Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

By B. John Casey, Roberta D. Anderson, Nicole C. Mueller

On June 23, 2014, the Supreme Court issued its highly-anticipated decision in Halliburton Co. v. Erica P. John Fund. The Court had accepted Halliburton for review to consider whether to overrule or substantially modify its earlier holding in Basic, Inc. v. Levinson, 485 U.S. 224 (1988), which afforded securities class action plaintiffs a presumption of class-wide reliance, critical to class certification, based upon the so-called “fraud-on-the-market” theory. A reversal of Basic would have had a drastic impact on the viability of securities class actions as we currently know them, but it was not to be: the Halliburton Court found no “special justification” for overturning the “long-settled precedent” of Basic.

Although the Halliburton ruling did not sound the death knell of securities class actions, the Court afforded defendants a tool that may in some cases prove useful in defeating securities class actions at the class certification stage. Specifically, the Court unanimously held that defendants may rebut the presumption of reliance afforded by the fraud-on-the-market theory at the class certification stage—thereby rendering the case unfit for class action treatment—by showing that the alleged misrepresentation(s) did not have an impact on the price of the stock in question.

Background


Class certification under Rule 23(b)(3) of the Federal Rules of Civil Procedure requires a showing that questions of law or fact common to the proposed class predominate over individual questions. In securities fraud class actions under Section 10(b) of the Securities Exchange Act of 1934, this has meant that plaintiffs must show that the elements of the claim demonstrate: “(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) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation”—can be established by common proof.

Element (4), reliance, requires that a plaintiff show that a specific misstatement induced “the investor’s decision to engage in the transaction.” Such a showing is necessary to establish that a plaintiff not only lost money, but that the loss resulted from the misrepresentation.

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4 Id. at 2184.
Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

The rationale behind this requirement is that, absent such a connection, the cause of action for securities fraud would become a "scheme of investor's insurance."5 Reliance, as the Supreme Court recognized in Basic, is an inherently individualized inquiry. Accordingly, the Court observed in Basic that, “[r]equiring proof of individualized reliance” from every class member would “prevent[] [plaintiffs] from proceeding with a class action … because “individual issues then would … overwhelm[] common ones.”6 Consequently, the Basic Court, following the lead of a number of lower courts, allowed securities fraud plaintiffs to raise a rebuttable presumption of reliance under the fraud-on-the-market theory. This economic theory presumes that (1) all material public information—including any misstatements—is reflected in the price of a stock traded on a well-developed market, and (2) investors rely on the integrity of the market price to reflect all such information when determining whether to buy or sell a security. Thus, under the doctrine, investors need not show that they relied directly on the misstatements in order to recover damages.

To invoke the fraud-on-the-market theory and thereby establish a rebuttable presumption of reliance, plaintiffs are required to demonstrate that: (1) the alleged misrepresentations were publicly known, (2) the stock in question traded in an efficient market, and (3) the relevant securities transaction occurred between the time the misrepresentations were made and the time the truth was revealed.7 Without the fraud-on-the-market presumption, issues of individual reliance likely would overwhelm common issues in securities class actions, resulting in the denial of class certification.8

The Court in Basic also held that a defendant could rebut the presumption of reliance by showing that the alleged misrepresentation or omission did not actually distort the stock price.9 A defendant may rebut the presumption with “[a]ny 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.”10

Circuit Split: Need a Plaintiff Show Loss Causation to be Entitled to the Fraud On-The-Market Presumption?

In Basic, the Supreme Court outlined guidelines for invocation of the fraud-on-the-market doctrine but did not provide specific procedural and substantive rules for its application. As a result, a split ultimately developed on the application of the doctrine. Specifically, the Fifth Circuit interpreted Basic to require that a securities plaintiff affirmatively establish loss causation—i.e., that the misstatement caused the loss—at the class certification stage;11 the

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6 Basic, 485 U.S. at 245.
7 Halliburton I, 131 S. Ct. at 2185.
8 More recently, the Court made the same observation in Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds, when it noted: “[a]bsent the fraud-on-the-market theory, the requirement that Rule 10b-5 plaintiffs establish reliance would ordinarily preclude certification of a class action seeking money damages because individual reliance issues would overwhelm questions common to the class.” 133 S. Ct. 1184, 1193 (2013) (holding that plaintiff need not establish materiality at the class certification stage).
9 Basic, 485 U.S. at 248.
10 Id.
11 See Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261 (5th Cir. 2007).
**Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification**

Seventh Circuit disagreed, holding that, in an efficient market, "each investor’s loss usually can be established mechanically, common questions predominate and class certification is routine, if a suitable representative steps forward," and the Second and Third Circuits similarly held that plaintiffs were not required to establish loss causation in order to invoke the presumption of reliance, but did allow defendants to rebut this presumption prior to class certification.

**Halliburton I: The Supreme Court Rejects the Fifth Circuit’s Interpretation**

It was in this setting that plaintiff Archdiocese of Milwaukee Supporting Fund, Inc., filed a class action against Halliburton alleging violations of Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5, on behalf of investors who had purchased shares in Halliburton between 1999 and 2001.

Plaintiffs moved to certify a class comprised of all investors who purchased Halliburton common stock during the class period. Plaintiffs survived a motion to dismiss, but the district court subsequently denied their motion for class certification on the basis that plaintiffs, as required by the Fifth Circuit in Oscar, had failed to establish loss causation at the class certification stage, and, thus, failed to show predominance as required by Fed. R. Civ. P. R. 23(b)(3). The Fifth Circuit upheld the district court’s denial of class certification on the same ground.

In a unanimous decision, the Supreme Court in Halliburton I vacated the Fifth Circuit’s judgment. The Supreme Court held that securities fraud plaintiffs need not establish loss causation at the class certification stage as a precondition for invoking the rebuttable fraud-on-the-market presumption. “Loss causation,” the Supreme Court explained, “addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.”

Importantly, in vacating and remanding the Fifth Circuit’s judgment, the Supreme Court observed that because it had rejected the Fifth Circuit’s loss causation requirement for class certification, it was not required to address other issues raised regarding “Basic, its presumption, or how and when it may be rebutted.”

On remand, both the District Court and Fifth Circuit refused to consider Halliburton’s “rebuttal” evidence, offered at the class certification stage, that the misrepresentations alleged by the plaintiffs had no impact on the stock price. Ultimately, the Supreme Court granted certiorari a second time, to resolve a conflict among the Circuits over whether

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12 Schleicher v. Wendt, 618 F.3d 679, 696 (7th Cir. 2010).
13 See In re Salomon Analyst Metromedia Litig., 544 F.3d 474, 485 (2d Cir. 2008); see also In re DVI, Inc. Sec. Litig., 639 F.3d 623 (3d Cir. 2011).
16 Halliburton I, 131 S. Ct. at 2186.
17 Id. (noting that requiring plaintiffs to show that a public misrepresentation caused subsequent economic loss “contravenes Basic’s fundamental premise” and was not logically connected to whether an investor relied on such a misrepresentation when buying or selling the company’s stock).
18 Id.
19 Id. at 2187 (emphasis supplied).
Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

Securities fraud defendants may attempt to rebut the Basic presumption at the class certification stage with evidence of a lack of price impact” and also “accepted Halliburton’s invitation to reconsider the presumption of reliance for securities fraud claims that [it] adopted in Basic.”

Halliburton II: The Supreme Court’s Ruling

In its opinion in Halliburton II, the Supreme Court held:

Halliburton had not shown the “special justification” needed to overrule Basic’s rebuttable presumption of reliance in a Rule 10b-5 action based upon the fraud-on-the-market theory;

A plaintiff need not prove price impact at the class certification stage in order to invoke the presumption; but

A defendant may rebut the presumption (and thereby presumably defeat class certification) by proving that alleged misrepresentations did not distort the market price of the company’s stock.

Writing for the majority, Chief Justice Roberts left the fraud-on-the-market theory intact, noting that the Supreme Court does not overturn precedents lightly, particularly where the Court is interpreting statutes that Congress may rewrite if it thinks the Court has erred in its ruling. The Court found that Halliburton had failed to demonstrate the “special justification” needed to overturn “long-settled precedent,” and had not identified “the kind of fundamental shift in economic theory that could justify overruuling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities.” With regard to the arguments Halliburton advanced for overturning the fraud-on-the-market presumption of reliance, the Court noted that many of the same arguments had been considered and rejected by the Court in Basic.

The Court also noted that the principle of stare decisis has “special force” “in respect to statutory interpretation” because “Congress remains free to alter what [the Court has] done.” The Court found that Basic’s presumption of reliance was not inconsistent with more recent decisions construing the Rule 10b-5 cause of action, but rather provided an alternative means of satisfying the reliance element. Nor was Basic inconsistent with recent law regarding class action certification because the presumption does not relieve plaintiffs of the burden of proving predominance at the class certification stage (rather than merely pleading it), but rather prescribes what plaintiffs must prove to demonstrate predominance. Finally, the Court reasoned that arguments about the harmful effects of securities class actions “are more appropriately addressed to Congress,” which had, the Court noted, in fact already addressed some of those potentially harmful effects.

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21 Halliburton II (slip op. at 4).
22 Id. at ___ (slip op. at 4).
23 Id. at ___ (slip op. at 11).
24 Id. at ___ (slip op. at 7-8).
25 Id. at ___ (slip op. at 12) (quoting John R. Sand & Gravel Co. v. United States, 552 U.S. 130, 139 (2008)).
27 Id. at ___ (slip op. at 14) (comparing Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011)).
28 Id. at ___ (slip op. at 15-16).
Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

For the same reasons that the Court declined to overrule Basic’s presumption of reliance, it also declined to modify the prerequisites for invoking the presumption by requiring plaintiffs to prove “price impact” directly at the class certification stage. Requiring plaintiffs to prove price impact directly, the Court held, would nullify Basic’s presumption that the misrepresentation affected the stock price where the misrepresentation was public and material and the stock traded in a generally efficient market. 29

The Court did, however, overturn the Fifth Circuit’s decision on a key holding on the more narrow issue of whether defendants can, at the class certification stage, rebut the allegation that a company’s stock price was inflated by purportedly fraudulent statements. Because defendants can use such evidence to rebut the underlying premise of market efficiency at later stages, Justice Roberts wrote, it does not make sense to deny the use of such evidence elsewhere in the proceedings. 30 The Court found that forbidding defendants to submit the same evidence at the class certification stage would readily lead to results that are inconsistent with Basic’s own logic.31 While Basic allows plaintiffs to establish price impact indirectly, it should not preclude the consideration of a defendant’s direct, more salient evidence showing that the purported misrepresentation did not actually affect the stock’s price and that, consequently, the Basic presumption should not apply.32 Such evidence has “everything to do with the issue of predominance at the class certification stage.”33 Indeed, “[t]he fact that a misrepresentation ‘was reflected in the market price at the time of [the] transaction’–that it had a price impact–is ‘Basic’s fundamental premise.’”34 Without price impact, the fraud-on-the-market theory “underlying the presumption completely collapses, rendering class certification inappropriate.”35

In a concurring opinion, Justice Thomas argued that the Court should have taken its decision one step further by overturning Basic.36 Justice Thomas, with Justices Scalia and Alito joining in his opinion, asserted that economic realities have “undermined the foundation of the Basic premise.”37 Justice Thomas derided the presumption that “most” investors rely on the integrity of the price of a security as a “judicial hunch.”38 Justice Thomas also argued that Basic conflicted with the Court’s recent rulings that plaintiffs seeking class certification must “affirmatively demonstrate … through evidentiary proof” certification requirements like the predominance of common questions.39 Regarding the majority’s holding on the stare decisis effect of Basic, Justice Thomas argued that “we ought to presume that Congress

29 Id. at ___ (slip op. at 16-18).
30 Id. at ___ (slip op. at 18-20). The Second and Third Circuits had previously ruled that a defendant may attempt to rebut the fraud-on-the-market presumption by showing no price impact at the class certification stage. In re DVI, Inc. Sec Litig., 639 F.3d at 638-39; In re Salomon Analyst Metromedia Litig., 544 F.3d at 484-86.
31 Id. at ___ (slip op. at 20).
32 Id. at ___ (slip op. at 20-21).
33 Id. at ___ (slip op. at 22).
34 Id. at ___ (slip op. at 22) (quoting Halliburton I, 131 S. Ct. at 2186).
35 Id.
36 Justice Ginsberg also filed a concurring opinion, stating that while advancing price impact consideration to class certification may broaden the scope of discovery available at that stage of the proceedings, “[t]he Court’s judgment … should impose no heavy toll on securities-fraud plaintiffs with tenable claims.” See id. at ___ (Ginsberg, J., concurring) (slip op. at 1). “On that understanding,” she, along with Justices Breyer and Sotomayor, joined the majority’s opinion. Id.
37 Id. at ___ (Thomas, J., concurring in judgment) (slip op. at 2).
38 Id. at ___ (Thomas, J., concurring in judgment) (slip op. at 10).
Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

expects us to correct our own mistakes—not the other way around." Justice Thomas contended that this was especially appropriate in the Rule 10b-5 context, noting that the Court has itself observed that the federal courts have “accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes.”

What This Means

Class certification in securities class actions has, in many respects, historically been a “rubber stamp”: If plaintiff submitted basic evidence of an asserted misrepresentation and market efficiency, the case likely would be certified. While the Halliburton II decision is a disappointment for those who had hoped that the Court would overturn Basic, the holding nonetheless provides defendants with an opportunity to defeat claims at the class certification stage, thereby potentially avoiding expensive and burdensome merits discovery that often accompanies securities class actions.

Questions certainly remain about how exactly a defendant can “rebut” the fraud-on-the-market presumption—e.g., a showing of no price impact at the time of the misstatement? At the time of the corrective disclosure? At both times? Nonetheless, the Court’s opinion should allow securities defendants to employ well-established economic stock price analyses, including regression analyses called “event studies,” at the class certification stage to rebut Basic’s presumption. Although this ultimately could devolve into a battle of the experts in cases in which there was strong market reaction to alleged misrepresentations, cases in which the market had little reaction to an alleged “fraud” now could be subject to dismissal at the class certification stage.

Authors:

B. John Casey
john.casey@klgates.com
+1.503.226.5716

Roberta D. Anderson
roberta.anderson@klgates.com
+1.412.355.6222

Nicole C. Mueller
nicole.mueller@klgates.com
+1.312.807.4341

40 Id. at ___ (Thomas, J., concurring in judgment) (slip op. at 16).
41 Id.
42 These kinds of studies also have historically been used on the issue of market efficiency.
Halliburton II: Supreme Court Upholds Fraud on the Market Presumption, but Gives Securities Defendants a Fighting Chance at Defeating Class Certification

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