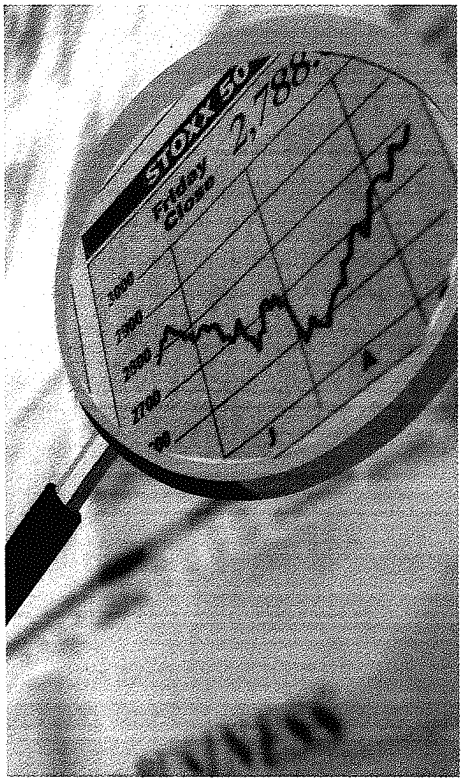
U.S. Supreme Court Reaffirms the Fraud-on-the-Market Presumption of Reliance in Securities Class Actions

by William A. Despo

In *Halliburton Co. v. Erica P. John Fund, Inc.*[1] (*Halliburton II*[2]), the U.S. Supreme Court was presented the opportunity to reexamine its ruling in *Basic v. Levinson*[3] that permits a securities class action plaintiff to use the presumption of fraud-on-the-market in order to satisfy the element of reliance in Section 10(b) claims against defendants. The *Basic* presumption applies class wide and discharges a plaintiff from establishing actual proof of common reliance among all class members. It presumes that all class members purchased their shares at a misleading price due to alleged misrepresentations by the defendant.



The plaintiff must establish four elements in order to apply the presumption: 1) the alleged misrepresentation was publicly known; 2) the misrepresentation was material; 3) the stock was traded in an efficient market; and 4) the plaintiff traded the stock between the time the misrepresentation was made and when the truth was revealed.

The Supreme Court declined to overturn *Basic*, but resolved a circuit conflict by confirming that, under *Basic*, defendants can challenge and defeat the presumption at the class certification state, while raising new issues for lower courts to resolve.

The Details of the Case

Erica P. John Fund, Inc. was the lead plaintiff in a securities class action against Halliburton Co, Inc. The fund alleged Halliburton misrepresented certain financial results. Following the release of negative news, the price of its stock dropped. The district court certified the class action, and the Fifth Circuit affirmed the district court's ruling to certify the fund's class.

The district court declined to consider 'price impact' evidence at the certification stage, and found common issues predominated under Rule 23(b)(3).[4] Halliburton argued before the Fifth Circuit that the district court should not have certified the class because the alleged fraud did not affect the market price of the stock, and that the fund was not entitled to rely on the fraud-on-the-market presumption. The Fifth Circuit reasoned that price impact evidence does not bear on the question of common predominance, and should be considered only at the merits stage.[5]

Basic addressed a public policy concern that defrauded purchasers of common stock in the open market transaction should be permitted to employ class actions in order to recover for losses incurred as a result of the fraud by a public company. Purchasers of common stock can bring private securities action under federal law to recover for fraudulent losses.[6] Section 10(b) of the Securities Exchange Act of 1934, as amended,[7] and the Securities Exchange Commission Rule 10(b)-5[8] prohibit false material statements in connection with the purchase or sale of a security.

A private securities plaintiff needs to establish six elements in a 10b-5 cause of action: 1) a material misrepresentation, 2)

scienter, 3) a connection with the purchase or sale of a security, 4) reliance, 5) economic loss, and 6) loss causation.[9] The *Basic* Court considered that too much burden would be placed on a securities fraud plaintiff who purchased stock on an impersonal stock market to prove reliance, without some accommodation. Proof of direct reliance by each plaintiff would significantly hinder certification of securities class actions.

Fraud-on-the-market presumption was the accommodation in *Basic*. The presumption assumes an open and developed market that reflects available information about a company.[10] *Basic* presumed the market "acts as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."[11]

Analysis

Since the *Basic* decision, academic research has questioned whether the capital market is fundamentally efficient. The *Halliburton II* Court was asked by Halliburton to overturn the premise espoused in *Basic*; namely, that if an efficient market exists, a securities fraud plaintiff can meet the evidentiary burden of reliance with the fraud-on-the-market theory. Halliburton asserted that *Basic* should not be followed because academic research shows that *Basic* was premised on a faulty assumption that markets operate efficiently. The fund argued that *Basic* is well settled, and that without *Basic* class actions could not be brought in 10(b) and 10(b)-5 cases. Congress also had the opportunity to overturn *Basic*, but failed to do so in enacting the Private Securities Litigation Reform Act of 1995.[12]

The *Halliburton II* Court was not persuaded by Halliburton's arguments, and affirmed *Basic*'s fraud-on-the-market presumption. However, importantly for Halliburton and for similarly situated defendants in other securities actions, the Court also ruled that Halliburton could rebut the presumption at the certification stage by showing a lack of price impact.

The Court interpreted Halliburton's argument that some markets for securities are more efficient than the market for others, and that Halliburton was not suggesting capital markets are always inefficient. The Court noted that the debate about an efficient market is not new and that the *Basic* Court acknowledged the disagreement and refused to be the judge of the debate. The Court reasoned it was not equipped to make a determination of the various views debated among the economists and social scientists, and that *Basic* adopted a middle ground in adopting a rebuttable presumption that the market operates efficiency.

The Court also declined to espouse Halliburton's argument that investors do not invest based on the integrity of the market, such as value investors. The Court noted *Basic* did not deny the existence of such investors, and had concluded that most investors rely on the integrity of the market price. However, the right to rebut the presumption provides a means to address the issue, and Halliburton can challenge specific plaintiffs.

The Court found *Basic* did not contradict recent Supreme Court decisions that require strict compliance with Rule 23, and does not provide an "escape hatch" for 10b-5 plaintiffs. Halliburton had argued that in the *Dukes* matter[13] the Court required a class action plaintiff to prove issues were in common for the entire class. However, the Court reasoned that *Basic* does not require proof of common reliance among class members, since the fraud-on-the-market presumption does away with common proof of reliance. According to the Court, in securities class actions the crucial requirement in class certifications remains the predominance element of Rule 23(b)(3). *Basic* did not relieve the securities plaintiff of the burden of proving predominance. However, *Basic* provided another roadmap under the fraud-on-the-market theory to prove predominance by establishing publicity, market efficiency, and market timing at the class certification stage.

While the fraud-on-the-market presumption does not require the plaintiff to prove the alleged misrepresentation impacted the price of the stock, the plaintiff still must establish that the defendant's misrepresentation was public, material and that the stock traded on an efficient market, through expert testimony.[14]

Conclusion

The Court confirmed that, at the class certification stage, the defendant may present rebuttal evidence to the effect that the alleged misrepresentation did not impact the price of the stock. Since *Basic*'s fundamental premise is that the misrepresentation impacted the price of the stock, price impact evidence goes to the predominance issue at the class certification stage. Consequently, the certification stage will involve more intensive discovery, experts for price impact, and a more rigorous inquiry by the court.

To what extent *Halliburton II* impacts other aspects of securities class actions, such as loss causation,[15] remains a question for the future. Nonetheless, *Halliburton* represents a significant decision for defendants in that it provides defendants another argument to defeat a class certification motion and an incentive to seek an early class certification determination. The practical effect of *Halliburton* on plaintiffs is increased costs due to the need to evaluate price impact and additional discovery costs. Nevertheless, the actual application of *Halliburton II* may be more theoretical because plaintiffs' burden at the class certification stage is

modest, and depends on the nature of the price movement of the stock at the time of the misrepresentation and at the time the truth is disclosed.[16] ⚖

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ENDNOTES

1. 134 S. Ct. 2398 (2014).
2. *Halliburton II* is the second time the Supreme Court decided an issue in this case. In 2011, the Court reversed the Fifth Circuit finding that the loss causation is not required to be shown for certification. 131 S. Ct. 2179 (2011) (*Halliburton I*).
3. 485 U.S. 224 (1988).
4. Federal Rule of Civil Procedure 23(b)(3) provides, in part, that a class action may be maintained if the court finds that questions of law or fact common to the class members predominate.
5. Halliburton had conceded that the fund had met the conditions of F.R.C.P. Rule 23(a) that a plaintiff must demonstrate numerosity, commonality, typicality, and adequacy of representation. The only issue remaining in the certification stage was whether common questions predominate.
6. *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723 (1975).
7. 15 U.S.C. § 78j(b).
8. 17 C.F.R. § 240.10b-5.
9. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005).
10. Also referred to as the efficient market theory.
11. *Basic*, 485 U.S. at 244.
12. Pub.L. No. 104-67, 109 Stat. 737; *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184, 1201 (2013).
13. 131 S. Ct. 2541 (2011).
14. Factors to be considered for the efficient market include: 1) the average weekly trading volume during the class period: 2) the number of security analysts who followed the company; 3) the number of market markers; 4) whether the company is entitled to file an S-3 registration statement: and 5) proof of cause and effect relationship between unexpected corporate events and the response in the stock price. *Cammer v. Bloom*, 71 F. Supp. 1264, 1286-87 (D.N.J. 1989).
15. A plaintiff is not required to establish loss causation at the certificate stage. *Erica P. John, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011). Price impact evidence often is relevant for the purpose of establishing loss causation at the merits stage and, to the extent that the defendant is unsuccessful at the certification stage, in establishing a lack of price impact will have unpleasant ramifications later in the case when attempting to settle.
16. *Luis Aranaz v. Catalyst Pharmaceutical Partners, Inc, et al.* (No. 13-23878 (S.D. Fl.) (Oct. 29, 2014) (*granting class certification*). The presumption of price impact may not be indirectly rebutted by showing the misrepresentation was immaterial in that the truth of the information was already known in the market.