

WSGR ALERT

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U.S. SUPREME COURT FINDS THAT PLAINTIFFS
NEED NOT PROVE LOSS CAUSATION AT OUTSET OF
SECURITIES FRAUD CLASS ACTIONS

Earlier today, the United States Supreme Court issued its decision in *Erica P. John Fund, Inc. v. Halliburton Co.* (<http://www.supremecourt.gov/opinions/10pdf/09-1403.pdf>) ("*Halliburton*"). In a unanimous decision authored by Chief Justice Roberts, the Court held that the Fifth Circuit Court of Appeals had erred in ruling that plaintiffs had to prove loss causation, an element of a securities fraud cause of action, at the class certification stage. The Court's decision, the second in recent months siding with securities class action plaintiffs,¹ takes away an interesting but controversial gambit on the part of class action defendants to terminate a securities class action in its early stages.

Background

Halliburton's relevant facts are straightforward. As in similar securities class actions, the plaintiffs alleged that Halliburton had made a number of false statements about its business, including the amount of revenue it expected to receive from construction contracts, thus inflating Halliburton's stock price. The plaintiffs also alleged that Halliburton issued later, corrective statements that caused its stock price to drop and damage investors who bought based on the prior false statements. Typical class action fare.

The plaintiffs then survived a motion to dismiss but ran into a roadblock at the class certification stage. Fifth Circuit precedent

(and *only* Fifth Circuit precedent) required plaintiffs to prove loss causation in order to certify a class. See *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007). A few basic principles clarify the significance of the Fifth Circuit's approach. First, to sustain a class action, "questions of law or fact common to class members [must] predominate over any questions affecting only individual members. . . ." F.R.C.P. 23(b)(3). If class certification requirements are not met, a class action cannot be certified and proceeds as an individual action. Second, to establish liability for securities fraud, plaintiffs eventually must prove reliance (i.e., that purchasers of the stock relied on the misrepresentations or omissions). Reliance is the element of a cause of action least susceptible to class treatment because it is individual by its nature. Third, by virtue of a prior Supreme Court decision, *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988), reliance can be presumed in securities class actions for purposes of certifying a class when certain requirements are met permitting a class to rely on the stock price as having impounded the impact of misrepresentations. Fourth, loss causation is another element of a securities fraud claim and it requires the plaintiff to establish a link between the alleged misrepresentations and corrective statements causing a stock price decline. See *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

The Fifth Circuit tied the above principles together and created a potent tool for blocking class actions. The Supreme Court summarized as follows: "Whether common questions of law or fact predominate in a securities fraud action often turns on the element of reliance. The courts below determined that EPJ Fund had to prove the separate element of loss causation in order to establish that reliance was capable of resolution on a common, classwide basis." Slip op. at 4.

The Court's Decision

The Court's decision was briskly efficient and focused on the dissonance between the Fifth Circuit's holding and the Court's prior decisions, *Basic v. Levinson* in particular. The Court discussed *Basic* at some length, noting that plaintiffs must plead certain things to invoke the presumption in the first place (e.g., an efficient market for the stock at issue). Not included among the things one needed to plead to invoke the *Basic* presumption, the Court stated quite pointedly, was loss causation. "The term 'loss causation' does not even appear in our *Basic* opinion. And for good reason: Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock." Slip op. at 6.

The Court then discussed the difference between "transaction causation," which is

¹ See http://wsg.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgalert_statistical_significance_materiality.htm

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relevant to the element of reliance under the *Basic* presumption, and the separate element of loss causation. Under *Basic*, an investor relies on a misrepresentation if that information is reflected in the stock prices at the time of the relevant transaction.

Transaction causation would be satisfied and the *Basic* presumption would attach if, for example, an investor alleges: (1) that a stock trades in an efficient market; (2) that misleading statements about revenue expectations caused the stock price to increase; and (3) that the plaintiff class is comprised of persons who purchased after those statements and before the "truth" was revealed.

The distinct element of loss causation requires that plaintiffs prove that the misrepresentation that affected the stock price also caused the loss suffered by the class. That goes beyond the requirements of *Basic*. The Court wrote: "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 the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory." Slip op. at 7. The

Court thus ruled that the connection the Fifth Circuit created between loss causation and reliance was misplaced and vacated the Fifth Circuit's ruling and remanded the case.

Impact of the Decision

Certainly, defendants in the Fifth Circuit lost a way to terminate class actions early in the life of a case. Defendants in the rest of the country, however, lost only a hope—the Fifth Circuit's reasoning had not been adopted in other circuits.

A failure to plead or prove loss causation, however, remains a powerful weapon in a securities class action defendant's arsenal. A causal connection between the alleged misrepresentations and the economic loss must be pleaded for a complaint to survive a motion to dismiss. And, of course, to establish liability, it must be proven that the misrepresentations caused a loss.

For more information on the implications of the Supreme Court's *Halliburton* decision or other securities litigation matters, please contact a member of Wilson Sonsini Goodrich & Rosati's securities litigation team.



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650 Page Mill Road
Palo Alto, CA 94304-1050
Tel: (650) 493-9300 Fax: (650) 493-6811
email: wsgr_resource@wsgr.com

www.wsgr.com

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