

## Supreme Court: Securities Fraud Class Action Is Certifiable Without Proof of Loss Causation

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*On June 6, the U.S. Supreme Court issued its unanimous ruling in Erica P. John Fund v. Halliburton Co., No. 09-1403, 2011 WL 2175208, holding that securities fraud plaintiffs need not prove loss causation to obtain class certification in cases under Rule 10b-5 invoking the fraud-on-the-market theory.*

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### Background

The fraud-on-the-market theory, adopted by the Supreme Court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), addresses the obstacle to class certification created if individual investors must prove that each of them knew about and relied on an allegedly false or misleading statement when deciding whether to invest in a security (such "reliance" is an essential element of a securities fraud claim under SEC Rule 10b-5, the most popular legal theory for securities fraud claims not involving initial public offerings).

For class certification to be appropriate, a court must decide that questions of law or fact common to class members predominate over individual questions. The "predominance" analysis often turns on the element of reliance: if reliance must be proved individually, courts usually hold that common questions do not predominate; but if reliance can be presumed and proved on a class-wide basis, courts often hold that common questions do predominate, and class certification is appropriate. In *Basic*, the Supreme Court announced a rebuttable presumption of reliance based on the economic theory that in an "efficient" market stock prices reflect all material public information, and thus investors implicitly rely on public misstatements whenever they buy or sell stock at the price set by the market – whether or not they personally have read or been influenced by the allegedly misstatement. *Basic* holds that this presumption of reliance is available so long as a plaintiff is able to show three things: that the misrepresentations were publicly known; that the stock traded in an "efficient" market; and that the relevant transaction took place between the time the misrepresentations were made and the time the truth was revealed.

### The Supreme Court's Holding

The Fifth Circuit, relying on its earlier decision in *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), added a fourth requirement: that plaintiffs also establish loss causation to trigger

the fraud-on-the-market presumption. But in *Erica P. John Fund*, the Supreme Court rejected this additional requirement, holding that it impermissibly conflates "transaction causation" (in essence, did the misrepresentation cause the investor to invest?), which is relevant to investor reliance, and "loss causation" (in essence, did correcting the misrepresentation cause the stock price to drop and the investor to lose money?), which is not relevant to investor reliance (though relevant to damages).

The Supreme Court declined to adopt an alternative position espoused by the defendant: that the Fifth Circuit's use of the term "loss causation" was shorthand for "price impact," and that the Fifth Circuit was merely allowing the defendant to rebut the reliance presumption by showing that the stock price was not distorted by the misrepresentation (i.e., a "price impact" analysis). According to the defendant, "if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation merely because he purchased stock at that price. If the price is unaffected by the fraud, the price does not reflect the fraud." The Supreme Court did not accept defendant's take on the Fifth Circuit decision, which had expressly and repeatedly spoken of "loss causation." Nor did it address, in dicta or otherwise, whether courts may engage in "price impact" analysis at the class certification stage.

The Supreme Court's decision comes as no surprise. Virtually every other circuit of the Court of Appeals that had considered the issue had rejected the Fifth Circuit's position, and the questioning at the oral argument in the Supreme Court was almost universally hostile to the Fifth Circuit position. But while the holding may not be surprising, the opinion does contain several clarifying statements of law that may prove helpful to litigants in future litigation:

*First*, the Supreme Court provided perhaps its clearest statement of the "loss causation" requirement in the following passage:

The [Fifth Circuit] determined that, in order to invoke a rebuttable presumption of reliance, [Plaintiff] needed to prove that the decline in [Defendant's] stock was 'because of the correction to a prior misleading statement' and 'that the subsequent loss could not otherwise be explained by some additional factors revealed then to the market.' ... This is the loss causation requirement as we have described it.

This statement may help in future cases, because lower courts often have disagreed about what it takes to prove loss causation.

*Second*, in describing the difference between "transaction causation" and "loss causation," the Supreme Court made it clear that a plaintiff must prove **both** forms of causation to win a private Rule 10b-5 action, even though loss causation is not needed to certify a class. As the Court explained, transaction causation is the element of reliance and focuses "on facts surrounding the investor's decision to engage in the transaction," while loss causation "requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss."

## Conclusion

The Supreme Court's *Erica P. John Fund* decision creates no new law, but does provide a succinct and useful summary of the loss causation requirement and the distinction between loss causation and transaction causation in federal securities litigation.

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