CLIENT UPDATE

SUPREME COURT UPHOLDS "FRAUD ON THE MARKET" PRESUMPTION BUT ALLOWS EVIDENCE OF LACK OF PRICE IMPACT AT THE CLASS CERTIFICATION STAGE

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On June 23, 2014, the U.S. Supreme Court issued its much anticipated decision in *Halliburton Co. v. Erica P. John Fund*, No. 13-317, 2014 WL 2807181. Although the Court declined to overrule the "fraud on the market" presumption of reliance adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), it held that a defendant may rebut that presumption at the class certification stage by introducing evidence that the alleged misrepresentation did not affect the stock price. The *Halliburton* decision does not fundamentally transform securities class action litigation, but it does arm defendants with a potentially important new weapon to defeat class certification in certain cases.

THE *BASIC* PRESUMPTION OF RELIANCE

In *Basic v. Levinson*, the Court held that plaintiffs asserting claims under Rule 10b-5 may – in most circumstances involving publicly traded securities – satisfy the reliance element of a Section 10(b) action by means of a rebuttable "fraud on the market" presumption.[1] This presumption was predicated upon the "efficient capital markets hypothesis" – an economic theory positing that "the market price of shares traded on well-developed markets reflects all publicly

[1] To establish liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, a plaintiff must prove "(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." *Stoneridge Inv. Partners, LLC v. Sci.-Atlanta*, 552 U.S. 148, 157 (2008).

available information," including "any material misrepresentations," and on the premise that an "investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Basic*, 485 U.S. at 246. According to *Basic*, "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action." *Id.* at 247. This rebuttable presumption is crucial to a plaintiff's ability to maintain a class action because, without it, each member of the purported class would have to offer proof of individualized reliance, and the requirement under Rule 23 that common issues of fact and law predominate over any questions affecting only individual members would not be satisfied. Plaintiffs invariably invoke the presumption of reliance in seeking to certify a class in securities fraud cases.[2]

THE *HALLIBURTON* DECISION

In *Halliburton*, the Court considered two related questions: *First*, whether *Basic*'s "fraud on the market" presumption of reliance should be overruled or substantially modified. *Second*, whether a defendant may rebut the presumption and defeat class certification by introducing evidence that the alleged misrepresentations did not distort the market price of defendant's stock.

In an opinion by Chief Justice Roberts, joined by five other justices, the Court declined to overrule or modify the "fraud on the market" presumption. The Court considered and rejected Halliburton's argument that numerous studies have cast doubt on the reliability of the "efficient capital markets hypothesis," noting that "[e]ven the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices." *Halliburton* at 10. The Court stated that "*Basic* recognized that market efficiency is a matter of degree." *Id.* The Court also rejected Halliburton's argument that investors do not rely on the integrity of the market price when buying stock. Investors, Halliburton argued, frequently make investment decisions believing that shares are undervalued or overvalued and therefore present an opportunity to profit. The Court observed, however, that even such investors rely "on the fact that a stock's market price will eventually reflect material information" – generating the market correction that

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[2] In order for the presumption to apply to a particular case, *Basic* required the plaintiff to demonstrate that (1) the alleged misrepresentations were publicly known, (2) they were material, (3) the stock traded in an efficient market, and (4) the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed. *See id.* at 248 n.27. Aside from materiality, plaintiffs bear the burden of proving the other prerequisite elements of the presumption at the class certification stage. In a handful of cases, defendants have successfully defeated class certification by challenging the sufficiency of plaintiffs' evidence, especially as it related to market efficiency. See, *e.g.*, *George v. China Auto. Sys., Inc.*, 2013 WL 3357170 (S.D.N.Y. July 3, 2013) (denying class certification where plaintiffs failed to establish that the stock traded in an efficient market).

eventually allows the investor to profit. *Id.* at 12. Having rejected these arguments, the Court concluded that Halliburton had not set forth the "special justification" necessary for the Court to overrule long-settled precedent, particularly in light of the fact that Congress has shown a willingness to address policy concerns in the area of securities litigation. *Id.* at 4, 12-16.

Justices Thomas, joined by Justices Scalia and Alito, argued in an opinion concurring in the judgment that *Basic* was wrongly decided and should be overruled – in particular because, in their view, the efficient capital markets hypothesis had been discredited by recent studies of economic behavior.

Although the Court rejected Halliburton's frontal assault on *Basic*, it nevertheless agreed that a defendant should be allowed to rebut the presumption of reliance at the class certification stage by producing evidence that any alleged misrepresentations did not affect the stock price. Prior to *Halliburton*, a defendant was limited at the class certification stage to challenging the prerequisites for the presumption – usually whether the market for the shares was efficient – and could not directly address price impact until the merits stage. This restriction, the Court held, "makes no sense." *Id.* at 19. "Under Basic's fraud-on-the-market theory, market efficiency and the other prerequisites for invoking the presumption constitute an indirect way of showing price impact. . . . [I]t is appropriate to allow plaintiffs to rely on this indirect proxy for price impact . . . [b]ut an indirect proxy should not preclude direct evidence when such evidence is available." *Id.* at 20.[3]

SIGNIFICANCE FOR SECURITIES LITIGATION

The *Halliburton* decision makes clear that defendants can attack class certification by offering evidence that an alleged misrepresentation did not actually affect the market price of the stock. As a result, the *Halliburton* decision is certain to increase defendants' focus on class certification as a substantial obstacle for putative securities class actions. Moreover, because evidence relating to price impact will often include statistical analyses, such as "event studies," class certification will likely involve expert opinions – increasing the costs of discovery in connection with class certification.

It remains to be seen whether this new basis for defendants to attack class certification will lead to a substantial increase in the frequency of defense victories at that stage. The decision is likely, however, to encourage more defendants to contest class certification vigorously rather than pursuing settlement when a complaint survives a motion to

[3] Despite the potential significance of *Halliburton*, it is important to bear in mind that the decision does not apply to claims under sections 11 and 12(a)(2) of the Securities Act of 1933, as those claims do not include an element of reliance.

dismiss, particularly when defendants believe – based on statistical analysis or an events study – that their chances of rebutting the presumption of reliance are strong.

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Please do not hesitate to contact us with any questions.

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