AMGEN AND PROVING MATERIALITY IN CLASS ACTION SECURITIES LITIGATION: HOW THE SEVENTH AND NINTH CIRCUIT’S APPROACH TO MATERIALITY OFFERS THE UNITED STATES SUPREME COURT THE CHANCE TO REINFORCE LEGAL MECHANISMS OF CORPORATE GOVERNANCE

Cory H. Howard†

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† The author is a J.D. candidate at the Wake Forest School of Law (2014) and an alumnus of The George Washington University (2011), where he graduated magna cum laude with a B.A in International Affairs. This article is the result of the encouragement and support of his family and friends. For that the author would like to express tremendous gratitude. The author would like to give thanks to Professor Omari Simmons, whose exceptional teaching and scholarly work inspired him to explore corporate governance, to Chris Wimbush whose advice and friendship constantly forces him to work harder, and most of all to Sara and to his parents, Dewey and Tracy, whose constant love and support is and continues to be the driving force behind all of his endeavors. Any remaining mistakes are the author's alone.
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I. INTRODUCTION

By granting certiorari in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, the United States Supreme Court is positioning itself to resolve a split among several circuits over a crucial issue in securities litigation. Five circuits are currently split on whether it is proper to hear arguments about materiality during the class certification stage of class action securities litigation, with their standards falling into three distinct camps. Most securities litigation is brought as a class action suit and therefore plaintiffs must meet the burdens imposed by Rule 23 subsections (a) and (b) of the Federal Rules of Civil Procedure in order to obtain class certification. Class certification is not only an essential pre-trial step which must be completed in order to continue to trial, but can also highly affect the prospect of settlement. Although the requirements of Rule 23(a) are easily satisfied, plaintiffs must also prove that the class is maintainable under Rule 23(b)(1), (b)(2), or (b)(3). Plaintiffs in securities litigation most often seek certification under Rule 23(b)(3)—predominance—which requires that the questions of law and fact common to the

2 Compare In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 484 (2d Cir. 2008) (holding that courts are required to make a definitive assessment on Rule 23 requirements as a threshold matter, even if identical to issues on the merits (first camp)), and Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005) (holding that elements of fraud-on-the-market, such as market efficiency, cannot be treated differently from other preliminary certification issues (falling into the first camp with the Second Circuit)), with In re DVI, Inc. Sec. Litig., 639 F.3d 623, 638 (3d Cir. 2011) (holding that materiality need not be proven at the class certification stage (second camp)), and with Schleicher v. Wendt, 618 F.3d 679, 687 (7th Cir. 2010) (holding that plaintiffs need not establish materiality before a class can be certified (third camp)), and Conn. Ret. Plans, 660 F.3d at 1176-77 (9th Cir. 2011) (holding that plaintiffs do not need to prove materiality at the class certification stage (falling into the third camp with the Seventh Circuit)).
3 Michael J. Kaufman & John M. Wunderlich, The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions, 43 U. Mich. J.L. Reform 323, 324 (2010) (noting that securities litigation normally takes the form of class actions, and class certification turns on whether the plaintiffs can meet the requirements of Rule 23 subsections (a) and (b)); see also Fed. R. Civ. P. 23(a)-(b).
4 See Margaret Anne Caulfield, Class Action Certification in Private Securities Litigation: Endangered Species?, 14 Suffolk J. Trial & App. Advoc. 94, 108 (2009) (noting that class certification is an essential step to settlement, and once a class is certified defendants often move to settle to avoid large damage awards).
5 Kaufman & Wunderlich, supra note 3, at 324-25.
members of the class predominate over any questions affecting only individual members. 7

In order to meet the predominance requirement in securities litigation cases, plaintiffs often rely on the fraud-on-the-market presumption, 8 a tool created by the Supreme Court in the seminal securities litigation case *Basic Inc. v. Levinson*. 9 In certain types of securities litigation suits, plaintiffs must prove that they relied on the actions or statements of a corporate director. The fraud-on-the-market presumption acts as a substitute for individualized proof of reliance: instead of requiring each plaintiff in the class to show that they relied on a director’s actions (or lack thereof) in their decision making, the fraud-on-the-market permits a judicial presumption without individualized showings. 10 However, some circuits—such as the Fifth and Second—require plaintiffs to prove materiality (an element of the presumption) at the class certification stage, while others—including the Ninth—consider it to be a merit of the case which should be relegated exclusively to the case-in-chief. 11

*Amgen* sets the stage for the Court to redefine the landscape of securities litigation by making securities litigation a readily available weapon for plaintiffs who seek to exert some influence on corporate managers. This case is especially important as the Court has, up until this point, issued decisions to facilitate class action suits 12 and the

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8 See Scudder, *supra* note 6, at 441-42 (explaining the Supreme Court’s adoption of the fraud-on-the-market presumption allowed plaintiffs to satisfy the predominance requirement of Rule 23(b)(3) in securities class action suits).
9 See Kaufman & Wunderlich, *supra* note 3, at 352-53.
10 Carol R. Goforth, *The Efficient Capital Market Hypothesis—An Inadequate Justification for the Fraud-on-the-Market Presumption*, 27 WAKE FOREST L. REV. 895, 913 (1992) (noting that the fraud-on-the-market presumption serves as a substitute for each member of the class having to show individual reliance on a director's actions or statements).
11 Compare *Oscar Private Equity Invs. v. Allegiance Telecom*, Inc., 487 F.3d 261, 265 (5th Cir. 2007), *abrogated on other grounds by Erica P. John Fund*, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (holding that materiality must be proven in order to trigger the fraud-on-the-market presumption), and *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485-86 (2d Cir. 2008) (holding that since a successful rebuttal of materiality defeats the fraud-on-the-market presumption and would prevent certification, the court must permit defendants to present rebuttal arguments before making a certification decision), with *Conn. Ret. Plans & Trust Funds v. Amgen Inc.*, 660 F.3d 1170, 1177 (9th Cir. 2011) (calling materiality a merit of the case and not permitting consideration of it until either trial or a summary judgment motion).
12 See *In re DVI*, Inc. Sec. Litig., 639 F.3d 623, 631 (3d Cir. 2011) (noting that the Supreme Court established the fraud-on-the-market rebuttable presumption in order to facilitate class action securities litigation).
imposition of additional legal burdens at the class certification stage could signal a pro-defense shift in the Court. More importantly, if the Court decides to adopt one of the more restrictive standards for plaintiffs, it could have a tremendous chilling effect on future class action securities suits. This could weaken the ability of shareholders to force directors and corporations to adopt corporate governance mechanisms, which would reduce agency costs. If there is an increased probability that plaintiff securities cases will be dismissed before or during the class certification stage, corporate directors and executives will feel less pressure to act in the shareholders’ best interests.

This note discusses the three different standards currently used to determine when issues of materiality in class action securities litigation may be heard by in various circuits. The note then explores how the goals of securities litigation (which now include corporate governance objectives13) favor the adoption of a less strict approach to materiality during the class certification stage. Although there are a multitude of arguments for why a less strict approach to materiality is beneficial, this note will primarily focus on how a less strict approach enhances corporate governance objectives in light of the expanding role that securities litigation plays in corporate governance theory and practice. The note concludes with a brief discussion of how the approach of the Seventh and Ninth Circuits offers the Court these types of opportunities, focusing on how plaintiffs’ access to the courts increases the pressure that shareholders can exert on corporate executives through the discovery and settlement processes.

II. CURRENT STANDARDS FOR DETERMINING MATERIALITY

Before delving into the current split among the circuits and discussing when and whether materiality can be considered before the case-in-chief, this article quickly rehashes several important points from Basic Inc. v. Levinson, a seminal decision in securities litigation. Once this foundation is established, the note explores the current trends in the various circuits for determining when materiality may be considered. Currently, five circuits have issued opinions on this subject and these decisions fall into three categories:14 (1) the Second and Fifth Circuit Approach, hereinafter referred to as the “strict approach”, (2) the Third Circuit, also known as the “intermediate approach”, and (3) the Seventh and Ninth Circuits’ “no consideration”


approach. Although they are all vastly different takes on the issue of materiality, all three approaches stem from the Court’s holding in Basic.

A. Basic Inc. v. Levinson

In Basic, former shareholders of the company alleged that the corporation had violated § 10(b) of the Securities Exchange Act of 1934, specifically alleging that the board’s misstatements about a potential merger with Combustion Engineering, Inc. had artificially depressed the price of Basic’s shares prior to the merger. Plaintiffs then brought a class action securities lawsuit against the company to recoup the losses that they sustained after prematurely selling their stock, which was a direct result of the board’s misstatements about a pending merger with a more profitable company. Instead of requiring each plaintiff to prove individual reliance on the alleged misstatements, the Court in Basic adopted the fraud-on-the-market presumption, which did not require such individual showings of reliance.

Footnote 27 from Basic, which established the guidelines under which the fraud-on-the-market presumption may be claimed, also appears to be the main source upon which the Second and Fifth Circuits rely in their adoption of a strict requirement for proving materiality. It was in this footnote that the Basic Court established the five elements which a plaintiff must satisfy in order to trigger the

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15 Basic Inc. v. Levinson, 485 U.S. 224, 228 (1988); see also Daniella Casseres, South Cherry Street, LLC v. Hennessee Group LLC: Investors’ Desperate Plea for Second Circuit Standards, 6 J. BUS. & TECH. L. 231, 235-36 (2011) (explaining that Rule 10b-5 of the Securities Exchange Act of 1934 implements § 10(b) of the act “which allows individuals to hold corporations liable for engaging in deceptive practices by giving the SEC the ability to civilly prosecute anyone who makes an untrue statement or who omits ‘to state a material fact . . . in connection with the purchase or sale of any security.’”).

16 Basic, 485 U.S. at 228-29 (plaintiffs alleging that the board’s denial of any potential merger activity led them to sell shares of the company that they would not have otherwise sold if they had known of a lucrative merger).

17 Id.

18 Id. at 247 (holding that an investor’s reliance on public material misrepresentations may be presumed for purposes of a Rule 10b-5 action); Michael J. Kaufman & John M. Wunderlich, Fraud Created the Market, 63 ALA. L. REV. 275, 297 (2012) (noting that in Basic, the Supreme Court adopted the fraud-on-the-market presumption of reliance for securities traded on efficient markets).

19 Conn. Ret. Plans & Trust Funds v. Amgen Inc., 660 F.3d 1170, 1176 (9th Cir. 2011) (noting that footnote 27 of the Basic opinion established the elements that a plaintiff must prove to invoke the fraud-on-the-market presumption, one of which being that “the misrepresentations were material.”).
fraud-on-the-market presumption. The second element, the requirement that the misrepresentation be material, continues to be the most litigious—not because courts struggle to determine when a misrepresentation is material, but because there is no uniformly set procedure as to when to hear the issue. Contention over this point caused a split among six of the circuits and resulted in varying guidelines for when it is appropriate to hear arguments related to the fraud-on-the-market presumption.

B. The Second and Fifth Circuits’ Approach

In deciding when to determine materiality, the Second and Fifth Circuits have traditionally adopted a strict approach, which requires plaintiffs to prove materiality in order to become certified as a class.\(^2^1\) Believing that each circuit is free to develop its own fraud-on-the-market rules,\(^2^2\) the Fifth Circuit has consistently “tighten[ed] the requirements for plaintiffs seeking a presumption of reliance.”\(^2^3\) In \textit{Unger v. Amedisys Inc.}, the court required that elements of the case, if pertinent to Rule 23(b) classification, must be tackled prior to class certification.\(^2^4\) In its decision, the Fifth Circuit held that plaintiffs must prove market efficiency in order to proceed with class certification, because “[w]ithout an initial demonstration of market efficiency, there is no assurance that the available material information

\(^{20}\text{Basic, 485 U.S. at 248 n.27 (1988) (The five elements which a plaintiff must allege and prove are: “(1) that the defendant made public misrepresentations; (2) that the misrepresentations were material; (3) that the shares were traded on an efficient market; (4) that the misrepresentations would induce a reasonable, relying investor to misjudge the value of the shares; and (5) that the plaintiff traded the shares between the time the misrepresentations were made and the time the truth was revealed.”).}\n
\(^{21}\text{In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 484 (2d Cir. 2008) (holding that the court is to make required a definitive assessment of the Rule 23 requirements as a threshold matter, even if it would be identical to an issue on the merits).}\n
\(^{22}\text{Abell v. Potomac Ins. Co., 858 F.2d 1104, 1120 (5th Cir. 1988) (noting that the Basic framework grants the circuits the ability to independently develop their own rules), abrogated on other grounds by sub nom. Fryar v. Abell, 109 S.Ct. 3236 (1989).}\n
\(^{23}\text{Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 265 (5th Cir. 2007), abrogated on other grounds by Erica P. John Fund, Inc. v. Halliburton Co., 131 S.Ct. 2179 (2011).}\n
\(^{24}\text{Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005) (holding that elements of the fraud on the market presumption, such as market efficiency, should not be treated differently than other issues normally handled at the class certification stage).}\n
supports a class-wide presumption of reliance." The adoption of the strict approach by the Fifth Circuit can be explained by the rationale that the court cannot simply presume facts bearing directly on class certification because the practical realities of class certification have serious financial implications through both increased litigation and settlement costs. Dicta from a rash of different decisions demonstrates that the Fifth Circuit’s approach to materiality for class certification is an attempt to protect defendants from extravagant costs imposed by frivolous lawsuits. In its attempt to protect corporate defendants, the Fifth Circuit extended its recognition of issues that can be considered for Rule 23(b) purposes to include issues usually considered to be merits of the case, while other circuits have balked at permitting such “sneak peeks.”

The Second Circuit adopted a strict approach to materiality as well, noting that Rule 23(b) requires that a definitive assessment as to the predominance requirement be made before the class can be certified. In In re Salomon, the court interpreted Basic to hold that a successful rebuttal of the fraud-on-the-market presumption would defeat certification, as the plaintiffs would then fail to meet the predominance requirement. Again, the court is concerned about preventing meritless litigation from proceeding past the class certification stage and needlessly increasing costs for defendants. Therefore, a potential class of plaintiffs who wish to rely on the fraud-on-the-market presumption instead of individualized showings of reliance by each plaintiff must successfully present elements of their claim to demonstrate the applicability of the presumption during the class certification stage.

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25 Id. at 322.
26 Id. at 322-23 (noting that courts have often imposed rigorous preliminary standards to ensure that inappropriate class certification does not impose significant financial burdens on defendants).
28 Unger v. Amedisys Inc., 401 F.3d 316, 322 (5th Cir. 2005).
29 Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 270 (5th Cir. 2007) (“The trial court erred in ruling that the class certification stage is not the proper time for defendants to rebut lead Plaintiffs’ fraud-on-the-market presumption.”), abrogated on other grounds by Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011).
30 In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 485 (2d Cir. 2008).
31 Id.
C. The Third Circuit or “Intermediate” Approach

Similar to the Second and Fifth Circuit’s strict approach, the Third Circuit adopted the “intermediate approach” to the materiality requirement.\(^{33}\) Under this approach, plaintiffs are not required to demonstrate materiality during the class certification stage because the fraud-on-the-market presumption implies materiality.\(^{34}\) However, defendants may present evidence to rebut the materiality of the misrepresentation, along with any issues usually handled during the class certification stage.\(^{35}\) The Third Circuit clearly articulated its belief that materiality, like other Rule 23 elements, “falls within the ambit of issues that, if relevant, should be addressed by district courts at the class certification stage.”\(^{36}\) Therefore, in the Third Circuit, while a showing of materiality by plaintiffs is not required at the class certification stage, defendants are allowed to rebut a presumption of materiality at this point.

Like the Circuits that have adopted the strict approach, the Third Circuit has consistently declined to presume facts essential to a plaintiff’s case and instead has held that if a defendant has serious concerns about the materiality of the alleged misrepresentations, then the issue can be raised before the class is certified.\(^{37}\) In fact, in its In re DVI decision, the Third Circuit approvingly quoted language from the Second Circuit’s seminal In re Salomon decision\(^ {38}\) and suggested that when the issue of materiality is brought up during class certification, “[e]ach element of a claim is examined through the prism of Rule 23(b)(3)”\(^ {39}\) to ensure that each “element of [the legal claim] is


\(^{34}\) In re DVI, Inc. Sec. Litig., 639 F.3d 623, 638 (3d Cir. 2011) (noting that plaintiffs are not required to prove materiality at the class certification stage).

\(^{35}\) Petition for Writ of Certiorari, *supra* note 14, at 11; see also In re DVI, 639 F.3d at 638 (noting that defendants may present evidence to rebut materiality at the class certification stage).

\(^{36}\) In re DVI, 639 F.3d at 638.

\(^{37}\) Zlotnick v. TIE Comm’ns, 836 F.2d 818, 821-22 (3d Cir. 1988) (explaining that while materiality can be proven by the plaintiff, the court will not simply presume it).

\(^{38}\) In re DVI, 639 F.3d at 638-39 (quoting In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 485 (2d Cir. 2008)).

\(^{39}\) In re DVI, 639 F.3d at 630 (citing In re Hydrogen Peroxide Antitrust Litig., 552 F.3d 305, 311-12 (3d Cir. 2009)); see also Marcus v. BMW of N. Am., LLC, 687 F.3d 583, 600 (3d Cir. 2012) (“To assess predominance, a court at the certification stage must examine each element of a legal claim ‘through the prism’ of Rule 23(b)(3).”).
capable of proof at trial through evidence that is common to the class rather than individual to its members.\textsuperscript{40} Although it is deemed the intermediate approach, the mere fact that materiality can be questioned at the class certification stage and that the court is willing to scrutinize it heavily makes certification a potential stumbling block for plaintiffs, and thus is more similar to the “strict approach” than to the Seventh and Ninth Circuit’s “no consideration” approach.

D. The Seventh and Ninth Circuits’ Approach

The Seventh and Ninth Circuits have been hesitant to impose the burden of proving materiality on plaintiffs prior to class certification. Instead of requiring, or even permitting, materiality to be proven at the class certification stage, the Seventh and Ninth Circuits impose a complete bar on consideration of this issue by the courts until the defense’s case in chief.\textsuperscript{41} The Seventh Circuit has expressly decreed that materiality, which is considered to be a merit of the plaintiff’s case, is independent of the issues affecting class certification and therefore, cannot be examined by the courts during the class certification stage.\textsuperscript{42} This holding narrowed a previous Seventh

\textsuperscript{40}In re DVI, 639 F.3d at 630 (quoting In re Hydrogen Peroxide, 552 F.3d at 311-12 (“Instead, the task for plaintiffs at class certification is to demonstrate that the element of antitrust impact is capable of proof at trial through evidence that is common to the class rather than individual to its members.”)); see also Marcus, 687 F.3d at 600 (“A plaintiff must ‘demonstrate that the element of [the legal claim] is capable of proof at trial through evidence that is common to the class rather than individual to its members.’”).

\textsuperscript{41}Conn. Ret. Plans and Trust Funds v. Amgen Inc., 660 F.3d 1170, 1177 (9th Cir. 2011) (“because proof of materiality is not necessary to ensure that the question of reliance is common among all prospective class members’ securities fraud claims, we hold that plaintiffs need not prove materiality to avail themselves of the fraud-on-the-market presumption of reliance at the class certificate stage.”) (emphasis in original)), cert. granted sub nom. Amgen Inc., v. Conn. Ret. Plans & Trust Funds, 132 S. Ct. 2742 (2012) (mem.); Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010) (rejecting the contention that “class certification is proper only when the class is sure to prevail on the merits” and explaining that “[i]t is possible to certify a class under Rule 23(b)(3) even though all statements turn out to have only trivial effects on stock prices,” in that situation “[c]ertification is appropriate, [even though] the class will lose on the merits.”); Timothy S. Bishop & Joshua D. Yount, US Supreme Court Grants Certiorari in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, MAYER BROWN LEGAL UPDATE (June 12, 2012), http://www.mayerbrown.com/us-supreme-court-grants-certiorari-in-emamgen-inc-v-connecticut-retirement-plans-and-trust-funds-06-12-2012/ (explaining that the Ninth Circuit has ruled that materiality is an element of the case and arguments for and against it should only be raised during trial or in a summary judgment motion).

\textsuperscript{42}Schleicher, 618 F.3d at 685 (noting that under the current version of Rule 23 class certification is largely independent of a case's merits).
Circuit decision, Szabo v. Bridgeport Machines, Inc., in which the appellate court permitted the trial court to “peek” at the merits of the case if they could potentially affect Rule 23 considerations and would therefore be inappropriate to grant class certification.\(^{43}\) The court in Schleicher provides a substantial amount of dicta that finds that even if there was an issue with materiality, that a class could still be certified, which effectively, but not explicitly, abrogates the Szabo decision.\(^{44}\) This effectively precludes lower court judges from ever encountering a situation in which they would be justified in peeking at the merits of a case before certifying the class.

The Ninth Circuit’s decision in Connecticut Retirement Plans and Trust Funds v. Amgen Inc. explicitly rejected the strict and intermediate approaches adopted by the other circuits. The Ninth Circuit joined the Seventh Circuit in holding that materiality is a merit consideration and that arguments against it should be heard during the defendant’s case-in-chief.\(^{45}\) This decision continues the Ninth Circuit’s trend of not requiring plaintiffs to prove materiality in order to certify as a class.\(^{46}\) The Ninth Circuit believes that the other circuits which require or even permit materiality to be heard during the class certification stage fundamentally misinterpret footnote 27 in Basic.\(^{47}\) Additionally, the Ninth Circuit looks to post-Basic Supreme Court decisions, which require the plaintiffs to prove certain elements to establish the fraud-on-the-market presumption, but make no mention of materiality as a pre-requisite for class certification.\(^{48}\)

\(^{43}\) Szabo v. Bridgeport Mach., Inc., 249 F.3d 672, 675-76 (7th Cir. 2001) (holding that the courts cannot consider the merits of the case during class certification unless the merits directly implicate elements of Rule 23).

\(^{44}\) Schleicher, 618 F.3d at 685 (finding that a class may still be certified if the falsehoods were only trivial and that even if there have to be individual hearings to include plaintiffs in a class, there is still a likelihood of certification). By naming situations in which class certification could still be granted even though there were issues with the claim on the merits, the court attempts to effectively limit the situations in which a judge could rely on the Szabo decision to ‘peek’ at the merits of the case for certification purposes.

\(^{45}\) Conn. Ret. Plans, 660 F.3d at 1176-77 (holding that “a plaintiff need not prove materiality at the class certification stage . . . [and] materiality is a merits issue to be reached at trial or by summary judgment motion if the facts are uncontested”).

\(^{46}\) Id. at 1176-77 (citing Binder v. Gillespie, 184 F.3d 1059, 1064 (9th Cir. 1999), and Blackie v. Barrack, 524 F.2d 891, 900-01 & n. 17, 905-908 (9th Cir. 1975) (noting that neither of these previous class action securities litigation cases required plaintiffs to prove materiality in order to be certified as a class)).

\(^{47}\) Id. at 1176 (citing Schleicher, 618 F.3d at 687 (noting that the materiality requirement contained in footnote 27 of Basic is essential to establishing a fraud-on-the-market presumption, but not a pre-requisite to achieve class certification)).

\(^{48}\) See Erica P. John Fund, Inc. v. Halliburton Co., 131 S.Ct. 2179, 2185 (2011) (discussing the elements a plaintiff must prove to trigger the fraud-on-the-market presumption continued . . .
III. THE POTENTIAL EFFECTS OF THE COURT’S DECISION ON CORPORATE GOVERNANCE

A. The Role of Securities Litigation in Corporate Governance

Of fundamental importance to this article is the interaction between securities litigation and its role in the legal community’s ongoing corporate governance efforts. Corporate governance is broadly characterized as the “process by which business decisions are made and the process by which the persons who will make those decisions are chosen.”\(^{49}\) It can be more narrowly seen, however, as a system to address the agency costs of businesses, that is, to minimize the strife between shareholders and non-ownership management.\(^{50}\) Although there are a variety of different legal and non-legal mechanisms that shareholders have in their struggle to continually monitor and control agency costs, one of the most significant, and controversial, is securities litigation. Securities litigation is increasingly seen as falling within the realm of corporate governance and no longer just a tool for investor protection.\(^{51}\) Therefore, any legal decision that purports to reduce shareholder access to class action litigation should be scrutinized heavily, not just because it could frustrate shareholder efforts to exert control over corporate managers, but because it could jeopardize corporate governance objectives aimed at reducing fraud.\(^{52}\)

\(^{49}\) David C. McBride, \textit{For Whom Does This Bell Toll?}, 27 Del. L. Rev. 28, 29-30 (2009).

\(^{50}\) Although there is currently substantial debate over whether or not corporate governance efforts should exclusively focus on the shareholder-manager relationship, for the purpose of this article corporate governance will be discussed as minimizing agency costs. For an extended discussion on the role of non-shareholder stakeholders, see generally John. C. Coffee, Jr., \textit{Unstable Coalitions: Corporate Governance As a Multi-Player Game}, 78 Geo. L.J. 1495 (1990); Jonathan R. Macey, \textit{Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective}, 84 Cornell L. Rev. 1266 (1999).

\(^{51}\) Fisch, supra note 13, at 335 (noting that scholars have begun to see the role of securities litigation as a corporate governance tool and not just a vehicle for investor protection).

\(^{52}\) See William S. Lerach, Partner, Milberg Weiss Bershad Hynes & Lerach, Achieving Corporate Governance Enhancements Through Litigation, Keynote Address Before the Council of Institutional Investors Spring Meeting (March 27, 2001), \textit{reprinted in} 24 T. Jefferson L. Rev. 1, 8-9 (2001) (explaining that corporations that implement corporate governance reforms can create an environment where fraud is less likely, and that corporations with deficient mechanisms such as a lack of auditors and inadequate supervision by independent\(\ldots\)})
There is serious contention about the role of securities litigation in corporate governance, with academics, practitioners and policy-makers divided and left arguing as to whether the potential benefits of securities litigation warrant the risk of systemic abuse. As a result, securities litigation is commonly seen by academics as either “dominated by greedy attorneys who use protracted litigation to extort large settlements from legitimate business[es]” or as a legitimate mechanism in the effort to force corporate compliance, especially as it pertains to disclosure requirements. Courts have also consistently recognized this power as both a positive force and a potential drain on resources. However, the potential that a meritorious suit has in discouraging corporate fraud makes securities litigation a powerful tool for shareholders. The Supreme Court must seriously consider the effects that its decision in Amgen will have on efforts to reduce corporate fraud by the use of securities litigation, as well as consider the important role that private securities litigation plays in the scheme of investor checks against corporate practices. There are several different ways in which securities litigation serves as an important tool for shareholders to rein in corporate executives and check corporate fraud. These include reinforcing the Court’s—and thus the legal community’s—dedication to increasing the monitoring power of shareholders through securities suits, and increasing shareholder access to certain litigation tools such as discovery and settlement negotiations.

54 See FISCH, supra note 13, at 334-35.
55 Compare In re Cendant Corp. Litig., 264 F.3d 201, 227, 247 (3d Cir. 2001) (upholding the trial court judge’s decision to approve a settlement agreement between plaintiffs and Cendant Corp. that included provisions to institute corporate governance changes), with Perkins v. Daniel, No. 06-CV-01518(PGS), 2007 WL 4322596, at *2 (D.N.J. Dec. 6, 2007) (noting that the detrimental effects of shareholder derivative suits on director control and corporate governance have led courts to caution against unchecked shareholder litigation in an effort to stem frivolous and opportunistic suits).
57 See Fisch, supra note 13, at 335 (noting that scholars have begun to see securities litigation as a corporate governance tool and not just as a vehicle for investor protection).
1. **Recent judicial and legislative history suggest a tendency to make securities litigation a readily available weapon for plaintiffs.**

What is significant about the *Amgen* decision is not just its potential to unify (or further divide) the circuits on a highly litigious issue, but that it can serve as a manifestation of the Court’s willingness to extend judicial protection either to shareholders or corporate directors. Recently, the trend has been for both the Court and Congress to increase plaintiffs’ access to the judicial system, enabling them to use litigation as a tool to rein in rogue executives.58 Therefore, if the Court decides to signal a shift in its thinking by restricting plaintiffs’ access to the judicial system as a means of redress against corporate directors, it could simultaneously create a chilling effect on plaintiffs’ litigation and increase confidence in the boardrooms of corporations who would otherwise feel pressure from shareholders during their decision making process.59 Either of these events would severely temper the corporate governance movement and set back years of scholarship and legal reforms. Quite simply, plaintiffs and defendants have been down this road before, as the Private Securities Litigation Reform Act (PSLRA) restricted plaintiff access to the courts, and resulted in an astounding amount of corporate fraud.60 If the Court decides to retry limitations on plaintiff litigation it could signal an implicit acceptance of the corporate practices that brought down some of the largest corporations in the world in the late 1990s.


1990s and early 2000s.

Two significant developments in securities litigation over the past thirty years demonstrate the Court’s and Congress’ willingness to make litigation an available weapon for plaintiffs: (1) the creation of the fraud-on-the-market presumption and (2) the passage of the Sarbanes-Oxley Act. The fraud-on-the-market presumption was specifically created by the Court to remove obstacles to litigation for plaintiffs. Indeed, “without the benefit of the fraud-on-the-market presumption of reliance, requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would prevent proceeding with a class action, since individual issues then would overwhelm the common ones.”

The Basic Court recognized that the adoption of the fraud-on-the-market presumption would make cases more manageable and noted that “[c]ommentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory.”

However, after years of increased plaintiffs’ litigation following the Basic decision, Congress attempted to curb the rising volume of class action securities litigation through the passage of PSLRA, which imposed significant hurdles on plaintiffs, including an increased pleading standard. Although the Sarbanes-Oxley Act did not substantially relax the pleading standard that was set forth in the PSLRA, its passage marked a noticeable break from a period of pro-corporate legislation. In the post-PSLRA, pre-Sarbanes-Oxley years, plaintiffs saw an increase in the amount of class action cases that were dismissed, with 39.3% of cases ending with a dismissal, up from only

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62 A.C. Pritchard, Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers, 85 VA. L. REV. 925, 948 (1999) (noting that the Court in Basic had recognized that the adoption of the fraud-on-the-market presumption would make cases more manageable, although it insisted that this was a procedural and not substantive change).


66 Id. at 504-05.
20.3% in the pre-PSLRA time period. These results were in line with the goal of the PSLRA, which was “to shift the advantage in private securities litigation from plaintiff to defendant” and therefore the reduction in plaintiff securities suits was considered a success. However, after the economic turmoil and string of corporate fraud scandals in the early 2000s, even the strongest supporters of the PSLRA admitted that the legislation “went too far.” In fact, the stunning amount of corporate fraud that surrounded the collapse of Enron and other large corporations led to congressional reconsideration of PSLRA.

As a result of the significant levels of fraud that came to dominate corporate America, Congress instituted a series of reforms to increase corporate governance. One such piece of legislation, the Sarbanes-Oxley Act, was designed to restore order to the “Wild West” corporate culture that prevailed in the early part of the twenty-first century. Sarbanes-Oxley, while incomplete and oftentimes ambiguous, did include a host of plaintiff-friendly provisions, such as one increasing the statute of limitations for private actions and one creating a requirement for the preservation of key financial audit documents. But the impact of Sarbanes-Oxley went beyond simply installing several notable, yet not truly fundamental, changes in favor of plaintiffs. Instead, its effects were more subtle, as it appeared to change the mindset of judges who seemed to become more open to class action securities litigation in the aftermath of the act’s passage.

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67 Id. at 505.
69 Cummings, supra note 60, at 1017 (noting that the aftereffects of the PSLRA caused even the staunchest of Republicans and the most ardent corporate supporters to question the act’s efficacy).
72 Savett, supra note 65, at 505 (listing some of the plaintiff-friendly provisions that Sarbanes-Oxley included).
73 Id. (noting that dismissals of class action securities litigation fell sharply after SOA was passed, which could be the result of “judges . . . being more generous at the margin in evaluating the merits of cases on their desks, allowing a few more
Given this subtle but very important trend, if the Court decides to again reduce or limit plaintiff access to the courts, it would be a major break in recent judicial and legislative history. Such a step by the Court would signal to corporate managers and executives that the judiciary is no longer serious about corporate governance reforms and that the actions which caused the tumultuous and scandal filled times of the late 1990s and early 2000s are acceptable ways to conduct business in corporate America.

2. Reduced access to securities litigation removes the possibility of reform through settlements.

Securities litigation is often maligned by academics and politicians as nothing more than a simple way for attorneys to extract large settlements from companies without even requiring a meritorious case. Its detractors often point to the ever increasing settlement amounts that securities litigation generates, an amount that reached over $26.5 billion between the years of 2005 and 2006.\(^\text{74}\) Even more concerning is the idea that the merits of a class action suit do not have to be strong in order to warrant a settlement from a corporation.\(^\text{75}\) Given the apparent disjoint between the strength of a class action case’s merits and the settlement potential, it is important to respect the substantial economic effects that unrestrained class action suits can have on corporations. Academics and corporate executives should rightfully be concerned about the havoc that unchecked plaintiff litigation can wreak on corporations.

However, restricting plaintiffs’ access to litigation by imposing increasingly difficult burdens during the class certification stage is not an appropriate response to the settlement problems. In fact, “one important nonmonetary factor in securities litigation is the potential to obtain corporate governance reforms through [a] settlement.”\(^\text{76}\) While


a strictly economic analysis of class action securities settlements may show a problem with current litigation trends, a broader view actually shows a potential solution. In fact, high probability that a class action case will settle could be the avenue for reform of securities litigation. Instead of focusing on limiting the number of classes that can be certified (certification being an essential step in obtaining a settlement) settlements should be seen as a tool for imposing corporate governance changes with little monetary cost to corporations.

Additionally, the fact that plaintiffs’ securities cases result in settlement so often\(^77\) not only provides shareholders with an additional corporate governance tool, but presents academics with a platform for reforms which could curb abusive and frivolous plaintiff litigation. There is a recent trend, which started in 1995 with the rise of institutional investors as lead plaintiffs in securities litigation, \(^78\) for class action securities settlements to include provisions for corporate governance reforms. \(^79\) The institutional investors who extract these types of reform settlements have serious power (often bordering on indirect regulation\(^80\)) to change some of the fundamental ways in which a company operates to reduce agency costs and monitor corporate behavior. \(^81\) Class action settlements, therefore, can have tremendous power to increase the speed and breadth at which new corporate governance principles are integrated into the everyday operations of a company by allowing shareholders to have a more significant directory role. If reformed, settlements could give shareholders and institutional investors the power to monitor corporations and restrain negative executive behavior without the traditional monetary ramifications with which corporate law scholars are concerned.

However, these settlements still come at a high cost to corporations, as these reform provisions cannot constitute a stand-alone settlement unless they are substantial. Some courts will not allow settlement agreements which do not include monetary relief.

\(^{77}\) Garry, supra note 75, at 287 (noting that almost all plaintiff class action securities cases settle).

\(^{78}\) John Landry, Possible Limitations on Securing Corporate Governance Reforms Through Class Action Settlements, WALLSTREETLAWYER.COM, Mar. 2006, at 12 (noting that lead plaintiff requirement of the PSLRA has increasingly led to institutional investors taking on lead roles in class action securities litigation).

\(^{79}\) Id. (discussing the recent trend of institutional investors/lead plaintiffs requiring settlements to contain corporate governance reform provisions addressing issues from executive compensation to board makeup).

\(^{80}\) Id.

\(^{81}\) Id. (providing examples of reforms that lead plaintiffs have obtained in recent settlements).
unless shareholders gain (what the court views to be) a substantial benefit.\textsuperscript{82} Although this type of reform certainly has its drawbacks, most noticeably that it could lead to class action suits where the lead plaintiff/institutional investor is acting with a different motive than the rest of the class, it is certainly a problem preferable to the economic ramifications of frivolous plaintiff litigation. Therefore, it is settlement process reform, not restriction on the availability of litigation, which is the necessary and appropriate mechanism for ensuring that securities litigation is a properly used tool for corporate governance.

3. Reducing plaintiff access to private securities litigation would limit access to the discovery process.

In addition to increasing the pressure on corporate executives and increasing the potential for non-monetary settlements, a more relaxed burden during the class certification stage ensures that plaintiffs have access to another important tool in the quest to detect corporate malfeasance: the discovery process. This is an important feature, as many other corporate governance tools, such as outside auditors, have failed to adequately uncover corporate fraud.\textsuperscript{83} The use of discovery to detect fraud has long been an important issue in securities litigation, as the courts have recognized the importance of discovery in uncovering corporate fraud,\textsuperscript{84} while at the same time realizing that the costs of discovery can result in unfair or meritless settlements.\textsuperscript{85} Increasing plaintiff access to discovery is an essential tool to uncovering and terminating corporate fraud, as plaintiffs may not have the ability to uncover information solely known to the parent company.

\textsuperscript{82} Id. (citing Polar Int’l Brokerage Corp. v. Reeve, 187 F.R.D. 108, 117-18 (S.D.N.Y. 1999) (rejecting a settlement agreement because the non-monetary concessions did not provide a “substantial benefit” to shareholders)).

\textsuperscript{83} Gideon Mark, Accounting Fraud: Pleading Scienter of Auditors under the PSLRA, 39 CONN. L. REV. 1097, 1148-49 (2007) (noting that external auditors only uncover 11.5\% of corporate fraud, with a higher percentage being discovered by accident).

\textsuperscript{84} Elliott J. Weiss, The New Securities Fraud Pleading Requirement: Speed Bump or Road Block?, 38 ARIZ. L. REV. 675, 704 (1996) (citing In re Time Warner Inc. Sec. Litig., 9 F.3d 259, 263 (2d Cir. 1993) (stating that the “interests in deterring fraud in the securities markets” can only protected by providing investors who believe they are victims of fraud with an opportunity to conduct discovery).

outside of the discovery process.\textsuperscript{86} Therefore, the ease of access to the discovery process must be a factor weighed considerably in the decision of when to consider materiality, and applying the strict materiality approach could stop plaintiff suits before the discovery process begins and hide otherwise detectable instances of corporate fraud.

B. How the Seventh and Ninth Circuit’s Approach Would Allow the Court to Reinforce Pre-existing Corporate Governance Tools

Given the scandals and failures that plagued corporations after the passage of the PSLRA, it is important to note that any judicial decision that attempts to reform class action litigation by reducing plaintiff access to the judiciary carries with it serious ramifications for the corporate governance movement. This is an important consideration to remember, as failure to ensure that corporations are sufficiently monitored by shareholders could lead to disastrous instances of fraud, similar to those which brought down Enron and Tyco. Therefore, when attempting to reconcile the various circuits’ stances on materiality and class certification, the Supreme Court must be aware of the ramifications. The Court’s decision will either continue recent literature and policy developments, which advocate for increased corporate monitoring, or it will strip plaintiffs of one of their most powerful tools for ensuring responsible corporate behavior and legal compliance.

By adopting the Seventh and Ninth Circuits’ approach and barring the evaluation of materiality at the class certification stage,\textsuperscript{87} the Court would open up lower courts for plaintiffs to file securities fraud actions. If the Court takes a more restrictive view on materiality by adopting the intermediate or strict standard, it risks losing meritorious suits to unnecessary hurdles. Plaintiffs’ attorneys face enormous up-front costs in securities litigation, from researching potential defendants, drafting the complaint, and responding to motions to dismiss, all before class certification and without immediate compensation.\textsuperscript{88} If plaintiffs’ attorneys are also forced to draft briefs...

\textsuperscript{86} Choi, \textit{supra} note 57, at 1473 (noting that discovery is an important tool in class action securities cases for plaintiffs to discover information only known to company insiders).

\textsuperscript{87} Petition for Writ of Certiorari, \textit{supra} note 14, at 12 (noting that the Ninth Circuit’s decision to reject discussions of materiality at the class certification stage puts it in line with the Seventh Circuit).

\textsuperscript{88} Choi, \textit{supra} note 57, at 1472-73 (listing the tasks that the plaintiffs’ attorneys must perform at the start of the trial and noting that these tasks impose high fixed continued \ldots
and take part in an extended materiality hearing before the class can be certified, it is conceivable that plaintiffs’ firms would become increasingly hesitant to take a case, even though it may be meritorious. The courts have already seen that imposing burdens on plaintiffs who file securities class action suits reduces the number of suits that are filed, which has the possibility of eliminating the frivolous with the meritorious.\(^{89}\) If the Court adopts a stricter standard than the Seventh and Ninth Circuits then it could close the courthouse to victims of fraud much like the PSLRA did with its increased pleading standard. This is a potentially disastrous consequence and many believe that the hurdles to plaintiff securities suits installed by the PSLRA contributed to the corporate scandals of the Enron-era.\(^{90}\)

The “no consideration” approach is also the only way to ensure that corporations are constantly threatened with discovery, which incentivizes corporations to conduct business in such a manner that discovery would not unearth instances of fraud. Since a securities class action case always has the potential to unearth any corporate fraud present through the discovery process,\(^{91}\) the Court should

\(^{89}\) Id. (noting that the PSLRA could reduce the number of meritorious cases filed along with the frivolous); Stephen J. Choi and Robert B. Thompson, Securities Litigation and its Lawyers: Changes During the First Decade After the PSLRA, 106 COLUM. L. REV. 1489, 1500 (2006) (referencing a 2005 Cornerstone study which reported that the PSLRA reduced litigation against Silicon Valley Companies in the Ninth Circuit, although the study did not differentiate between meritorious and frivolous litigation); Patrick Hall, The Plight of the Private Securities Litigation Reform Act in the Post-Enron Era: The Ninth Circuit’s Interpretation of Materiality in Employer-Teamster v. America West, 2004 BYU L. REV. 863, 889 (2004) (noting that even if the number of suits filed in the post-PSLRA era slightly increased, that is likely less than would have been filed given the huge increase in publicly traded companies since 1995); David S. Escoffery, A Winning Approach to Loss Causation Under Rule 10B-5 in Light of the Private Securities Litigation Reform Act of 1995 (“PSLRA”), 68 FORDHAM L. REV. 1781, 1815 n.313 (citing a Stanford study that after the passage of the PSLRA, the number of securities class action suits filed decreased in federal courts, although the number of state filings increased until additional Congressional action was taken in 1998) (2000). Although the Stanford study showed a temporary increase in state court filings, it still supports the proposition that when confronted with additional obstacles (such as the PSLRA’s increased pleading requirement), plaintiffs in securities class action cases will change their filing patterns. Since a 1998 reform effectively removed state court as an option for filing, another obstacle in the way of plaintiffs could lead to a decrease in the number of suits filed in toto.

\(^{90}\) Hall, supra note 89, at 888 (explaining that after the collapse of Enron, judges and lawmakers began to suspect that the PSLRA protected corporate fraud by making it difficult for innocent victims of fraud to file suit).

\(^{91}\) Choi, supra note 57, at 1499 (giving examples of settlements under PSLRA-scheme).
consider the impact on corporate behavior if it adopts a standard that would effectively shield corporate defendants from the potentially embarrassing discovery process. By reducing the number of suits, even seemingly frivolous ones, at the class certification stage, the Court risks allowing corporations to roll the dice on illegal behavior, since uncovering fraud would be conditioned on an extremely strong shareholder case. The Seventh and Ninth Circuits’ approach, which permits materiality to be heard after certification and during trial, allows the two sides to begin the discovery process before materiality becomes an issue. This is essential to corporate governance objectives, as it allows plaintiffs, even those with weaker cases, to monitor corporations through the discovery process, which in turn incentives good corporate behavior.

Many commentators are quick to point out that permitting more suits to get to the discovery portion of a trial is exactly what litigation reforms should aim to prevent, as discovery is an extraordinarily expensive part of private securities litigation. However, these fears are misplaced as discovery abuse is misperceived to be widespread when in actuality it is not as common as scholars and lawmakers believe it to be. Additionally, leverage gained by discovery works as a two-way street where defendants can use voluminous discovery requests to force plaintiffs to either settle or even to dismiss cases, sometimes regardless of the underlying merits. Although this has served as a justification for imposing barriers on plaintiffs in the past, plaintiffs’ attorneys generally struggle more with discovery than their corporate adversaries. Therefore, restricting access to discovery for fear of burdening corporate defendants should not be the argument to carry the day, as the potential to uncover fraud through discovery and the absence of widespread discovery abuse make the “no consideration” approach a highly preferable alternative to other, more restrictive standards.

92 Alexander, supra note 75, at 537.
94 Id. at 242-43 (explaining that defendants, like plaintiffs, can use discovery to force the opposition to settle).
95 Kaufman & Wunderlich, supra note 3, at 370 (stating that in securities litigation it is often the plaintiffs who struggle with discovery, not the corporate defendants).
IV. Conclusion

Although the merits of shareholder litigation are a subject of intense debate, securities litigation can serve as a powerful tool in corporate governance to ensure that directors act in the best interests of the shareholders. Courts should therefore err on the side of caution and rely on other legal hurdles, such as motions for summary judgment, to weed out frivolous lawsuits. Increased class certification requirements should not be imposed to serve this purpose. If the Supreme Court follows the trends of the more restrictive courts by adopting either the strict or intermediate approach to the materiality requirement, it will risk creating a chilling effect on future class action suits.

If the Court adopts the strict approach towards proving materiality at the class certification stage, corporate executives may feel emboldened for several reasons. Recent legislative action has turned securities oversight from corporation-friendly to shareholder-accessible, and a change in direction could begin to shift momentum in the legal and academic worlds back toward protecting corporations (and thus their misdeeds) from monitoring by shareholders. Restricting plaintiff access to the judiciary would also threaten the settlement process which, as noted above, could be reformed to ensure that settlements are the primary vehicle of corporate governance reforms without a large economic impact on corporations. Adopting a strict approach to materiality also threatens to protect corporations from the discovery process, a litigation tool which is extraordinarily effective in unearthing corporate fraud.

The approach to materiality adopted by the Seventh and Ninth Circuits is therefore superior, as it empowers shareholders by strengthening a pre-existing weapon in their corporate governance arsenal. The not-so-distant PSLRA experience has demonstrated that restricting shareholder access to the judiciary not only removes their ability to monitor corporations, but in essence “deregulates” corporate behavior by removing the threat of a class action suit from the mind of corporate executives. Let Enron, Tyco, and the most recent economic collapse remind the Court that an unmonitored corporation quickly becomes a bold one, taking risks and committing fraud in a way that

has and will continue to pose a systemic threat to the American economy.