

August 25, 2010

## “Fraud Created The Market” Securities Fraud Theory Rejected By The Third Circuit, Widening Circuit Split

In an August 16, 2010 opinion, the United States Court of Appeals for the Third Circuit rejected use of the so-called “fraud created the market” theory for securities fraud claims. *Malack v. BDO Seidman, LLP*, No. 09-4475 (3d Cir. Aug. 16, 2010). The “fraud created the market” theory posits that a securities fraud plaintiff should not have to prove individual reliance upon alleged misrepresentations if the plaintiff can show that, absent the misrepresentations, the securities that the plaintiff purchased would not have been offered for sale at all, on the premise that under such circumstances the plaintiff’s reliance can be presumed. The Third Circuit’s ruling adds to the split among the federal circuit courts of appeals on the viability of this controversial theory, thus potentially presaging an eventual resolution of the issue by the United States Supreme Court.

### Background

The plaintiff in *Malack* had purchased notes issued by a subprime mortgage originator. Those notes later became worthless after the decline of the subprime mortgage sector. The plaintiff sued the accounting firm that allegedly provided clean audit opinions that were used to obtain SEC registration of those notes, seeking recovery on his own behalf as well as certification of a class of allegedly defrauded purchasers of the notes.

The plaintiff did not allege that he had read, reviewed, or directly relied upon the audit opinion that was the basis for his suit. Nor did he allege that the notes (which did not trade on any securities exchange) traded in an “efficient market,” such that their price could be presumed to promptly reflect all relevant information available to the investing public. Instead, in order to establish reliance upon the audit opinion, the plaintiff alleged that “without clean audit opinions, American Business would not have been able to register the Notes with the SEC, the Notes would not have been marketable, and Malack and the other investors would not have purchased the Notes.”

The United States District Court for the Eastern District of Pennsylvania denied class certification, finding that Malack’s “fraud created the market” theory lacked a legal basis, and that without the theory, individual reliance issues rendered class certification inappropriate. The Third Circuit agreed and affirmed.

### The “Fraud Created the Market” Theory

The Third Circuit began its opinion by noting that a presumption of reliance has been recognized by the United States Supreme Court in two circumstances. First, the presumption has been recognized where a defendant failed to disclose material facts despite having a duty to do so. Second, reliance may be presumed under a “fraud on the market” theory, which can be applicable when a plaintiff shows that

the securities at issue trade in an “efficient market,” *i.e.*, a market that can reasonably be presumed to reflect the impact of false statements in the market price of securities, whether or not the particular plaintiff ever saw or read such statements.

Some federal appeals courts, however, have recognized a third circumstance as being appropriate for a presumption of reliance upon the alleged misstatements. Such courts have recognized a “fraud created the market” theory, which “posits that the securities laws allow an investor to rely on the integrity of the market to the extent that the securities it offers to him are entitled to be in the market place.” Thus, reliance should be presumed when a plaintiff shows that absent fraud, the securities at issue would have been “unmarketable,” and that the plaintiff “purchased in reliance on the market.” The theory assumes that investors are entitled to “rely on a security’s availability on the market” as an “indication of its apparent genuineness.”<sup>1</sup> Other courts, though, have rejected the theory.<sup>2</sup>

### The Third Circuit’s Analysis

The court analyzed the proposed “fraud created the market” presumption by looking to the factors that have traditionally led courts to create factual presumptions. Presumptions, the court wrote, have traditionally been recognized where courts conclude that the presumption is very likely to be accurate, such that it is “sensible and timesaving” to apply a presumption. Presumptions have also, the court wrote, been created to correct imbalances “resulting from one party’s superior access to the proof,” or in order to further congressional policy, or to avoid a “factual impasse.”

Creating a “fraud created the market” presumption, the court held, was not warranted in light of these considerations. Such a presumption would not be likely to accurately reflect reality, because “common sense” fails to support “the idea that securities on the market, by the mere virtue of their availability for purchase, are free from fraud.” In particular, the court noted that a security’s availability on the market should be taken as an indication of genuineness only if there were “some entity involved in the process of taking the security to market that acts as a bulwark against fraud.” But to the contrary, the court wrote, all of the private actors involved in bringing securities to market have incentives to act in a self-interested, and perhaps dishonest, manner, so that it is not reasonable to assume that securities are free from fraud simply because they have been brought to market.

Moreover, the court found that SEC approval of a securities registration statement does not provide a reasonable basis to presume that the securities offered are free from fraud, because the SEC’s role is limited to reviewing the registration statement to ensure that it contains adequate disclosures. The court noted that the SEC does not conduct “merit regulation” of securities, seeking to determine whether the offered securities are, in fact, a good investment. Nor does the SEC endorse offering documents or vouch for their truthfulness.

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<sup>1</sup> This theory has been endorsed by the Fifth, Tenth, and Eleventh Circuits. *See Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981) (en banc); *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983); *Ross v. Bank South, N.A.*, 885 F.2d 723 (11th Cir. 1989).

<sup>2</sup> The theory has been rejected by the Seventh Circuit, *see Eckstein v. Balcort Film Investors*, 8 F.3d 1121 (7th Cir. 1993), and the Sixth, Eighth, and Ninth Circuits have declined to follow it in particular cases without expressly ruling on whether it could never in any circumstances be viable. *See Ockerman v. May Zima & Co.*, 27 F.3d 1151 (6th Cir. 1994); *In re NationsMart Corp. Sec. Litig.*, 130 F.3d 309 (8th Cir. 1997); *Desai v. Deutsche Bank Sec. Ltd.*, 573 F.3d 931 (9th Cir. 2009).

The court further noted that even if a security were offered in a fraudulent manner, disclosure of the truth will seldom render the security truly “unmarketable,” since “disclosure of adverse information may lower the price of a security, but it will not prevent that security from going to market.” Finally, the court noted that unlike the fraud-on-the-market theory, the “fraud created the market” theory lacks a basis in accepted economic theory.

The court additionally explained that policy considerations did not support employing a “fraud created the market” presumption. In particular, the court wrote, such a presumption would actually reduce investors’ incentive to carefully read and review the offering materials and fully research their investment, since with the presumption they would be able to recover for any misstatements whether or not they had reviewed the offering materials; “moreover, an investor might seek rationally to avoid reading disclosures in order to preserve a possible claim” under the theory. The court concluded that expanding the scope of private securities fraud actions is a task that courts should not undertake without direction from Congress, and expressed concern that recognizing the “fraud created the market” theory could lead to a surge in “frivolous” securities fraud litigation and place excessive pressure on defendants to settle meritless claims.

For these reasons, the court rejected the “fraud created the market” presumption. Thus, because without the presumption each plaintiff in the proposed class would have to prove individual reliance, the court found class certification to be improper and refused to recognize the case as a class action.

### **Implications of the Decision**

The decision in *Malack* intensifies the circuit split among the federal courts of appeals on, and thus increases the likelihood that the Supreme Court will be called upon at some point to resolve definitively, the question of whether to adopt a “fraud created the market” presumption. The Third Circuit’s rejection of the presumption will have the immediate effect of precluding plaintiffs within the Third Circuit (which includes Pennsylvania, New Jersey, and Delaware) from relying on it. The court’s analysis also serves as a reminder that reliance issues are sometimes the most formidable barrier to class certification in securities cases, and that federal courts increasingly have been skeptical of efforts to expand the scope and availability of private securities class action lawsuits

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