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Halliburton: Supreme Court Changes Little About Securities Fraud Class Actions

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In a widely anticipated decision, the Supreme Court upheld a twenty-six-year-old precedent that plaintiffs in securities fraud class actions may satisfy the reliance element by showing that they traded on an "efficient market" presumed to reflect all public material information, including material misstatements. For the first time, the Court also held that defendants may rebut this presumption at the motion for class certification stage with actual evidence that the alleged misrepresentation did not affect the stock price. The decision is likely to increase litigation budgets as both sides commission expensive expert reports on stock prices. Some D&O carriers may seize this development to raise premiums for public companies. Some plaintiffs' counsel may decide not to invest the additional resources required and exit the securities class action business in favor of focusing on other kinds of securities litigation with a lower barrier to entry. Otherwise, the decision will change little about the securities fraud class action landscape.

Unlike Sunday's World Cup match between the United States and Portugal, there was no sudden surprise ending Monday in *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317. Rather, the Court did what most commentators expected: it declined to overrule *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), but held that a defendant may, at the class certification stage, offer evidence to rebut *Basic*'s presumption that the alleged misstatements affected the price of the stock in question.

The Fraud-on-the-Market Presumption

In a private securities fraud action, investors may only recover money damages if they prove they relied on the defendants' misrepresentations in deciding whether to buy or sell a company's stock. In *Basic*, the Court held that investor plaintiffs could satisfy this reliance requirement by invoking the "fraud-on-the-market" theory, i.e., by alleging that investors purchased the stock at the market price and showing that the stock traded in an efficient market reflecting all public, material information, including material misstatements. The *Basic* presumption was in theory rebuttable, for example, by showing that the alleged misrepresentation did not actually affect the stock price (also known as a lack of "price impact"). But few courts seriously entertained such evidence once the plaintiff showed a market to be efficient.

The Supreme Court's Decision

Halliburton demonstrates the importance of the presumption in securities class actions. The case, a putative class action against Halliburton and one of its executives, asserts violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The complaint alleges that defendants made a variety of misrepresentations—ranging from understating Halliburton's anticipated liability in asbestos litigation to overstating its anticipated benefits from a merger—all in an effort to inflate the price of its stock. A later series of corrective disclosures allegedly caused the company's stock price to drop, harming those who had bought at assertedly inflated prices.

Plaintiffs moved to certify a class. The District Court found that the proposed class of investor plaintiffs satisfied all requirements for class certification but one: "loss causation"—a causal connection between the defendants' alleged misrepresentation and the plaintiffs' economic losses. The Court of Appeals for the Fifth Circuit affirmed the decision not to certify the class. In 2011, the Supreme Court reversed, holding that loss causation need not be proved at the class certification stage to invoke the *Basic* presumption.

On remand, defendants argued that a class should not be certified because defendants had rebutted any presumption of price impact, so investors would have to make an individualized showing of reliance on the alleged misrepresentation, rendering class treatment improper. The District Court and Fifth Circuit rejected the argument, held that the *Basic* presumption applied and further found that the class should be certified.

Defendants again petitioned the Supreme Court, which agreed to hear two issues: (1) whether to overturn the *Basic* presumption; and (2) whether securities fraud defendants may rebut the *Basic* presumption at the class certification stage with evidence demonstrating a lack of price impact.

The Court again reversed the Fifth Circuit. This time, it upheld the *Basic* presumption, quoting the original justification for the presumption: direct proof of reliance "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market," thus effectively barring misrepresentation class actions. The Court rejected Halliburton's arguments that the *Basic* presumption was no longer viable given developments in economic theory and that markets are not as "efficient" as *Basic* assumed. The Court reasoned that the principal stock markets are sufficiently affected by public information to justify the *Basic* presumption and that most investors do rely on the integrity of market prices. The Court also declined to overturn *Basic* under the principle of *stare decisis*. Justices Thomas, Scalia and Alito would have relegated *Basic* to the scrap heap of history.

Although the Court left the fraud-on-the-market presumption fundamentally untouched, it did clarify one potentially important point: defendants may defeat the presumption at the class certification stage with evidence that the misrepresentation did not affect the stock price. Noting that plaintiffs themselves can introduce evidence of a price impact through "event studies"—regression analyses that seek to show that the market price of the defendant's stock tends to respond to publicly reported events—the Court reasoned that it would be unfair to bar defendants from demonstrating a *lack* of price impact, particularly when the *Basic* presumption is itself merely an indirect way of showing price impact.

Consequences of *Halliburton*

While *Halliburton* did not do away with the fraud-on-the-market presumption as many companies and the defense bar had hoped, it nonetheless likely will result in some minor changes in the way securities fraud class actions under Section 10(b) and Rule 10b-5 are litigated.

- Class certification motions will now require expert testimony about whether alleged misstatements had any price impact. It will be boom times for experts, who will be retained more often and earlier in securities class actions. This, in turn, will drive up both sides' costs—for experts and for attorney time spent on class certification discovery and motions. D&O carriers may seize upon this development to ratchet up premiums for D&O insurance that provides coverage for securities class actions. Some members of the plaintiffs' securities bar, who are paid on a contingency fee basis, may prefer to concentrate on derivative shareholder litigation or their whistleblower practice instead of having to invest even more resources into class actions.

- Other than in the exceptional case, defendants are unlikely to defeat more class certification motions in their entirety by employing "event studies" post-*Halliburton* than they did with other arguments pre-*Halliburton*. This is even more the case as the plaintiffs' securities bar now will be less inclined to file the marginal cases that are more susceptible to attack due to lack of price impact. What is likely is that defendants will have more success at the class certification stage in narrowing class definitions, eliminating purported misstatements shown not to have caused any price movement and thus materially reducing the potential damages.

- Plaintiffs' counsel may attempt to rely more on alleged omissions and less on alleged misstatements in hopes of avoiding *Basic* altogether in favor of the different presumption created by *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972), which held that proof of reliance is not necessary to support a claim based on omissions. Though neither the Court's opinion nor the concurring opinions in *Halliburton* even mention *Affiliated Ute*, the next wave of securities class action litigation could seize on *Affiliated Ute* in an attempt to recast affirmative misrepresentations as material omissions. Such claims would require proof of a duty to disclose and a larger fraudulent scheme; they also have to overcome other significant legal hurdles presented by Rule 10b-5.

Time will tell if any of these consequences are borne out in practice. For now, however, *Halliburton* looks like evolution, not revolution, in the world of securities fraud litigation.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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