plaintiffs brought a Rule 10b-5 class action against the defendant companies, alleging that the defendants engaged in a series of sham transactions with one of their customers, Charter, to boost Charter's financial performance. *Id.* at __, 128 S. Ct. at 767–68. Although the defendants had not made any public misstatements or violated their duty to disclose, the plaintiffs sought recovery from the two companies on the theory that they had aided and abetted Charter in conducting "a scheme to violate" Rule 10b-5. *Id.* at __, 128 S. Ct. at 767. The Court ruled against the plaintiffs, finding the class had failed to satisfy the reliance element of Rule 10b-5 because of the defendants' merely indirect involvement. *Id.* at __, 128 S. Ct. at 769. The Court explained:

> Respondents have no duty to disclose; and their deceptive acts were not communicated to the public. No members of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability.

Id. at __, 128 S. Ct. at 769. The Court refused to acknowledge, absent Congressional approval, a private cause of action for aiding and abetting violations of Rule 10b-5, *id.* at __, 128 S. Ct. at 772–73, despite the fact that the basic private remedy available under 10b-5 was of judicial creation, *see id.* at __, 128 S. Ct. at 769 (citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971)). Justice Stevens, joined by Justice Souter and Justice Ginsburg, delivered a fiercely written dissent that characterized the majority

Finally, the Supreme Court's recent holding in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*,[93] a case concerning the Rule's scienter requirement, may further indicate the trend of imposing additional limits on Rule 10b-5 actions.[94] Taken together, these cases seem to indicate that the Supreme Court and the federal circuits are ready and willing to erode the availability of private recourse under Rule 10b-5.

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opinion as "unduly stringent and unmoored from authority." *Id.* at __, 128 S. Ct. at 777 (Stevens, J., dissenting). The dissent argued that the defendants could be held liable as principals for employing a " 'deceptive device' prohibited by § 10(b)" rather than as aiders and abettors. *Id.* at __, 128 S. Ct. at 774. Nevertheless, as with *Dura*, *Stoneridge* was a narrow holding only addressing aider and abettor liability under Rule 10b-5. *Id.* at __, 128 S. Ct. at 769 (majority opinion). Further discussion of such liability is outside the scope of this Recent Development.

93. 551 U.S. __, 127 S. Ct. 2499 (2007).

94. In *Tellabs*, the plaintiffs alleged that the defendant corporation made false statements regarding demand for the company's products and revenue projections. *Id.* at __, 127 S. Ct. at 2505. When the company later released substantially different results and the stock price dropped, investors who bought the company's stock between the misstatements and the later revelation brought suit. *Id.* at __, 127 S. Ct. at 2505–06. At issue in the case was the extent to which the plaintiff's complaint had to demonstrate scienter. *Id.* at __, 127 S. Ct. at 2506. In PSLRA, Congress determined that, among other things, the plaintiff's complaint had to "state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (2000) (emphasis added). In interpreting the phrase "strong inference," the United States Court of Appeals for the Seventh Circuit held they would "allow [a] complaint to survive if it alleges facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." Makor Issues & Rights, Ltd. v. Tellabs, Inc., 437 F.3d 588, 602 (7th Cir. 2006), *vacated*, *Tellabs*, 551 U.S. at __, 127 S. Ct. at 2513. Yet the Supreme Court overruled this interpretation of "strong inference." *Tellabs*, 551 U.S. at __, 127 S. Ct. at 2504. Justice Ginsburg explained:

> It does not suffice that a reasonable factfinder plausibly could infer from the complaint's allegations the requisite state of mind. Rather, to determine whether a complaint's scienter allegations can survive threshold inspection for sufficiency, a court . . . must consider, not only inferences urged by the plaintiff, as the Seventh Circuit did, but also competing inferences rationally drawn from the facts alleged.

Id. at __, 127 S. Ct. at 2504. The Court ruled that "the inference of scienter must be more than merely 'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations." *Id.* at __, 127 S. Ct. at 2510. In reaching this result, the Court accepted one of the stricter definitions from among the circuits' decisions addressing the scienter element of Rule 10b-5, thus further limiting the potential for injured plaintiffs to reach trial. *See Makor*, 437 F.3d at 602; *In re* Credit Suisse First Boston Corp., 431 F.3d 36, 49, 51 (1st Cir. 2005), *overruled by* ACA Fin. Guar. Corp. v. Advest, Inc., No. 07-1367, 2008 U.S. App. LEXIS 451, at *3 (1st Cir. Jan. 10, 2008); Ottmann v. Hanger Orthopedic Group, Inc., 353 F.3d 338, 347–49 (4th Cir. 2003); Pirraglia v. Novell, Inc., 339 F.3d 1182, 1187–88 (10th Cir. 2003); Gompper v. VISX, Inc., 298 F.3d 893, 896–97 (9th Cir. 2002); Helwig v. Vencor, Inc., 2001 FED App. 0179P, ¶¶ 18–19 (6th Cir.), 251 F.3d 540, 553. In any event, further discussion on the scienter element of the claim is outside the scope of this Recent Development.

In his dissent in *Oscar*, Judge Dennis adamantly claimed that the majority's holding will lead to "a split from other circuits."[95] But whether other circuits will refuse to follow *Oscar*, or fall in line with what may be a new and detrimental trend, is still an open question. Future courts must decide whether *Oscar* stands as a rare deviation from Rule 10b-5 precedent or as one of the first cases establishing a new standard for securities fraud litigation.

TAD E. THOMPSON

95. *Oscar*, 487 F.3d at 272 (Dennis, J., dissenting).