THE BATTLE OVER CLASS REPRESENTATIVE TESTIMONY AT THE TRIAL OF SECURITIES FRAUD CLASS ACTIONS

by

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The controversy over the testimony of class representatives at the trial of securities fraud class actions brought by defrauded investors under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act")[2] and Rule 10b-5[3] promulgated thereunder by the Securities and Exchange Commission has provoked considerable debate with both sides advancing persuasive arguments. This article (i) addresses the interplay of the Federal Rules of Evidence, the Federal Rules of Civil Procedure and the fraud-on-the-market presumption of reliance, (ii) discusses both the plaintiffs' and the defendants' perspective on the issue of class representative testimony and (iii) notes the current trend of the courts in precluding class representatives from testifying at trial.

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[2] 15 U.S.C. §78j(b). Section 10(b) of the Exchange Act provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -- To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[3] 17 C.F.R. §240.10b-5. Rule 10b-5 of the Exchange Act provides: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were make, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

I. FEDERAL RULES OF EVIDENCE

A. RELEVANCY

The Federal Rules of Evidence define "relevant evidence" as evidence tending to make the existence of any consequential fact more or less probable.[4] Additionally, the Rules of Evidence provide that relevant evidence is generally admissible while irrelevant evidence is always inadmissible.[5]

Defendants in securities fraud class action trials often seek to call individual representatives of the plaintiff class as witnesses arguing such testimony is directly relevant to the element of materiality and to rebut the presumption of reliance. Rules 401 and 402 of the Federal Rules of Evidence, however, represent a significant obstacle for defendants seeking class representative testimony at trial.

B. PREJUDICE/CONFUSION

The Federal Rules of Evidence mandate the exclusion of any evidence that is prejudicial, confusing, or overly time consuming.[6] Accordingly, under certain circumstances, evidence must be excluded even though it is unquestionably relevant. The rules of evidence require the court to balance the need for, or probative value of, a particular piece of evidence against the harm likely to result from its admission. In

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[4] FED. R. EVID. 401. Rule 401 provides in its entirety: "'Relevant evidence' means evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." *Id.*

[5] FED. R. EVID. 402. Rule 402 states: "All relevant evidence is admissible, except as otherwise provided by the Constitution of the United States, by Act of Congress, by these rules, or by other rules prescribed by the Supreme Court pursuant to statutory authority. Evidence which is not relevant is not admissible." *Id.*

[6] *See* FED. R. EVID. 403. Rule 403 states: "Although relevant, evidence may be excluded if its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence." *Id.*

securities fraud class actions, these rules represent a significant obstacle for defendants seeking class representative testimony at trial.

1. Defendants' Point of View

The class representatives' testimony is directly relevant to the defense of the case. Thus, the probative value substantially outweighs all other considerations, including any potential for prejudice or jury confusion.

2. Plaintiffs' Point of View

The probative value of class representative testimony is minimal at best and, in any event, it is highly prejudicial. Defendants' sole motivation for introducing such evidence is to make ulterior suggestions to the jury. For example, if a jury determines that one class representative is not deserving of recovery, that jury will naturally be more prone to discriminate against the claims of the entire class. A jury may not approve of a class representative who is shown to have done no research prior to making an investment. A jury may not see any injury to a class representative who may have profited from a transaction in some of the securities issued by the defendants. Similarly, a jury may have difficulty identifying with a class representative who has an extensive investment portfolio and a relatively high net worth. Plaintiffs will underscore that these facts are irrelevant and highly prejudicial to the claims at issue and, therefore, ought to be excluded from the record.[7]

Moreover, jury confusion is inevitable if the court allows the testimony of class representatives. With respect to claims brought under the securities laws, the jury is

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[7] *See Berkovich v. Hicks*, 922 F.2d 1018, 1024 (2d Cir. 1991) (excluding evidence that possessed "slight probative value relative to its tendency to confuse the issues, mislead the jury, or unfairly prejudice"). *See also* J. WEINSTEIN ET AL., WEINSTEIN'S EVIDENCE, § 403[3], at 403-40 to 403-41 (1995)

required to judge the class by the "reasonable investor" standard. Therefore, even if the court were to preface class representative testimony with a jury instruction on the definition of the market or the objective standard, the court would inevitably appear hypocritical to a jury by virtue of its allowance of a subjective examination of the class representatives. Additionally, when presented with a live witness, a jury is likely to confuse the fraud-on-the-market concept with the issue of direct reliance and, inevitably, mistake common issues for individual ones. Such testimony presents a substantial risk of confusion and, therefore, it ought to be excluded.[8]

C. MATERIALITY

In *TSC Industries v. Northway, Inc*., 426 U.S. 438 (1976), the United States Supreme Court characterized materiality under the Exchange Act as "a mixed question of law and fact, involving as it does the application of a legal standard to a particular set of facts."[9] The *TSC* Court clearly defined the legal standard as an objective one that requires a jury to determine what a reasonable investor would consider important, not what an actual or so-called "typical" investor would consider important.[10]

(noting that evidence which "may cause a jury to base its decision on something other than the established propositions in the case" should be excluded under the Federal Rules of Evidence).

[8] *See Hicks v. Michelson*, 835 F.2d 721, 726 (8th Cir. 1987) (observing that evidence should be excluded that would "cause the jury to lose sight of the essential issue in the case"). *See also* MCCORMICK, EVIDENCE § 185 (2d ed. 1972) (recognizing that evidence may be excluded when "the probability that the proof and the answering evidence that it provokes may create a side issue that will unduly distract the jury from the main issues").

[9] 426 U.S. at 450 (addressing issue of materiality in context of liability for false or misleading representations in proxy statements).

[10] *See id.* at 445. The *TSC* Court observed: "The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor. Variations in the formulation of a general test of materiality occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment." *Id.*

1. Defendants' Point of View

The defendants deem class representative testimony regarding the circumstances of their individual stock trades to be relevant to the issue of whether the defendants' allegedly fraudulent misrepresentations and omissions were material to the investment decisions of the class. Such subjective testimony is necessary because it is relevant to the objective question of whether a reasonable investor would have found such statements or omissions material. Defendants further insist it is relevant because in deciding to certify the class prior to trial, the court implicitly held that the claims of the class representatives were typical of the claims of the class as a whole.

2. Plaintiffs' Point of View

Plaintiffs, however, counter that the role of the jury in a securities fraud class action is to determine the issue of materiality solely with respect to what a "reasonable investor" would consider important. For materiality purposes, the "reasonable investor" is equivalent to the market itself.[11] Thus, the testimony of one, two or more class representatives is irrelevant to the jury's determination of the issue of materiality.

In certifying the class, courts hold that the claims of the class members are sufficiently typical of the claims of other class members to warrant class certification. Courts do *not* hold, however, that the claims of the class representatives are factually identical to the claims of the class. More importantly, holding that the claims of the class representatives are typical of the claims of the hypothetical "reasonable investor" does

[11] *See Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996) (citation omitted) (in fraud-on-the-market case, for materiality purposes, hypothetical reasonable investor "must be 'the market' itself, because it is the market, not any single investor, that determines the price of a publicly traded security").

not mean that the class representatives' testimony would bind the class as a whole.[12] Therefore, any sampling of class representative testimony is entirely irrelevant.

Likewise, if class representatives testified that they did *not* find defendants' allegedly fraudulent statements material, then the Class, by way of rebuttal, would offer additional class members who would testify that they *did* find the defendants' allegedly fraudulent statements material. How then would the jury decide? Would the jury's decision be based on the number of witnesses each side produces? The more the case is based on such testimonial assessments, the more the jury would understandably be distracted from the "reasonable investor" standard of materiality.[13]

II. FEDERAL RULES OF CIVIL PROCEDURE

Under Rule 23 of the Federal Rules of Civil Procedure, certification of a class action is appropriate "if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are *typical* of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class." Fed. R. Civ. P. 23(a) (emphasis added).

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[12] *See TSC Indus.*, 426 U.S. at 445 (equating material facts and omissions with those that "would affect a reasonable investor's judgment"); *see also Stahl v. Gibraltar Fin. Corp.*, 967 F.2d 335, 337 (9th Cir. 1992) ("As materiality is an objective standard, it should not matter whether any particular shareholder was actually misled by the challenged misrepresentations."); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1118 (5th Cir. 1988) (materiality is not a matter of individualized proof, but it is an objective determination and common issue for the entire class); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.) *cert. denied*, 414 U.S. 910 (1973) (citation omitted) (noting that test for materiality "is concerned only with whether a prototype reasonable investor would have relied").

[13] *In re: ICN/Viratek Sec. Litig.*, 87 Civ. 4296 (KMW), slip op. (July 15, 1996) at 9-10 (Exhibit 1 attached hereto).

A. Typicality

1. Defendants' Point of View

Defendants may seek trial testimony of class representatives in order to rebut the fraud-on-the-market presumption of reliance by attacking a plaintiff's reliance as not typical of the class members they ostensibly represent. For example, the defendants may wish to offer class representative testimony to establish that the circumstances surrounding the stock purchases of the class representative differ factually from those of the class. The defendants will vehemently maintain that the class representatives are atypical of the class in that they did not rely on any misleading statements and/or omissions by the defendants. Such an argument is subject to attack since the focus must be on the "market" and not whether plaintiffs relied on defendants' statements and/or omissions.

2. Plaintiffs' Point of View

Once the class has been certified, plaintiffs can rely on "the law of the case" doctrine.[14] Moreover, in certifying a class, a court finds that the class representatives' claims are typical of the other class members' claims on the theory that (1) the class representative would zealously represent other class members, and similarly, that (2) the class representatives would not likely suffer conflicts of interest with other class members. In so ruling, a court does *not* hold that the factual bases for the class representatives' claims are identical to the factual bases for the other class members' claims. Nor does a court hold that the class representatives' claims are typical of the claims of a "reasonable investor." Hence, any testimony offered to show lack of typicality is irrelevant under the Federal Rules of Evidence. Additionally, in raising the

issue of typicality at trial, the defendants are merely attempting to reargue certification in front of the jury in an effort to prejudice the claims of the class.[15]

III. FRAUD-ON-THE-MARKET THEORY -- PRESUMPTION OF RELIANCE

The fraud-on-the-market theory provides that plaintiffs in securities fraud actions are entitled to a presumption of reliance upon a prima facie showing of fraud.[16] Courts presume that plaintiff investors relied on the integrity of the marketplace in purchasing the defendant company's securities.[17] The market "transmits information to the investor in the processed form of a market price. . . . The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price." *Basic*, 485 U.S. at 244 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).[18]

Defendants are entitled to rebut the presumption of reliance by establishing that a particular plaintiff did not, in fact, rely on the market.[19] "Any 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

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[14] *Id*. at 6.

[15] *See infra* notes 6, 7 and 8 and accompanying text (discussing basis for exclusion of prejudicial evidence).

[16] *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-47 (1988) (discussing reliance and fraud-on-the-market theory).

[17] *See Basic*, 485 U.S. at 247 (explaining justification for presumption of reliance). The United States Supreme Court in *Basic* stated: "Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the marketplace may be presumed… An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Id.*

[18] *See generally*, Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 Stan. L. Rev. 1059 (1990).

[19] *See Basic*, 485 U.S. at 251-52 (White, J., joined by O'Connor J., concurring in part) ("fraud-on-the-market presumption must be capable of being rebutted by a showing that a plaintiff did not 'rely' on the market price. . . . A nonrebuttable presumption of reliance -- or even worse, allowing recovery in the face of 'affirmative evidence of non-reliance' -- would effectively convert Rule 10b-5 into 'a scheme of investor's insurance.' There is no support in the Securities Act, the Rule, or our cases for such a result.")

presumption of reliance." *Basic*, 485 U.S. at 248. *See also In re Harcourt Brace Jovanovich, Inc. Sec. Litig.*, 838 F. Supp. 109, 113-14 (S.D.N.Y. 1993) ("It is axiomatic under *Basic* that non-reliance on the integrity of the market is critical in rebutting the presumption of reliance in a fraud on the market case.") (citing cases).

A. Defendants' Point of View

The defendants in a securities fraud class action may argue that, in order to rebut the presumption, they should be allowed to call class representatives at trial who are presumably typical members of the class. The defendants may seek examination of a class representative in order to show that the individual engaged in speculation and was altogether indifferent to whether the market price of the stock accurately reflected its true value. Accordingly, the defendants maintain that the integrity of the market price is irrelevant to the investor who relies merely on the momentum and movement of a stock to turn quick profits.

Defendants can also rebut the presumption of reliance by demonstrating that the plaintiff relied entirely on a source other than market information in making the decision to invest.[20] "For example a plaintiff who believed that [defendants'] statements were false and that . . . [defendants'] stock was artificially underpriced, but sold his shares nevertheless because of other unrelated concerns . . . could not be said to have relied on the integrity of a price he knew had been manipulated." *Basic*, 485 U.S. at 249.

(citations omitted); *Katz v. Comdisco, Inc.*, 117 F.R.D. 403, 409 (N.D. Ill. 1987) (suggesting that defendants can rebut presumption of reliance by showing that plaintiff engaged in stock speculation).

[20] *See Greenspan v. Brassler*, 78 F.R.D. 130, 132-33 (S.D.N.Y. 1978) (citations omitted) (asserting that primary reliance on a source other than market integrity is sufficient to rebut presumption of market reliance). *But see Basic*, 485 U.S. at 246-47 (recognizing that "'it is hard to imagine that there is ever a buyer or seller who does not rely on market integrity'") (quoting *Schlanger v. Four-Phase Sys., Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

Other examples of facts relevant to rebutting the reliance presumption include situations where a plaintiff "decides months in advance of an alleged misrepresentation, to purchase stock; one who buys or sells a stock for reasons unrelated to its price; [or] one who actually sells a stock 'short' days before the misrepresentation is made." *Basic*, 485 U.S. at 251 (White, J. with O'Connor J. concurring in part) (citations and internal quotation marks omitted). "[S]urely none of these people can state a valid claim under Rule 10b-5." *Id*.

Accordingly, at trial, defendants must be allowed to question the class representatives about their general trading practices as well as the specific circumstances surrounding their stock purchases, including why they bought or sold, when they decided to buy or sell, the information they relied on, and whether they sold the stock "short." Additionally, defendants have a keen interest in bringing any inconsistencies in the testimony of class representatives to the attention of the jury.

B. Plaintiffs' Point of View

Naturally, plaintiffs want to avoid the possibility of any impeachment using inconsistent statements as well as any other scenario that may serve to discredit the class' collective claim in the eyes of the jury. The testimony of a single unsympathetic class representative, for example, might have the effect of embittering a jury and potentially spoiling the claims of the entire class.

Defendants can rebut the presumption of reliance for the *entire* class by showing that, even if defendants made materially false statements, those statements did not affect the stock price; *i.e.*, did not cause the price to be artificially inflated. For example, defendants could show that there was other publicly available *true* information which

offset the false statements, or that the market was otherwise aware of the truth about the Company.[21]

As a wholly separate matter, defendants may rebut the presumption of reliance for individual members of the Class by showing that that individual would have bought despite the fraud or that they in fact did buy knowing of the fraud.[22] Plaintiffs propose that the most efficient procedure that affords the defendants an opportunity to attempt to rebut the presumption of *individual* reliance on the integrity of the market, and one repeatedly endorsed by courts, is that all common issues should be tried by the jury, with individual issues to be determined in a subsequent proceeding.

The common jury issues are: whether the statements were made, whether they were false, whether the misrepresentations or omissions were material, whether the defendants made such statements with scienter, and whether and by how much such statements inflated the market prices on each day of the class period. Once these common issues are determined at trial, the court can institute a separate proceeding to determine individual claims.[23]

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[21] *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 513 (9th Cir. 1991) (summary judgment granted based on showing that true information entered the marketplace); *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115, 1116 (9th Cir. 1989), *cert. denied*, 496 U.S. 943 (1990) (summary judgment affirmed as to statements concerning product problems which were described in numerous news articles); *In re Seagate Tech. II Sec. Litig.*, 802 F. Supp. 271, 275 (N.D. Cal. 1992) (summary judgment denied due to genuine issue as to whether truth entered marketplace). Evidence concerning the individual plaintiffs' reliance on investment decisions was not considered in any of the foregoing cases, as it has absolutely no bearing on the issue of class-wide reliance.

[22] *Basic*, 485 U.S. at 248-49; *Fine v. American Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990), *cert. dismissed*, 502 U.S. 976 (1991); *Gilbert v. First Alert, Inc.*, 904 F. Supp. 714, 720 (N.D. Ill. 1995); *In re Seagate Tech. II Sec. Litig.*, 843 F. Supp. 1341, 1355 (N.D. Cal. 1994); *McEwen v. Digitran Sys. Inc.*, 160 F.R.D. 631 (D. Utah 1994).

[23] *See Jaroslawicz v. Engelhard Corp.* 724 F. Supp. 294, 302-03 (D.N.J. 1989) ("If Englehard is found liable, separate proceedings will begin in which it will be determined (a) which claimants may be denied recovery through individual rebuttal proceedings, and (b) how much the successful claimants can recover based on the per share amount established at the liability phase. The second calculation is mechanical."); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969); *Tucker v. Arthur Andersen & Co.*, 67 F.R.D. 468 (S.D.N.Y. 1975); *Arthur Young & Co. v. United States Dist.*

Plaintiffs contend the fairest procedure, consistent with both goals of efficiency and due process, would be, after a judgment on the common issues by the jury, to send each class member (including the class representatives) a claim form or questionnaire on which class members would set forth the facts underlying their claim (including dates and prices of their purchases of the Company's stock). Defendants would then be given the opportunity to review the forms or questionnaires to ascertain such facts as would enable them to determine whether there is a basis to rebut the individual presumption of reliance, whether the individual has unique defenses, or simply whether the individual has any damages.

IV. TREND OF THE COURTS

Under Federal Rule of Civil Procedure 42(b), a court may:

> in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy . . . order a separate trial of any claim . . . or of any separate issue or of any number of claims . . . or issues, always preserving inviolate the right of trial by jury as declared by the Seventh Amendment to the Constitution or as given by the statute of the United States.

Applying this standard, judges in two recent securities class action trials, *In re: Biogen, Inc. Sec. Litig.*, Civil Action No. 94-12177-PBS (D. Mass. April 1998) and *In re ICN/Viratek Sec. Litig.*, 87 Civ. 4296 (KMW) (S.D.N.Y. July 1996), bifurcated the trials and precluded class representatives' testimony during the common issues phase of the trial.

Judge Kimba Wood of the United States District Court for the Southern District of New York in *In re ICN/Viratek*, bifurcated the action into a jury trial regarding class-wide issues, including issues of class-wide reliance and class-wide damages (the "First

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Court, 549 F.2d 686 (9th Cir. 1977), *cert. denied*, 434 U.S. 829 (1977) (endorsing district court's use of

Trial") and a jury trial regarding individual reliance issues and the calculation of individual damages (the "Second Trial") and thus precluded the testimony of the six class representatives at the First Trial.[24] Judge Wood deemed it "appropriate for defendants' attempts at rebutting the presumption of reliance with respect to individual investors to take place at a separate, Second Trial." *In re: ICN/Viratek,* Slip. op. at 3 (citing *Jaroslawicz v. Englehard Corp.*, 724 F. Supp. 294, 302 (D.N.J. 1989) (bifurcating securities fraud class action into two stages in this fashion)).

Judge Wood concluded that bifurcating the trial with separate juries empaneled for the two trials significantly furthered the "convenience" of the jurors; "avoid[ed] prejudice" to the parties, in that potential jury confusion was avoided "as to the distinction between the different purposes for which (1) evidence as to individualized reliance, or the lack thereof may be used; and (2) evidence as to class-wide reliance, or the lack thereof, may be used." Slip op. at 4-5.

Finally, Judge Wood in *In re ICN/Viratek* held that "because the First Trial will consider only class-wide issues, any testimony by the individual class representatives at the First Trial would be either irrelevant, or marginally relevant but overly confusing to the jury." Slip op. at 5.[25]

Similarly, in *In re: Biogen*, Judge Patti Saris of the United States District Court for the District of Massachusetts ordered from the bench the bifurcation of the trial into

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bifurcated trial in securities fraud action).

[24] *In re ICN/Viratek Sec. Litig.*, 87 Civ. 4296 (KMW) slip. op. (S.D.N.Y. July 15, 1996). Note that Seventh Amendment jury trial right issues arise when a different jury from the First Trial is empaneled for the Second Trial. *Id. But see Arthur Young & Co. v. United States Dist. Court*, 549 F.2d 686, 697 (9th Cir.), *cert. denied*, 434 U.S. 829 (1977) (Seventh Amendment does not prevent bifurcation of securities fraud trial into common and individual phases); *Green v. Wolf Corp.*, 406 F.2d 291, 301 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969) (in securities fraud action, court may by bifurcation reserve individual reliance issues for separate trial).

two phases and denied defendants' motion to compel the testimony of the class representative during the common issues phase of the trial.

IV. CONCLUSION

The issue of class representative testimony at the trial of securities class actions is certainly not a foregone conclusion. Both sides have persuasive arguments advancing their positions. Given the recent rulings by the courts, however, bifurcating the trial into two phases with class representative testimony during the second phase, if at all, seems to be the way of the future.

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[25] Judge Wood further noted that "the class representatives' testimony, offered to show lack of typicality, would not be relevant in either the First or the Second Trial." Slip op. at 6.