SCOTUS Sticks to Basic[s] but Allows Defendants to Present Rebuttable Evidence at Class Certification Stage

On June 23, 2014, the Supreme Court issued its much-anticipated decision in *Halliburton Co.* v. *Erica P. John Fund, Inc.*,[1] holding that while plaintiffs can continue, in appropriate circumstances, to invoke the "fraud-on-the-market" presumption of reliance in securities fraud lawsuits, defendants will now have a meaningful opportunity to rebut the presumption at the class certification stage by demonstrating that the alleged misstatement(s) of which plaintiffs complain had no impact on the market price of a company's stock. *Halliburton* must be read in conjunction with the Supreme Court's decision in *Dura Pharmaceuticals, Inc.* v. *Broudo*,[2] addressing loss causation and holding that plaintiffs bear the burden of showing that their losses were attributable to the revelation of the fraud and not other factors that affect a company's stock price.[3]

To satisfy the Supreme Court's instruction in *Halliburton* that defendants have a meaningful opportunity to demonstrate no market price impact, plaintiffs must be required to identify with particularity (by published date, time and content) each alleged misstatement of which they complain, and the district courts must rigorously enforce the heightened pleading requirements of both Rule 9(b) of the Federal Rules of Civil Procedure[4] and the Private Securities Litigation Reform Act that require plaintiffs to do so.[5]

I. Background

In 2002, the Erica P. John Fund, Inc., (the "Fund") sued Halliburton Co., alleging the company made a number of misstatements in violation of Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5.[6] Specifically, the Fund alleged that, between June 3, 1999, and December 7, 2001, Halliburton (1) understated its potential liability for asbestos claims, (2) overstated its revenues related to certain construction contracts, and (3) exaggerated the expected benefits of its merger with Dresser Industries. The Fund alleged that these misrepresentations artificially inflated Halliburton's stock price, which later fell when Halliburton released corrective disclosures.

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[1] 573 U.S. __ (2014), slip opinion (the "Opinion") *available at* http://www.supremecourt.gov/opinions/13pdf/13-317_mlho.pdf.

[2] 544 U.S. 336 (2005).

[3] Loss causation is among the six elements of a private cause of action for securities fraud. *See Halliburton*, Opinion at 5. To prove loss causation a plaintiff must show a sufficient connection between the fraudulent conduct and the losses allegedly suffered. In *Dura*, the Supreme Court held that a plaintiff does not show loss causation in a private securities fraud action if the share price reflects "not the earlier misrepresentation, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." 544 U.S. at 341-43. In other words, plaintiffs bear the burden of showing that their losses were attributable to the revelation of the fraud and not the myriad other factors that affect a company's stock price.

[4] The law presumes "in favor of honesty and against fraud." *Duncan* v. *Jaudon*, 82 U.S. 165, 170 (1872). "In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake." Fed. R. Civ. P. 9(b).

[5] The PSLRA's heightened pleading standards require a private securities fraud complaint alleging false or misleading statements to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation . . . is made on information and belief . . . state with particularity all facts on which that belief is formed. 15 U.S.C. § 78u-4(b)(1); *see Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 551 U.S. 308, 321 (2007).

[6] Opinion at 2.

After years of discovery, the Fund moved to certify a class of all Halliburton shareholders purchasing stock between June 1999 and December 2001. In seeking certification, the Fund invoked the fraud-on-the-market presumption of reliance.[7] Established by the Supreme Court in *Basic Inc.* v. *Levinson*,[8] the presumption assumes that the price of a stock trading in an efficient market generally reflects all public information—including material misstatements—and thus that "anyone who buys or sells the stock at market price may be considered to have relied on those misstatements."[9] Further, because all purchasers will have "relied" on those misstatements in the same manner—that is, by buying the stock at the market price—it also allows the plaintiffs to satisfy the requirement in Rule 23(b)(3) of the Federal Rules of Civil Procedure that, in a class action, common questions of law and fact predominate over individual ones.

Under *Basic*, plaintiffs can satisfy their burden for invoking the presumption by showing: (1) misrepresentation publicity, (2) misrepresentation materiality, (3) market efficiency, and (4) that the plaintiff traded the shares between the time the misrepresentations were made and the time corrective statements are publicly made.[10] The Fund moved to certify a class comprising all investors who purchased Halliburton common stock during the class period. Relying on Fifth Circuit precedent, however, the U.S. District Court for the Northern District of Texas refused to permit plaintiffs to invoke the presumption (and thus denied certification) because the plaintiffs had failed to demonstrate loss causation, "a causal connection between the defendants' alleged misrepresentations and the plaintiffs' economic losses."[11] The Fifth Circuit affirmed.[12]

In 2011, the Supreme Court reversed, holding that plaintiffs need not show loss causation at the certification stage to invoke the fraud-on-the-market presumption of reliance.[13] Loss causation, the court said, "addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock."[14] On remand, the District Court granted class certification and the Fifth Circuit affirmed.[15]

Halliburton petitioned for writ of certiorari, raising two issues: (1) whether the Court should overrule the fraud-on-the-market presumption of reliance established in *Basic*; and (2) if not, whether a defendant may nonetheless rebut the fraud-on-the-market presumption at the class certification stage by showing the alleged misrepresentations had no effect of the price of the company's shares—that is, by using so-called "price impact" evidence.[16] In November 2013, the Court granted cert.

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[7] Reliance is one of the elements of a 10b-5 securities action, along with: (1) a material misrepresentation or omission by the defendant; (2) *scienter*; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) economic loss; and (5) loss causation. *Id.* at 5.

[8] 485 U.S. 224 (1988).

[9] Opinion at 1.

[10] *Id.* at 14.

[11] *Id.* at 2-3.

[12] *Archdiocese of Milwaukee Supporting Fund, Incorporated v. Halliburton Co.*, 597 F. 3d 330 (5th Cir. 2010).

[13] *Erica P. John Fund, Inc.* v. *Halliburton*, 131 S. Ct. 2179 (2011)

[14] *Erica P. John Fund Incorporated, formerly known as Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 718 F. 3d 423 (5th Cir. 2013).

[15] Opinion at 4.

[16] *Id.*

II. Decision

As for the first question, the Court held that *Basic*'s rebuttable presumption should not be overruled, dismissing Halliburton's arguments as failing to provide a "special justification" for overturning *Basic*'s long-settled precedent.[17] After rejecting Halliburton's arguments regarding Congressional intent, Justice Roberts, writing for the majority, addressed Halliburton's primary arguments, which attacked the economic assumptions on which *Basic* relied. Regarding one of these premises, the efficient markets hypothesis,[18] the Supreme Court said Halliburton "fail[ed] to take *Basic* on its own terms."[19] Halliburton argued that *Basic* assumed that markets either are or are not efficient, failing to recognize that efficiency is often a matter of degree—that is, not all types of information will be processed by markets at exactly the same speed. The Court, however, pointed out that these arguments were not new—*Basic* itself acknowledged the debate on this issue and ultimately declined to endorse any particular economic theory. Rather than assume that efficient markets *always* incorporate *all* public information, the *Basic* Court "based the presumption on the fairly modest premise that 'market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.'"[20] Indeed, "[i]n making the presumption rebuttable," the Court said "*Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof."[21] The Court also rebuffed Halliburton's claims about a second economic assumption: the notion that investors "invest 'in reliance on the integrity of [the market] price.'"[22]

After addressing Halliburton's primary arguments, the Court discussed a number of additional, non-economic arguments for overruling *Basic*. While Halliburton argued that *Basic* was in tension with the Court's recent precedents regarding both Rule 10b-5 and Rule 23 of the Federal Rules of Civil Procedure, the Court said that there was, in fact, no inconsistency.[23] While many had urged the Court to overturn *Basic* on policy grounds, the Court said such arguments were better addressed to Congress, which has the power to enact legislation mooting *Basic*.[24]

Although the Court declined to overturn *Basic*, it sided with defendants on the second question, holding that they should have a meaningful opportunity to rebut the presumption prior to class certification by presenting evidence to prove that the alleged misrepresentation did not actually have an effect on the price of the stock.[25] The Court explained that market efficiency and the other prerequisites for invoking the presumption are essentially *indirect* proxies for demonstrating that a misrepresentation had this effect.[26] It thus "makes no sense," the Court said, to prohibit defendants from raising *direct* evidence regarding price impact at the class certification stage, especially given that the parties can already submit this evidence pre-certification to support (or counter) an

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[17] *Id.* at 7.

[18] As the Court described it, the efficient-market hypothesis assumes that the "market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."

[19] *Id.* at 9.

[20] *Id.*

[21] *Id.*

[22] *Id.* at 11-12.

[23] *Id.* at 13-15.

[24] *Id.* at 15-16.

[25] The Court, however, declined to adopt a rule that would *require* plaintiffs to prove price impact at the class certification stage in order to invoke the presumption.

[26] *Id.* at 20.

argument that a market is efficient.[27] Because the lower courts had denied Halliburton the chance to present this evidence to directly rebut the presumption, the Court reversed the Fifth Circuit's decision and remanded the case for further consideration.

Two justices issued concurring opinions. Justice Ginsberg, joined by Justices Breyer and Sotomayor, wrote to emphasize her understanding that the burden of rebutting the presumption remained on the defendant, which meant the holding "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." Of course, the obligation that plaintiffs comply with the pleading standards of the Private Securities Litigation Reform Act and Rule 9(b) of the Federal Rules of Civil Procedure is not new and is something that plaintiffs must do if defendants are to have a meaningful opportunity to show that a specific (date/time/content) alleged misstatement did not have an impact of the market price of the securities at issue.

Justice Thomas, joined by Justices Scalia and Alito, concurred in the judgment only and argued that *Basic* should be overruled.

III. Significance

Ignoring calls to completely upend the *status quo*, the Supreme Court took a more modest approach. By refusing to overturn *Basic* altogether, the Court preserved the ability of plaintiffs, in appropriate circumstances, to certify class actions in securities fraud actions with tenable claims. Nonetheless, its decision makes crystal clear the importance of requiring plaintiffs to identify the specific statement(s) at issue so that defendants can have a meaningful opportunity to demonstrate at the class certification stage that the publication of those specific statements on the date(s) alleged did not impact the market price of the securities at issue.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Jack Herman at 212.701.3654 or jherman@cahill.com.

[27] *Id.* at 19-20.