CLIENT UPDATE

SUPREME COURT TO REVIEW "FRAUD ON THE MARKET" PRESUMPTION OF RELIANCE IN SECURITIES CLASS ACTIONS

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On November 15, 2013, the U.S. Supreme Court agreed to consider two questions that have the potential to transform the landscape of private securities litigation. Specifically, the Court granted a petition for a writ of certiorari in *Halliburton Co. v. Erica P. John Fund* and agreed to review: (i) whether the "fraud on the market" presumption of reliance adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) should be overruled or substantially modified; and (ii) whether, in a class action, a defendant may rebut the presumption and defeat class certification by introducing evidence that the alleged misrepresentations did not distort the market price of the defendant's stock. In the twenty-five years since *Basic*, the "fraud on the market" presumption has been a lynchpin of private securities class actions, allowing plaintiffs to submit common proof of reliance on the theory that individual investors rely upon the integrity of a stock's trading price and, when the stock trades in an efficient market, the market price reflects all public information, including any alleged material misstatements. *See Basic, Inc.*, 485 U.S. at 241–42.

This much watched case is widely regarded as a potential game-changer for securities litigation, because plaintiffs would have only a limited prospect of successfully supporting class certification in securities fraud cases if each class member's individual reliance on alleged misstatements was at issue. Absent class action status, plaintiffs likely would find the pursuit of securities cases impractical.

BACKGROUND

In *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 12-10544, 2013 WL 1809760 (5th Cir. Apr. 30, 2013), the United States Court of Appeals for the Fifth Circuit held that a defendant in a securities fraud class action is not entitled to rebut the "fraud on the market" presumption of reliance at the class certification stage by showing the alleged misstatement had no effect on the defendant's stock price. In so holding, the Fifth Circuit applied the same analysis the Supreme Court developed in *Amgen Inc. v. Connecticut Ret. Plans and Trust Funds*, 133 S. Ct. 1184 (2013), where the Court held that class action securities fraud defendants have no right to rebut the "fraud on the market" presumption at the class certification stage by introducing evidence showing the alleged misstatements were not material. The Fifth Circuit's opinion in *Halliburton* extends *Amgen* by further limiting the rebuttal evidence a district court may consider at the class certification stage.

CRITICISM OF THE "FRAUD ON THE MARKET" PRESUMPTION

The "fraud on the market" presumption articulated in *Basic* has been widely criticized from the outset. The Court's adoption of the presumption in *Basic* itself found the support of only four justices (which constituted a majority of the Court due to recusals). Moreover, in the years since *Basic*, more and more economists have questioned the "efficient market hypothesis" that undergirds the "fraud on the market" presumption, abandoning a strictly rational economic model in favor of behavioral economics. Many of these economists focus on the seeming irrationality of the markets at various times. In the recent economic crisis, for example, many have questioned how a housing market "bubble" could have formed if the market were truly efficient. A similar criticism could be based on the bursting of the technology bubble in the early 2000s. In fact, one highly regarded work called the idea of a "rational market" a "myth."

All of these perspectives seem to recognize that securities prices may not be as tied to the factual information in the market as the "efficient market hypothesis" assumes. In particular, market prices for securities, although they may be closely tied to available factual information, also reflect individual judgments about the importance of that information to the future prospects and performance of the company. Market prices reflect not only the influence of factual information about past performance and events at a company, but also evaluations about what those past events mean for the future.

In light of these emerging doubts about the "efficient market hypothesis," Justice Thomas, joined by Justices Scalia and Kennedy, dissented in *Amgen* by raising doubts about the viability of the "fraud on the market" theory. Justice Thomas's argument echoed the dissent by Justices White and O'Connor in *Basic*, that "the Court is not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory." Justice Alito, concurring in *Amgen*, also said that the time may be right to reconsider *Basic*. Indeed, even the majority in *Amgen* acknowledged that modern economic research tends to show that market efficiency is not a simple "binary" matter—rather, "differences in efficiency can exist within a single market." The majority nevertheless sidestepped the question, finding the *Amgen* case a "poor vehicle to explore" the issue, because the defendant in that case had conceded in its answer that the market for its securities was efficient.

SIGNIFICANCE FOR SECURITIES CLASS ACTION LITIGATION

The potential implications of this appeal on securities class action litigation are significant. Almost all securities class actions invoke *Basic*'s "fraud on the market" presumption of reliance in seeking class certification. Without the presumption, securities litigation plaintiffs would have to affirmatively establish that class-wide reliance is susceptible to common proof in order to achieve class certification under Federal Rule of Civil Procedure 23. Private securities fraud claims, however, hinge on individual investors' investment decisions by their very nature. As a result, in the absence of a "fraud on the market" presumption, almost no private securities litigation could be certified as a class action due to the predominance of individualized issues of reliance.

Even if the *Basic* presumption is upheld, the second question before the Court—whether a defendant may defeat the presumption by introducing evidence that the alleged misstatements had no effect on stock price—is also of great consequence to issuers. Defendants have successfully contested an increasing number of issues at the class certification stage of individual cases, including the efficiency of the market in which a defendant's stock trades. *See, e.g., George v. China Auto. Sys., Inc.*, 2013 WL 3357170 (S.D.N.Y. July 3, 2013) (denying class certification where defendants introduced evidence that market for securities was not efficient). Allowing price-impact evidence to rebut the "fraud on the market" presumption of reliance at the class certification stage would add another important line of argument for defendants battling class certification.

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Please do not hesitate to contact us with any questions.

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