

Securities Litigation Alert

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Everybody Wins: The Supreme Court Upholds the Fraud-on-the-Market Presumption of Reliance But Allows Defendants to Fight Back

On Monday, the U.S. Supreme Court saved securities class-action plaintiffs from their worst nightmare and upheld the fraud-on-the-market presumption of reliance in securities class actions filed under Section 10(b) of the Securities Exchange Act of 1934. At the same time, however, the Court ruled that defendants have a right to rebut the presumption *before* class certification with evidence of lack of price impact. *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, 573 U.S. __ (June 23, 2014).

In an [opinion](#) by Chief Justice Roberts, joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor and Kagan, the Supreme Court declined to overrule the fraud-on-the-market presumption of reliance established in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), but interpreted it to allow for certification-stage rebuttal. Justice Thomas, joined by Justices Scalia and Alito, concurred in the judgment but argued that *Basic's* fraud-on-the-market presumption should be overturned.

Background

The securities fraud case against Halliburton was brought by lead plaintiff Erica P. John Fund, a nonprofit supporting the Catholic Archdiocese of Milwaukee. Plaintiff claimed that Halliburton misrepresented the company's legal exposure from asbestos claims, improperly accounted for certain contracts and overstated the benefits of a merger. The U.S. Court of Appeals for the 5th Circuit affirmed the district court's grant of class certification, finding plaintiff had properly invoked the "fraud on the market" presumption and holding that the decision in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds* (No. 11-1085) (Feb. 27, 2013) precluded defendants from presenting evidence of no price impact to rebut the presumption.

In the precursor to the current *Halliburton* case, the Supreme Court held that plaintiffs were not required to prove loss causation at the class-certification stage. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185 (2011). And in *Amgen*, the Supreme Court ruled that materiality was not an issue to be decided at class certification. By contrast, the Court's decisions in *Wal-Mart Stores, Inc. v. Dukes*, 564 U.S. __ (2011), and *Comcast Corp. v. Behrend*, 569 U.S. __ (2013), held that plaintiffs must actually prove—not simply plead—that the proposed class satisfied each requirement of Rule 23. *Halliburton* thus set the stage for a decision on whether the presumption of reliance would survive, and, if so, whether defendants could introduce evidence of price impact at the class-certification stage.

Opinion

In an opinion heralded by both sides as a victory, the Court upheld the fraud-on-the-market presumption of reliance, finding that no special circumstances existed to overturn the presumption. The Court reasoned that many of defendant's arguments for overturning the presumption were considered and

rejected by the *Basic* court. But in accepting defendant's fallback argument, the Court also held that defendants are permitted to rebut the presumption at the class-certification stage through evidence of the lack of price impact.

To prevail under Section 10(b), an investor must prove that it relied on the misrepresentation at issue. Proof of individual reliance by hundreds or thousands of investors would be all but impossible (especially at the class-certification stage), if not for the presumption of reliance created in *Basic*. The *Basic* Court reasoned that under the efficient-market theory, stock prices reflect all material, publicly available information. Assuming such a market, plaintiffs should not be required to prove one-by-one that they relied on a particular misstatement. Instead, because the information should already be reflected in the price of the stock, the investor would be entitled to a presumption that it relied on the misstatement. In *Halliburton*, applying *stare decisis* principles, the Court rejected the invitation to overrule that presumption because no "special justification" warranted departure from *Basic*.

The Court placed the burden of proving the predicates for the presumption on plaintiffs: "a plaintiff satisfies that burden by proving the prerequisites for invoking the presumption—namely, publicity, materiality, market efficiency and market timing. The burden of proving those prerequisites still rests with plaintiffs and (with the exception of materiality) must be satisfied before class certification."

At the same time, the Court held that defendants should be afforded the opportunity to rebut the presumption. Noting that market efficiency serves as an "indirect proxy" for price impact, the Court reasoned that such an indirect proxy "does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply."

Distinguishing *Amgen*, which held that evidence of price impact to establish materiality was *not* appropriately considered at the class-certification stage, the Court reasoned that such evidence was already necessary to establish the publicity and market-efficiency prerequisites, which go to Rule 23's predominance requirement. So it made no sense to artificially limit evidence of price impact to rebut the presumption directly.

Justices Ginsburg, Breyer and Sotomayor issued a concurring opinion "on the understanding" that though the scope of discovery may be broadened, defendants bear the burden "to show the absence of price impact" and "therefore, should impose no heavy toll on securities-fraud plaintiffs with tenable claims."

Justices Thomas, Scalia and Alito concurred in the judgment only. They argued that "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains. *Basic* should be overruled."

Future Implications

The *Halliburton* decision will almost certainly spawn significant litigation in lower courts over the extent in practice of plaintiffs' burden to prove market efficiency, defendants' burden to rebut it and implications on loss causation.

The Court's decision raises more questions than answers for what plaintiffs must do to prove market efficiency. The decision makes no mention of *Cammer v. Bloom*, 711 F. Supp. 1263 (D.N.J. 1989), an opinion relied on by both plaintiffs and defendants nationwide in assessing market efficiency. The dictum in Chief Justice Roberts' opinion that "market efficiency is a matter of degree" could be argued by some plaintiffs to require only loose proof of market efficiency.

Plaintiffs will likely use the Court's discussion of the efficient capital markets hypothesis to bolster their loss-causation arguments. The Court indicated that information need only be incorporated "within a reasonable period." Plaintiffs may see this as a tacit endorsement of "leakage" theory, where the stock price slowly declines as the information is leaked to the market in pieces. They will also likely use the Court's citation to *Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010), as an endorsement of "maintenance" theory: the idea that the alleged misrepresentations falsely confirmed market expectations, keeping the price steady when it should have declined.

Ultimately, the question of whether defendants should introduce evidence of the lack of price impact to rebut the presumption at the class-certification stage will be a critical one. At the class-certification stage, the burden of disaggregation of confounding information contained in the corrective disclosure would be on defendants; at summary judgment or trial, however, that burden would fall on plaintiffs. If successful, defendants could significantly limit any future exposure by defeating class certification and could even win on the merits: if the Court finds no price impact, then the suit arguably fails for lack of materiality too. But if unsuccessful, the cost of settlement will likely increase with emboldened plaintiffs.

For now, the *Halliburton* decision is considered a victory by both sides, but that will almost surely change depending on how difficult it is in practice for defendants to satisfy the burden of rebutting the presumption.

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