

# Client Alert

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## The Second Circuit Applies the Traditional Fraud on the Market Standard But Questions Its Applicability

On October 14, 2008, the Second Circuit decided *Teamsters Local 445 Freight Division Pension Fund v. Bombardier Inc. et al.*, 06-3794-cv, holding that the "fraud on the market" presumption did not apply to asset-backed securities issued by a subsidiary of Bombardier, Inc. Accordingly, the Court refused to certify under Federal Rule of Civil Procedure 23 a putative class of investors suing Bombardier. The Court declined, however, to establish a governing standard for when the "fraud on the market" doctrine applies, and indicated that separate standards may be required for equity and debt securities.

### The "Fraud on the Market" Presumption

To assert a claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act), plaintiffs must plead, among other things, that they *relied* on a misrepresentation or omission in connection with the purchase or sale of a security. In 1988, the Supreme Court adopted the "fraud on the market" doctrine as a basis for permitting a presumption of reliance in certain securities fraud cases. *Basic Inc. v.*

*Levinson*, 485 US 224 (1988). The doctrine holds that in an efficient market where material misrepresentations or omissions about a company are reflected in the price of its securities, it may be presumed that investors (directly or indirectly) rely on the misleading information when purchasing or selling the securities at that price.

The Second Circuit has not developed a standard for determining whether the market for a particular security is entitled to the fraud on the market presumption. However, other courts addressing this issue have relied upon factors first articulated by a New Jersey federal court in *Cammer v. Bloom*, 711 F. Supp. 1264 (D.N.J. 1989). These factors (commonly referred to as the "Cammer factors") include: (1) average weekly trading volume expressed as a percentage of total outstanding shares; (2) the number of securities analysts following and reporting on the security; (3) the extent to which market makers and arbitrageurs trade in the security; (4) the company's eligibility to file SEC registration Form S-3; and (5) the existence of a cause and effect relationship between unexpected corporate news and changes in the price of the security.

"The *Bombardier* Court applied the *Cammer* standard in determining the efficiency of the market for a security, but declined to formally adopt it, or to set forth a potential alternative."

## The “Predominance” Requirement for Class Certification

To certify a class action in federal court, the putative class must satisfy the elements of Rule 23 of the Federal Rules of Civil Procedure. One of these elements — known as the “predominance” requirement — calls for plaintiffs to establish that the issues in the lawsuit that are subject to generalized proof, and therefore apply to the class as a whole, predominate over issues that each class member must prove on an individual basis. The fraud on the market presumption enables securities fraud class action plaintiffs, in cases involving securities traded on an efficient market, to demonstrate predominance with respect to the “reliance” prong of Section 10(b). Absent the presumption, each class member will have to prove reliance individually, thereby precluding any attempt to satisfy the predominance requirement.

### The Bombardier Case

Bombardier, Inc. (BI) is a Canadian corporation that manufactures and sells a variety of products, including aircraft, recreational vehicles, and locomotives. Bombardier Capital, Inc. (BCI) is a subsidiary of BI that was involved in financing and leasing mobile homes. Bombardier Capital Mortgage Securitization Corporation (BCM), a subsidiary of BCI, packaged mobile home loans and sold “Certificates” in the packages to the public.

Plaintiffs, Certificate purchasers, filed this lawsuit in 2005 in the US District Court for the Southern District of New York, asserting claims under Section 10(b) of the Exchange Act. They accused the Bombardier entities of reckless underwriting practices that caused escalating mobile home loan delinquency rates, which were systematically underreported. According

to plaintiffs, the Certificate prices finally collapsed when the Certificates, BI and BCI were downgraded by ratings agencies in 2002 and 2003, and in response to several additional disclosures from the same time period.

In February 2006, plaintiffs moved for class certification. The district court employed *Cammer* to determine whether plaintiffs were entitled to the fraud on the market presumption. *Teamsters Local 445 Freight Division Pension Fund v. Bombardier, Inc.*, No. 05 Civ. 1898 (SAS), 2006 WL 2161887 (S.D.N.Y. Aug. 1, 2006). According to the court, two of the *Cammer* factors — high average weekly trading volume and eligibility to file Form S-3 — supported a finding that the Certificates traded in an efficient market. However, three others — the absence of analyst coverage, of market makers and arbitrageurs, and of a causal connection between company events and the price of the security — led the district court to conclude that the market for the Certificates was inefficient. It therefore denied class certification, holding that the fraud on the market presumption did not apply and plaintiffs could not, therefore, satisfy Rule 23. The plaintiffs appealed.

On appeal, the Second Circuit first clarified that plaintiffs bear the burden to show the facts necessary for class certification by a “preponderance of the evidence.”

The Court then addressed whether plaintiffs had established the fraud on the market presumption. The Court began its analysis by acknowledging that it had not yet adopted a test for determining the market efficiency of stocks or bonds, and by expressly declining to adopt one here. The Court nevertheless proceeded to address the efficiency of the market for the Certificates within the *Cammer* rubric, noting that “[t]he *Cammer* factors have been routinely applied by district courts” and that the plaintiffs “d[id] not contest the district court’s consideration

of the *Cammer* factors." This is the first time the Second Circuit has applied the *Cammer* factors to determine market efficiency. The Court focused on the three *Cammer* factors utilized by the district court in denying plaintiffs' motion for class certification.

*First*, the Court found that although there were numerous analysts following BI, the activities of those analysts were irrelevant because the Certificates were issued by BCM and not BI. Since the value of the Certificates was only incidentally related to BI's performance, the analyst coverage of BI did not significantly contribute to the efficiency of the Certificate market.

*Second*, the plaintiffs in *Bombardier* failed to identify a firm that regularly published bids and quotes for the Certificates or that would furnish bids and quotes on request and effect transactions for Certificates. The Court ruled that the absence of such a "market maker" supported a finding of inefficiency.

*Finally*, although Plaintiffs proffered an event study purporting to demonstrate a relationship between news about BI and the price of the Certificates, the Court did not credit this study, because measuring price reactions to news solely concerning the financial health of BI, and not BCI or BCM, was irrelevant. To the contrary, the Certificate transaction prices reacted weakly to unexpected downgrades of the Certificates themselves in 2002 and 2003.

Based on its analysis of these *Cammer* factors, the Court held that the Certificate market was inefficient, thereby preventing plaintiffs from relying on the fraud on the market presumption and from certifying a class. Yet the *Bombardier* opinion also warns that *Cammer* may not have universal applicability, suggesting that "an adjusted set of *Cammer* factors or even a different analytical approach altogether" might be "better suited to analyze market efficiency in securities cases arising from the sale of debt instruments." The Court did not specify when these different criteria might apply, instead leaving that "nettlesome question" for another day.

## Conclusion

*Bombardier* is the second fraud on the market decision issued by the Second Circuit in recent weeks. The first, *In re Salomon Analyst Metromedia Litig.*, No. 06-3225-cv, 2008 WL 4426412 (2d Cir. Sept. 30, 2008), unambiguously answered the question — in the affirmative — whether the fraud on the market presumption may apply to misleading analyst reports. The implications of *Bombardier*, however, are less clear. The *Bombardier* Court applied the *Cammer* standard in determining the efficiency of the market for a security, but declined to formally adopt it, or to set forth a potential alternative.

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