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Revisiting Affiliated Ute: And Its Limits In The 5th Circ.

By **Susanna Buergel, Andrew Ehrlich and Audra Soloway**

Law360, New York (May 24, 2017, 12:42 PM EDT) -- Last month marked 45 years since the U.S. Supreme Court's ruling in Affiliated Ute Citizens of Utah v. United States, which established a rebuttable presumption of reliance for securities fraud claims based on omissions of material fact. This Expert Analysis special series explores the decision's progeny in the Supreme Court and various circuits.


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Rule 10b-5's apparently simple command prohibiting a "misstatement or omission" has spawned numerous thorny questions, none more challenging than what kinds of alleged untruths qualify as misstatements, as opposed to omissions. The answer to the question has implications not only about the scope of substantive liability, but perhaps just as importantly, also about what claims are amenable to class certification. That is so because unlike misstatement cases, where plaintiffs bear the burden of proving the applicability of the fraud-on-the-market presumption under Basic Inc. v. Levinson,[1] omission cases are different. In cases involving alleged untruths that a court categorizes as omissions, the burden of proof on classwide treatment shifts to the defendant as a result of the so-called Affiliated Ute presumption, first established 45 years ago in Affiliated Ute Citizens of the State of Utah v. U.S.[2]

The Fifth Circuit has had limited occasion to address the Affiliated Ute presumption, but where it has, it has taken a typically practical, narrow approach to the presumption's application. Two opinions, Abell v. Potomac Insurance Co.[3] and Regents of University of California v. Credit Suisse First Boston (USA) Inc.,[4] both written by Judge Jerry Smith but written nearly two decades apart, are the guideposts in the circuit. They provide a useful framework for practitioners, both in the Fifth Circuit and more broadly.

Origins of the Presumption

The U.S. Supreme Court established the Affiliated Ute presumption 45 years ago. The decision arose out of 10b-5 claims brought by a group of Native Americans against a local bank and two of its employees. These Native Americans had organized a corporation to distribute assets to its members through shares of stock. To manage the stock, the Native Americans hired the bank to serve as a transfer agent and enforce title restrictions on the shares. But while managing the stock, the bank employees allegedly began cultivating a secret secondary market where the stock price of the Native Americans' shares soared in value. This alleged scheme allowed the bank employees to purchase the stock at a depressed price, resulting in what the Native Americans argued was a breach of a fiduciary duty to disclose information.

Reversing the Tenth Circuit, the Supreme Court ruled in favor of the Native Americans. The Supreme Court acknowledged that, as emphasized by the Tenth Circuit, the Native Americans had not proved they relied on any "positive representation"[5] made by the bank employees. Nevertheless, the court held that "positive proof of reliance is not a prerequisite to recovery" in cases involving a "failure to disclose."[6] Instead, the Native Americans needed only to show that "a reasonable investor" might have considered the omitted facts "important in the making of" their investment decisions.[7] In such cases, a plaintiff could recover the difference between the fair value of what she actually obtained for a sale of stock, and that which she would have received in the absence of the fraudulent omission.

Given the significant challenges presented to defendants by certification in securities class actions, the Affiliated Ute presumption has the potential to be a powerful weapon in a plaintiff's arsenal. This makes two questions all the more critical: (1) the question of whether an allegation may fairly be characterized as an omission or a misrepresentation, and (2) the question whether, assuming an allegation asserts an omission, there exists a duty to disclose that which was allegedly omitted. The Fifth Circuit's two key treatments of Affiliated Ute thus frame its application with reference to these two issues.

Abell v. Potomac Insurance Co.

The Fifth Circuit did not meaningfully engage with Affiliated Ute until 15 years after its issuance. In Abell v. Potomac Insurance Co., the court established its basic framework for applying the presumption, focusing in particular on the first of the two questions: When does the omission of a fact qualify as an "omission" under Rule 10b-5?

The plaintiffs in that action were bondholders who claimed that the defendant securities sellers had failed to disclose material facts about the business issuing the bonds. One of the sellers, for example, had set up a suspicious real estate transaction designed to create the illusion that he had staked $2 million of his own money in the business. The seller also failed to mention to the bondholders that an accounting firm had raised concerns about the business's feasibility. After the bondholders lost millions on their securities, they sued the sellers under rule 10b-5 and won a judgment for damages totaling $15 million.

On appeal, however, the Fifth Circuit reversed, finding that the bondholders had failed to establish reliance for the class. In reaching this decision, the court rejected the bondholder's argument that they were entitled to the Affiliated Ute presumption. The court explained that the presumption applies only where the defendant has "failed to disclose any information whatsoever relating to material facts about which the defendant has a duty to the plaintiff to disclose."[8] Here, the securities sellers did not omit facts about which the bondholders had "no inkling."[9] The sellers instead purposely revealed only part of the truth in an effort to mislead potential purchasers. Put differently, the Abell court held that "we apply the Ute presumption in non-disclosure cases, but not in falsehood or distortion cases."[10]

To illustrate this distinction — and particularly "distortion" cases — the court offered a hypothetical. Imagine a car owner advertises her vehicle for sale. As a first example, suppose the owner claims the car has a "new" battery when she knows the battery is five years old. That statement is an outright lie, a type of misstatement. Now as a second example, suppose a prospective buyer asks the owner, “How is the engine?” and she replies, “I've never had a problem with it.” If she has only owned the car for a few weeks, and knows the previous owner had issues with the engine, then in the Fifth Circuit’s view her affirmative statement is not an omission, but rather a “distortion” of the truth — another type of misstatement. Finally, assume the owner is selling the car because a mechanic told her the vehicle is “not safe at any speed.” Nonetheless, the owner only shares this information if specifically asked why she is selling the car. Only this last scenario — where the owner fails to share a key detail, rather than actively mislead the buyer — is an omission that qualifies for the invocation of Affiliated Ute, according to the framework set out by the Fifth Circuit in Abell.[11]

Regents of University of California v. Credit Suisse First Boston (USA) Inc.

It was nearly 20 years before the Fifth Circuit again took up the Affiliated Ute presumption in detail, in Regents of University of California v. Credit Suisse First Boston (USA) Inc, one of many significant securities law opinions to emerge from the Enron debacle. This time, the court took up the second of the two key issues: duty to disclose.

In Regents, the plaintiffs alleged that the defendant banks had entered into deals that allowed Enron to book profits when it was actually incurring debt. Based on a duty “not to engage in a fraudulent scheme,” and pursuant to Rule 10b-5(a)’s prohibition on schemes to defraud, the lower court sustained the complaint against a motion to dismiss, and then certified a class, holding the plaintiffs entitled to take advantage of the Affiliated Ute presumption — even though there were no allegations that banks were fiduciaries of the plaintiffs or otherwise obligated to them.[12]

The Fifth Circuit granted review of the class certification order under Rule 23(f), acknowledging that in securities cases, class certification may be the “backbreaking decision that places ‘insurmountable pressure’ on a defendant to settle.”[13] Notably for purposes of class action jurisprudence, in language that presaged the Supreme Court’s later discussion in Halliburton II about the introduction of price impact evidence at the class certification stage,[14] the Regents court held that on Rule 23(f), “this court can, and in fact must, review the merits of the district court's theory of liability insofar as they also concern issues relevant to class certification.”[15]

The court then recast its holding in Abell as a two-part test. To receive the presumption, the court held, a plaintiff must “(1) allege a case primarily based on omissions and (2) demonstrate that the defendant owed him a duty of disclosure.”[16] The plaintiffs in Regents failed this test, in the Fifth Circuit’s view, because the banks were not Enron’s fiduciaries — the bank defendants entered into arm's-length transactions with Enron, such as alleged round-trip transactions. The court explained that “[t]he logic of Affiliated Ute is that, where a plaintiff is entitled to rely on the disclosures of someone who owes him a duty, requiring him to prove 'how he would have acted if omitted material information had been disclosed' is unfair.”[17] Here, because the plaintiffs never expected the banks to provide them with information, there was “no reason to expect that the plaintiffs were relying on their candor.”[18]

Following Halliburton II, and perceived higher hurdles to class certification under the fraud-on-the-market presumption, there has been some suggestion that counsel for plaintiffs in securities cases will seek to recharacterize, to the extent possible, their claims as omission claims to take advantage of the Affiliated Ute presumption. In the Fifth Circuit, at least, that will be a challenging task given the parsimonious view of omissions it has espoused.

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[1] 485 U.S. 224 (1988).

[2] 406 U.S. 128 (1972).

[3] 858 F.2d 1104, 1119 (5th Cir. 1988), vacated on other grounds sub nom. Fryar v. Abell, 492 U.S. 914 (1989).

[4] 482 F.3d 372 (5th Cir. 2007).

[5] Affiliated Ute, 406 U.S. at 153.

[6] Id.

[7] Id. at 154.

[8] Abell, 858 F.2d at 1119.

[9] Id.

[10] Id.

[11] Id. at 1119 n.15.

[12] Regents, 482 F.3d at 384.

[13] Id. at 379 (citation omitted).

[14] Halliburton Co. v. Erica P. John Fund Inc., 134 S. Ct. 2398,

[15] Regents, 482 F.3d at 381.

[16] Id.

[17] Id.at 385.

[18] Id. at 385.