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## The Fifth Circuit Raises the Bar for Class Certification in Securities Cases Involving the “Fraud-on-the-Market” Presumption: *Oscar Private Equity Investments, et al. v. Allegiance Telecom, Inc., et al.*, No. 05-10791 (5th Cir. May 16, 2007).

A divided panel of the United States Fifth Circuit Court of Appeals recently upped the ante for securities fraud plaintiffs seeking to certify their claims as a class action. In order to invoke the “fraud-on-the-market” presumption to satisfy the “predominance” requirement of Federal Rule 23(b)(3), “loss causation must be established at the class certification stage by a preponderance of all admissible evidence,” said Judge Patrick Higginbotham for the majority. In a polite but vigorous dissent, Judge James Dennis described the majority’s decision as “a breathtaking revision of securities class action procedures that eviscerates [the Supreme Court’s] fraud-on-the-market presumption.” Whether or not one goes quite that far, there is no denying the decision saddles prospective securities class action plaintiffs with a significant additional threshold burden in the Fifth Circuit.

### Background

Allegiance was a national telecommunications provider based in Dallas, Texas, whose common stock traded on the NASDAQ. Plaintiffs alleged that Allegiance and certain individuals associated with it misrepresented Allegiance’s telephone line-installation count in the company’s first three quarterly announcements of 2001, and that Allegiance’s stock dropped after it restated and corrected that line-installation count in its announcement of fourth quarter 2001 results.

The evidence showed that in quarterly reports in April, July, and October, 2001, Allegiance announced significant numbers of new line installations, but that each of those announcements also contained other good news — increased revenues over the same period in the preceding year, performance better than analysts’ consensus estimates, and the like. On the next trading day after each of these announcements, Allegiance’s stock price rose.

In early 2002, after installing a new billing system, Allegiance restated its line-installation count, reducing the overall count from previous reports by more than ten percent. In the mirror image of its announcements from the previous three quarters this negative information was itself accompanied by still other bad news — that Allegiance had missed analysts’ earnings expectations for both the fourth quarter and for the 2001 fiscal year, that it had realized a greater EBITDA loss than many analysts had expected, and that it was in danger of failing to meet revenue covenants for 2002 with respect to its lines of credit. The next trading day, Allegiance’s stock price fell significantly. Soon thereafter, Allegiance defaulted on its loan covenants and ultimately filed for bankruptcy.

The setting for these events was not exactly the heyday of telecom stocks. Although Allegiance’s stock had risen on the heels of each of the favorable reports in the first three quarters of 2001, that stock (like other telecom stocks) was on a downward trend throughout this period. The day after Allegiance’s positive first-quarter 2001 announcement, its stock traded at \$16.20. But, even though it ticked up following each of the next two favorable quarterly reports, on the day before the “curative” statements of Allegiance’s fourth quarter report, its stock had fallen to \$3.70 per share.

Plaintiffs filed suit and sought certification of a class of all persons — other than those related to the Defendants — who had purchased Allegiance common stock in the open market during the period from April 24, 2001 (the date of the first positive quarterly statement) through February 19, 2002 (the date of Allegiance’s “curative” fourth quarter report). On behalf of this class, Plaintiffs proposed to pursue securities fraud claims under §§ 10(b) and/or 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. After conducting an evidentiary hearing, Senior District Judge Barefoot Sanders certified the case as a class action, as Plaintiffs had requested.

## To Rely on the Fraud-on-the-Market Presumption, Plaintiffs Must Prove Loss Causation

Under Federal Rule 23(b)(3), in order for a case to be certified as a class action, a plaintiff must demonstrate that “questions of law or fact common to the members of the class predominate over any questions affecting only individual members.” This “predominance” requirement could present an almost insurmountable obstacle in most securities fraud cases, if the plaintiffs were required to prove that each putative class member had relied upon the alleged fraudulent misstatements or omissions. In 1988, however, the Supreme Court offered securities fraud plaintiffs a mechanism for avoiding the requirement that they prove each individual class member’s reliance upon the purported fraud: the “fraud-on-the-market” presumption. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court declared that plaintiffs would be entitled to a rebuttable presumption of reliance upon a material misrepresentation if the plaintiffs traded in the stock at issue during the proposed class period in an open and efficient market. Reliance upon this rebuttable presumption allowed securities fraud plaintiffs to fulfill the “predominance” requirement for class certification, where that presumption could properly be invoked.

The Fifth Circuit, however, has been less than hospitable to the “fraud-on-the-market” presumption in a series of decisions commencing shortly after its articulation by the Supreme Court. Observing that *Basic* allowed each of the circuits room to develop its own fraud-on-the-market rules, the Fifth Circuit has taken the opportunity to “tighten the requirements for plaintiffs seeking a presumption of reliance,” said Judge Higginbotham for the majority. This trend culminated in the court’s decision in *Greenberg v. Crossroads Systems, Inc.*, 364 F.3d 657 (5th Cir. 2004). Citing *Greenberg*, Judge Higginbotham explained that the Fifth Circuit “require[s] plaintiffs to establish loss causation in order to trigger the fraud-on-the-market presumption” — that is, to invoke the presumption plaintiffs must first establish that the allegedly fraudulent statement or omission materially affected the market price of the security.

The pivotal question posed in *Allegiance Telecom* was whether this “loss causation” requirement would be imposed at the class certification stage upon plaintiffs seeking to use the fraud-on-the-market presumption to grease the skids toward class treatment. Citing “the *in terrorem* power of certification,” the *Allegiance Telecom* majority answered that question in the affirmative. Deflecting arguments that the procedure would improperly delve into the merits of the case at the class certification stage, the *Allegiance Telecom* majority held that “loss causation must be established at the class certification stage by a preponderance of all admissible evidence” in order for the plaintiff to rely on the fraud-on-the-market presumption. The majority then went on to hold that the evidence presented to the district court below had not been sufficient to prove loss causation in this case, and therefore that the class certification must be vacated.

In his dissent, Judge Dennis took issue with almost every aspect of the majority’s decision. He argued that the majority had misconstrued and overstated the Circuit’s prior decision in *Greenberg*, that *Greenberg* itself was contrary to the Supreme Court’s opinion in *Basic*, and that even under the standards articulated by the majority in this very case, there had been no abuse of discretion by the district court in certifying the class here. Judge Dennis also argued that the majority’s holding created a conflict with decisions from the Second, Fourth, and Seventh Circuits.

### Looking Ahead

The long term effect of the majority decision in *Allegiance Telecom* is difficult to predict. In the immediate future, one can expect efforts to upset that decision by subjecting it to further review both by the Fifth Circuit en banc and potentially by the United States Supreme Court — especially in view of the charge that the majority’s decision conflicts with rulings in other circuits and with the Supreme Court’s own decision in *Basic*.

In the meantime, however, the majority’s decision will make it tougher to certify a securities fraud class action in the Fifth Circuit. The requirement that a putative class action plaintiff demonstrate “loss causation” at the class certification stage may be devilishly difficult — particularly in a case like *Allegiance Telecom*, where the allegedly false and misleading positive statement is accompanied by other good news, and where the negative “curative” statement is simultaneously accompanied by other bad news. Requiring that the class action plaintiff “establish by a preponderance of the admissible

evidence” that a stock’s price moved up in response to the alleged misstatement — and not in reaction to the other positive news that accompanied it — or that it moved down because of the later revelation of the truth — and not because of other negative news that accompanied that revelation — presents plaintiffs with a very difficult mountain to climb. Where a plaintiff nevertheless elects to try scaling that peak, the *Allegiance Telecom* decision almost certainly will make both the pursuit of and defense against certification more protracted and expensive, as attorneys seek more extensive and detailed discovery and expert analysis in an effort to address “loss causation” at the threshold.

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