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**SECURITIES****SUPREME COURT**

The U.S. Supreme Court is set to hear oral argument March 5 in *Halliburton v. Erica P. John Fund*, and review the fraud-on-the-market presumption that has become a hallmark of securities fraud class actions, attorney Michelle A. Reed says in this BNA Insight. The author analyzes the issues in *Halliburton II*, their potential outcomes, and the tactics plaintiffs may employ to continue bringing securities fraud claims should the court ultimately reverse or substantially limit the fraud-on-the-market principle established in *Basic v. Levinson*.

**The Sky Is Not Falling: Why Supreme Court Review of *Halliburton* Does Not Forebode the End for Securities Fraud Litigation**

BY MICHELLE A. REED

**T**he petition in *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, (“*Halliburton II*”), condemns the economic theory underpinning the fraud-on-the-market presumption, created in *Basic Inc.*

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*v. Levinson*,<sup>1</sup> as “naive,” “simplistic” and “at war with economic reality.”

Claiming that the theory contravenes Supreme Court precedent, and Rule 23 itself, which requires that class action plaintiffs prove that common issues predominate over individual concerns, the petition calls on the Court to overrule *Basic*, or at least substantially modify the threshold for invoking a presumption of reliance so that plaintiffs seeking class certification are required to prove that the misrepresentations they allege distorted the price of the security at issue. The petition alternatively seeks the Court’s resolution of a circuit split concerning whether defendants may rebut the fraud-on-the-market presumption at the class certification stage.

**Back to the Basics:  
The Fraud-on-the-Market Presumption**

Before a class can be certified in Section 10(b) securities fraud cases, Federal Rule of Civil Procedure 23(b)(3) requires the plaintiff to convince the district court that the element of reliance will not predominate over common class issues. Recognizing that the large class sizes typical to securities fraud class actions would normally make such a showing impossible, the

<sup>1</sup> 485 U.S. 224 (1988).

Supreme Court, in *Basic, Inc. v. Levinson*,<sup>2</sup> held that plaintiffs can establish a presumption of classwide reliance by invoking the “fraud-on-the-market” presumption—i.e., the market price of a security traded in an efficient market incorporates all public and material information available, and therefore that all buyers of that security are presumed to have relied (albeit indirectly) on the truthfulness of that information in deciding whether to purchase. That is, if the fraud-on-the-market presumption applies, the element of common reliance is presumed to have been satisfied because it is assumed that buyers and sellers who rely on the integrity of the market price also necessarily rely on any material misrepresentations reflected in that price.

After the market anomalies following the bursting of the internet bubble and the market crash in 2008, defendants began successfully fighting back against class certification. Defendants argued that plaintiffs could not invoke the presumption because the market was not efficient, or rebutted the presumption by arguing that the alleged misrepresentations did not distort the market price of its stock. Hiring experts at the class-certification stage became commonplace: Experts would regularly battle over whether the market was efficient or whether the misstatements were material. Despite the bluster of the class certification battle, the reality was stark: In less than 2 percent of filed securities litigation cases was class certification denied on the merits.<sup>3</sup>

Defendants fought back on the substance of class certification as well, arguing that plaintiffs should have to prove (or at least make a strong showing) of materiality and loss causation before a class could be certified. The Supreme Court rejected these arguments in two key decisions. In the precursor to the current *Halliburton II* case, the Supreme Court held that plaintiffs were not required to prove loss causation at the class-certification stage.<sup>4</sup> And in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*, the Supreme Court ruled that materiality was not an issue for class certification.<sup>5</sup>

In both of these decisions, some justices signaled that the fraud-on-the-market presumption may be overturned or substantially limited. In *Amgen*, Justice Thomas remarked, “*Basic* is a judicially invented doctrine based on an economic theory adopted to ease the burden on plaintiffs bringing claims under an implied cause of action.”<sup>6</sup> Justice Alito further noted, “[M]ore recent evidence suggests that the presumption may rest on a faulty economic premise. In light of this development, reconsideration of the *Basic* presumption may be appropriate.”<sup>7</sup> Justice Scalia likewise dissented, specially noting the “regrettable consequences” of *Basic*.<sup>8</sup>

<sup>2</sup> *Id.*

<sup>3</sup> Cornerstone Research, *Securities Class Action Filings: 2013 Year in Review*, at 9.

<sup>4</sup> *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185 (2011) (“*Halliburton I*”).

<sup>5</sup> No. 11-1085, 133 S. Ct. 1184 (Feb. 27, 2013).

<sup>6</sup> *Id.* at 1213 (Thomas, J., Kennedy, J., dissenting).

<sup>7</sup> *Id.* at 1204 (Alito, J. concurring).

<sup>8</sup> *Id.* at 1206 (Scalia, J. dissenting) (noting that the *Amgen* “holding does not merely accept what some consider the regrettable consequences of the four-Justice opinion in *Basic*; it expands those consequences from the arguably regrettable to the unquestionably disastrous”).

## Arguments Presented to the Court

In *Halliburton II*, the petitioners present two questions to the Court: (1) whether the fraud-on-the-market presumption should be overturned or substantially limited; and alternatively (2) whether the defendant may rebut the fraud-on-the-market presumption, and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock. Petitioner’s merit brief was joined by 11 amicus briefs.<sup>9</sup>

The petitioners’ principal arguments for overruling *Basic* are that it is fundamentally flawed and at odds with current Supreme Court jurisprudence on class actions. They argue that the academic consensus now rejects *Basic*’s view of market efficiency and in fact supports fundamental inefficiency.<sup>10</sup> They further suggest that *Basic* is at odds with the rigorous class certification requirements set forth in *Comcast Corp. v. Behrend*<sup>11</sup> and *Wal-Mart Stores, Inc. v. Dukes*.<sup>12</sup> The petitioners’ fallback position is that defendants be allowed to rebut the presumption, and in support of this, petitioners stress policy effects. They contend that class certification forces settlement without regard to merit and that class actions poorly compensate investors, fail to deter culpable parties, and consume excessive judicial resources.<sup>13</sup>

The amici in support of petitioners set forth a wide array of arguments. One suggests that plaintiffs should be required to prove actual reliance, analogizing to Section 18(a) of the 1934 Act, and suggesting that this is the most analogous express right (notably, a right that requires proof of actual reliance).<sup>14</sup> They argue that the *Basic* presumption is de facto irrebuttable and has effectively dispensed with the element of reliance under Section 10(b).<sup>15</sup> Other amici suggest that the “event study”—a tool used by economists to determine relationship between movement of stock price and company disclosures—should be the tool used to determine reliance.<sup>16</sup> Still others go so far as to say that proof of price movement upon corrective disclosure does not necessarily demonstrate that the alleged misrepresenta-

<sup>9</sup> See Br. for the Am. Inst. of Certified Pub. Accountants in Supp. of Pet’rs; Br. for Amgen Inc. in Supp. of Pet’rs; Br. for Chamber of Commerce of the U.S. of Am., Nat’l Ass’n of Mfrs., Pharm. Research and Mfrs. of Am., and Bus. Roundtable in Supp. of Pet’rs; Br. for the Comm. on Capital Markets Regulation in Supp. of Pet’rs; Br. for DRI—The Voice of the Defense Bar in Supp. of Pet’rs; Br. for Former SEC Comm’rs and Officials and Law Professors in Supp. of Pet’rs; Br. for Law Professors in Supp. of Pet’rs; Br. for the Sec. Indus. and Fin. Mkts. Ass’n in Supp. of Pet’rs; Br. for Vivendi S.A. in Supp. of Pet’rs; Br. for the Washington Legal Found. in Supp. of Pet’rs; and Br. for Former Members of Congress, Senior SEC Officials, and Congressional Counsel in Supp. of Neither Party.

<sup>10</sup> Br. for Pet’rs at 15-21.

<sup>11</sup> 133 S. Ct. 1426 (2013) (holding that certification is improper when proponents do not actual “establish[]” predominance under Rule 23(b)(3)).

<sup>12</sup> 131 S. Ct. 2541 (2011) (requiring putative class to “affirmatively demonstrate . . . compliance” with Rule 23 and “prove . . . in fact” that the issuers were common).

<sup>13</sup> Br. for Pet’rs at 40-45.

<sup>14</sup> Br. for Former SEC Comm’rs and Officials and Law Professors as Amici Curiae Supp. Pet’rs at 13-20.

<sup>15</sup> *Id.* at 22.

<sup>16</sup> Br. of Law Professors as Amici Curiae in Supp. of Pet’rs at 24-34.

tion affected the market price.<sup>17</sup> Many of the other amici stress the policy effects of the current *Basic* regime.<sup>18</sup>

The respondents emphasize *stare decisis* and congressional inaction as the first-line reasons why *Basic* should not be overruled.<sup>19</sup> They argue that overruling *Basic* “could mean the demise of private securities actions and the deterrent and compensatory role they serve.”<sup>20</sup> They note that numerous SEC regulations and the practice of proving market effects through event studies are premised on efficient markets—that securities prices react to material information.<sup>21</sup> They then conclude that *Basic* should not be modified to allow courts to evaluate price impact at class certification, suggesting instead that this is a summary judgment inquiry.<sup>22</sup>

The respondents have lined up their cavalry, with 11 amici in their support.<sup>23</sup> Even the famed author of the Efficient Capital Markets Hypothesis itself—Eugene Fama—has submitted an amicus brief arguing that disagreement among economists concerning the extent to which stock prices reflect underlying values is not the same as a disagreement over whether prices respond to information.<sup>24</sup> That simple proposition underlying *Basic*, Professor Fama and others argue, is overwhelmingly accepted in academic literature.<sup>25</sup>

The amici for respondents emphasize that *stare decisis* and policy considerations support maintaining the presumption. A group of U.S. senators and representatives submitted an amicus brief in support of respondents, outlining much of the legislative history of the PSLRA, and noting that proposed bills that would have eliminated the fraud-on-the-market presumption were rejected by Congress.<sup>26</sup> The Department of Justice and former SEC Chairmen have added their voices to the chorus of briefs arguing that private securities litigation

is an “essential supplement” to civil and criminal proceedings.<sup>27</sup>

State attorneys general from 22 states and territories agree and state that class actions are an essential enforcement tool, particularly where regulators’ resources are limited.<sup>28</sup> With 22 amicus briefs and heavy hitters on both sides, there is no doubt that the Supreme Court’s decision in *Halliburton II* may change the face of securities litigation for years to come.

## Future of Securities Litigation

While many commentators—and the respondents themselves—have argued that a win for *Halliburton* would signal an end of securities class actions as we know it, it is unlikely that will be the case. There are numerous strategies that plaintiffs may employ to continue bringing securities fraud claims should the Court ultimately reverse or substantially limit the fraud-on-the-market principle.

### Affiliated Ute Presumption

Securities class action plaintiffs are likely to turn to the *Affiliated Ute* presumption,<sup>29</sup> which allows reliance to be presumed in omission cases; that is, where plaintiffs allege that companies failed to disclose information that was required to be disclosed by law, reliance is presumed. The amicus brief submitted by Vivendi S.A. wards against this approach, as it details the actual pre-trial, trial, and post-trial proceedings of the securities class action against Vivendi.<sup>30</sup>

In *Vivendi*, the plaintiffs failed to prove at trial that individual public statement made by Vivendi corresponded to a change in Vivendi’s stock price.<sup>31</sup> Plaintiffs then argued that everything became a single omission that spanned two years.<sup>32</sup> Plaintiffs were not required to identify any misleading statements and in fact the jury returned a verdict against Vivendi, using the “materialization of risk method,” which “allowed the plaintiffs to rely on ‘revealing events that negatively affect stock price’ and ‘do not identify prior company statements as misleading.’”<sup>33</sup> From a plaintiff perspective, this approach may simplify matters, where they are not required to plead with particularity actual false and misleading statements and instead may simply rely on omissions.

### Institutional or Large Investor Private Actions

The rise of the institutional or large investor private actions in recent years has been substantial and this may be the de facto effect of an overruling of *Basic*. Co-

<sup>17</sup> Br. of the Sec. Indus. & Fin. Markets Ass’n as Amicus Curiae in Supp. of Pet’rs at 22-23.

<sup>18</sup> Br. of Am. Inst. of Certified Pub. Accountants (detrimental effect on accountants); Br. of Chamber of Commerce (excessive costs for businesses and hampered capital markets); Br. of Comm. on Capital Markets Regulation (significant costs on U.S. corporations and their shareholders and undermine competitiveness of U.S. capital markets)

<sup>19</sup> Br. for Resp’ts at 11-23.

<sup>20</sup> *Id.* at 24.

<sup>21</sup> *Id.* at 27.

<sup>22</sup> *Id.* at 50-55.

<sup>23</sup> Br. for AARP and N.A. Sec. Admin. Ass’n, Inc., in Supp. of Resp’ts; Br. for Civil Procedure Scholars in Supp. of Resp’ts; Br. for the Council of Institutional Investors et al. in Supp. of Resp’ts; Br. for Current and Former Members of Congress and Staff in Supp. of Resp’ts; Br. for Fin. Economists in Supp. of Resp’ts; Br. for Former SEC Chairmen William H. Donaldson and Arthur Levitt Jr. in Supp. of Resp’ts; Br. for Institutional Investors in Supp. of Resp’ts; Br. for Sec. Law Scholars in Supp. of Resp’ts; Br. for the States of Oregon, Connecticut, Pennsylvania, Washington, Arkansas, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Mississippi, Missouri, New Mexico, New York, North Carolina, North Dakota, Rhode Island, Tennessee, Vermont, and Territory of Guam in Supp. of Resp’ts; Br. for Testifying Economists in Supp. of Resp’ts; Br. for the United States in Supp. of Resp’ts.

<sup>24</sup> Br. for Fin. Economists in Supp. of Resp’ts.

<sup>25</sup> *Id.*

<sup>26</sup> Brief for Current and Former Members of Congress and Staff in Support of Respondent.

<sup>27</sup> Brief for Former SEC Chairmen William H. Donaldson and Arthur Levitt Jr. in Support of Respondent; Brief for the United States in Support of Respondent.

<sup>28</sup> Brief for the States of Oregon, Connecticut, Pennsylvania, Washington, Arkansas, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Mississippi, Missouri, New Mexico, New York, North Carolina, North Dakota, Rhode Island, Tennessee, Vermont, and Territory of Guam in Support of Respondent.

<sup>29</sup> *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

<sup>30</sup> Br. for Vivendi S.A. as Amicus Curiae in Supp. of Pet’rs.

<sup>31</sup> *Id.* at 14.

<sup>32</sup> *Id.* at 14-15.

<sup>33</sup> *Id.* at 16 (quoting *In re Vivendi Universal, S.A. Sec. Litig.*, 765 F. Supp. 2d 512, 555 (S.D.N.Y. 2011)).

lumbia Law Professor John Coffee called the emergence of the large class action opt-outs “probably the most significant new trend in class action litigation.”<sup>34</sup> A recent report evaluated 1,272 securities class action settlements between 1996 and 2011 and found that a plaintiff opted out and pursued a separate suit in just 3 percent of the cases.<sup>35</sup> As the size of the class action settlement grew larger, however, “the propensity of plaintiffs to bring an opt-out case also increas[ed].”<sup>36</sup> For settlements over \$20 million, 10 percent of the cases had opt out litigation. And for settlements over \$500 million, more than 50 percent of the cases had opt out litigation.<sup>37</sup>

It is unclear whether such opt out litigation was financially rewarding for plaintiffs because such settlements do not have the public scrutiny of the class action judicial approval process. Anecdotal information and the sheer percentage of opt out suits in high-dollar settlement cases suggest that such litigation was likely profitable for large investors.

Should the court overturn *Basic*, it is likely that large investors will pursue private actions individually. This may lead to splintered litigation across multiple jurisdictions and also may leave smaller investors with little to no remedy.

### Multidistrict Litigation

Given the big business of securities litigation, it is unlikely that plaintiff lawyers will abandon securities suits altogether in the wake of a ruling overruling or substantially limiting *Basic*. The federal courts will continue to have exclusive jurisdiction over any Section 10(b) claim and there will continue to be common issues in any securities proceeding. Plaintiffs may consider the use of

multi-district litigation procedures to coordinate discovery and other pre-trial processes for actions involving smaller investors.

Pursuant to 28 U.S.C. § 1407, civil actions with one or more common questions of fact that are pending in different districts may be transferred for coordinated or consolidated pretrial proceedings. The judicial panel on multidistrict litigation authorizes such transfers upon determining that consolidated pretrial proceedings will be convenient for parties and witnesses and promote just and efficient resolution. The actions are then remanded by the panel at or before the conclusion of such pretrial proceedings to the district from which it was transferred. The multi-district procedure would enable smaller investors to pursue their claims, banding together for cost-savings for the bulk of the proceedings. In reality, few securities class actions are tried even under the current class action mechanism.<sup>38</sup> It is likely under the MDL procedure, securities actions would simply settle in a different context, and likely with greater expense to defendants.

### Conclusion

The stakes are high for both sides in *Halliburton II*, but the defense attempt to overrule *Basic* may ultimately result in a new, expensive world of litigation for corporate defendants. Instead of facing a single lead plaintiff, corporate defendants may face multiple suits from institutional investors or costly MDL proceedings of smaller investors.

Even the omission-based approach of *Affiliated Ute* may result in the challenges faced by *Vivendi*, where traditional loss-causation defenses are lost in the “materialization of risk method” of calculating damages. The Supreme Court’s decisions in *Halliburton I* and *Amgen* sent strong signals that change is on the horizon. For now, companies must simply stand by to see the new world of securities litigation that awaits.

<sup>34</sup> John C. Coffee, Jr., *Accountability and Competition in Securities Class Actions: Why ‘Exit’ Works Better Than ‘Voice,’* Columbia Working Paper No. 329 (July 2, 2008).

<sup>35</sup> Cornerstone Research, *Opt-Out Cases in Securities Class Action Settlements* (Nov. 19, 2013).

<sup>36</sup> *Id.* at 3.

<sup>37</sup> *Id.*

<sup>38</sup> Br. of Pet’rs at 41 (noting that of the 3,988 securities class actions filed from the enactment of the Private Securities Litigation Reform Act through 2012, only 14 went to verdict).