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# Alert

Class and Derivative Actions

Securities Litigation and Enforcement

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# Supreme Court Rejects Applying Stringent Loss Causation Requirement To Obtain Class Certification In Securities Fraud Class Actions

In a decision of consequence for publicly traded companies and their directors and officers, the U.S. Supreme Court recently rejected any requirement that class action plaintiffs prove "loss causation" at the class certification stage. *Erica P. John Fund, Inc. v. Halliburton Co*., No. 09-1403. The decision takes away from defense lawyers what might have been a valuable tool in seeking to defeat motions to have a class certified.

The decision by a unanimous Supreme Court reversed precedent from the U.S. Court of Appeals for the Fifth Circuit, which had required class action plaintiffs to establish loss causation by a preponderance of the evidence as a condition of obtaining class certification. That requirement was often difficult to meet and served as a major obstacle to obtaining certification of a class in securities lawsuits.

Courts in other circuits had not imposed such a requirement, and the Supreme Court agreed to hear the case to resolve this conflict among circuits. The *Halliburton* decision means that the stringent standard applied by the Fifth Circuit will not apply in any federal courts.

The issue in the case was procedural, but it was one that played a decisive role in securities class actions based, as many are, on the "fraud on the market" theory.

Securities fraud suits involve claims that investors suffered losses when they bought or sold securities because of a misrepresentation or omission by the defendant. In a typical fraud case, a plaintiff must show "reliance" on the alleged misrepresentation or omission – that is, that she knew of a defendant's misrepresentation or omission, and bought or sold securities based on it.

In *Basic Inc. v. Levinson*, 458 U.S. 224 (1988), the Supreme Court held that reliance could be presumed where the investor bought shares of a public company and was alleging a securities "fraud on the market." The rationale was that in an efficient market for traded securities, it can be presumed that the share price reflects all material information in the market, including any misrepresentations by the issuer in its financial or other statements.

Under the *Basic* approach, courts will presume such reliance by a plaintiff on a misrepresentation even if she did not actually hear or read it. The plaintiff bears the burden of establishing that the misrepresentations were publicly known, the stock traded in an efficient market, and her transaction occurred between the time of the misrepresentation and the time the market learned the truth. The defendant bears the burden of rebutting the presumption of reliance if established by the plaintiff.

In order to certify a class under the Federal Rules of Civil Procedure, a court must find that "common" questions of law or fact predominate over questions affecting only individual members. The inquiry into whether common questions predominate often turns on the element of reliance. The presumption of reliance in a fraud on the market case under *Basic* effectively enhanced the ability of plaintiffs to meet the commonality requirement for class certification purposes, since they would be entitled to a presumption that the entire class relied on the same information available to the market.

In addition to reliance, also referred to as "transaction causation" and similar to the tort concept of "but-for" causation, a securities fraud plaintiff at trial must also prove loss causation – that is, that the misrepresentation not only induced the plaintiff to invest, but also that the misrepresentation caused the plaintiff's economic loss. The crux of this inquiry is whether any price decline resulted from revelation of a prior false representation, or instead was caused by other factors, such as market-wide or industry-wide declines or development of new products or advances by competitors. *Dura Pharmaceuticals, Inc. v. Broudo*, 554 U.S. 336 (2005).

The Fifth Circuit had held that in order to invoke the *Basic* presumption of reliance at the class certification stage, a plaintiff would have to prove loss causation. It was that approach that the Supreme Court rejected in *Halliburton*.

The plaintiffs there had brought a putative securities fraud class action for all purchasers of Halliburton common stock between June 3, 1999, and December 7, 2001. They alleged that Halliburton made false statements "about (1) the scope of its potential liability in asbestos litigation, (2) its expected revenue from certain construction contracts, and (3) the benefits of its merger with another company." The allegations in the complaint were deemed sufficient to defeat a motion to dismiss the complaint.

However, when plaintiffs moved for class certification, the district court denied the motion solely because plaintiffs had failed to meet the "stringent loss causation requirement." The Court of Appeals affirmed. It stated: "In order to obtain class certification on its claims, [the plaintiff] was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses."

The Supreme Court rejected the notion that plaintiffs must establish loss causation at the class certification stage in order to invoke the fraud on the market presumption of reliance on a misrepresentation or omission: "The fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on a misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory."

The Court also rejected Halliburton's argument that the Fifth Circuit did not really mean "loss causation," even though it repeatedly used that phrase in its opinion. Halliburton argued that the Fifth Circuit truly meant that the plaintiff had not shown "price impact" (i.e., whether the misrepresentations affected the market price). The Supreme Court declined to accept this recharacterization of the Fifth Circuit's decision: "[W]e simply cannot ignore the Court of Appeals' repeated and explicit reference to 'loss causation,'" which is a distinct matter in securities law.

Practitioners in the Fifth Circuit formerly had another tool to oppose class certification in securities fraud class actions. While this opinion eliminates that argument, it brings all circuits into uniformity on the issue. The opinion does not address whether, at the class certification stage, the defendant may successfully rebut the *Basic* presumption of reliance by establishing that the alleged misrepresentations did not affect the stock price, an issue which it directed the Fifth Circuit to address on remand.

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