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Supreme Court Preserves "Fraud-on-the-Market" and Validates Use of "Price Impact" Defense Against Class Certification in Securities Class Actions

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

New York

Jaculin Aaron
+1.212.848.4450
jaaron@shearman.com

Stuart J. Baskin
+1.212.848.4974
sbaskin@shearman.com

Matthew L. Craner
+1.212.848.5255
matthew.craner@shearman.com

Kirsten Nelson Cunha
+1.212.848.4320
kirsten.cunha@shearman.com

Agnès Dunogué
+1.212.848.5257
agnes.dunogue@shearman.com

H. Miriam Farber
+1.212.848.5156
mfarber@shearman.com

Christopher R. Fenton
+1.212.848.4707
christopher.fenton@shearman.com

Stephen Fishbein
+1.212.848.4424
sfishbein@shearman.com

Jerome S. Fortinsky
+1.212.848.4900
jfortinsky@shearman.com

In its long-awaited decision in *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*"), the US Supreme Court upheld the validity of the fraud-on-the-market presumption set forth in *Basic Inc. v. Levinson*, 485 US 224 (1988), while clarifying that a defendant in a securities fraud class action must be permitted to rebut *Basic*'s presumption of reliance at the class certification stage with evidence that alleged misrepresentations had no price impact at the time of investment. This ruling confirms the existence of an important defense against class certification in federal securities fraud class actions and raises significant new questions for consideration by the lower courts.

A. Background

Plaintiff Erica P. John Fund, Inc. (the "EPJ Fund") brought a putative class action against Halliburton Company and its CEO David Lesar (together, "Halliburton") alleging that Halliburton violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by making misrepresentations in Halliburton's SEC filings between June 1999 and December 2001. The EPJ Fund's attempts to bring a viable suit and certify a class based on the fraud-on-the-market presumption have resulted in more than a decade of litigation and two significant Supreme Court decisions, including *Halliburton II*, which was issued on June 23, 2014.

Contacts (cont.)

Joseph J. Frank
+1.212.848.5254
joseph.frank@shearman.com

Alan S. Goudiss
+1.212.848.4906
agoudiss@shearman.com

John Gueli
+1.212.848.4744
jgueli@shearman.com

Adam S. Hakki
+1.212.848.4924
ahakki@shearman.com

Daniel H.R. Laguardia
+1.212.848.4731
daniel.laguardia@shearman.com

Christopher L. LaVigne
+1.212.848.4432
christopher.lavigne@shearman.com

Daniel Lewis
+1.212.848.8691
daniel.lewis@shearman.com

John A. Nathanson
+1.212.848.8611
john.nathanson@shearman.com

Brian H. Polovoy
+1.212.848.4703
bpolovoy@shearman.com

William J.F. Roll III
+1.212.848.4260
wroll@shearman.com

Richard F. Schwed
+1.212.848.5445
rschwed@shearman.com

Joanna Shally
+1.212.848.4700
jshally@shearman.com

Claudius O. Sokenu
+1.212.848.4838
claudius.sokenu@shearman.com

James P. Tallon
+1.212.848.4650
jtallon@shearman.com

The fraud-on-the market presumption was adopted by the Supreme Court in its landmark opinion in *Basic*. It established that plaintiffs may satisfy the reliance element of a claim under Rule 10b-5 without showing that they were actually aware of alleged misrepresentations if they can establish "(1) that the alleged misrepresentations were publicly known, (2) that they were material, (3) that the stock traded in an efficient market, and (4) that the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed."[i] The presumption, which is based on the efficient capital markets hypothesis (which, in simple terms, theorizes that the price of actively traded public securities will reflect all material public information), assumes that (a) material public information in an efficient market is reflected in a security's price, and (b) investors therefore necessarily rely on all such information when they purchase or sell securities in an efficient market.[ii] The presumption is a key element in modern securities class action practice. Without it, plaintiffs would not be able to meet the predominance requirement of Federal Rule of Civil Procedure 23(b)(3), because individual questions—concerning which members of a purported class actually relied on which misrepresentations (and whether they did so reasonably)—would predominate over common questions and thereby preclude class certification.

In 2011, the Supreme Court reversed a prior decision of the US Court of Appeals for the Fifth Circuit in the *Halliburton* case by holding that plaintiffs need not establish loss causation (*i.e.*, that the revelation of the "truth" actually caused an economic loss) to satisfy the fraud-on-the market presumption at the class certification stage because, the Court held, the presence or absence of loss causation is a merits issue that does not, in and of itself, implicate Rule 23 predominance issues.[iii] The Court remanded the case for further proceedings and, in 2012, the US District Court for the Northern District of Texas granted the EPJ Fund's motion for class certification, notwithstanding Halliburton's argument that it had rebutted the presumption of reliance with direct evidence that the alleged misrepresentations had not actually affected Halliburton's stock price. In the District Court's view, Halliburton could not use "price impact" evidence at the class certification stage to rebut the presumption of reliance because such evidence, like evidence of loss causation, has no bearing on whether common issues predominated under Rule 23(b)(3).[iv] In 2013, the Fifth Circuit affirmed that decision, relying heavily on *Halliburton I* and the US Supreme Court's intervening 2013 decision in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*—which held that plaintiffs need not prove the materiality of the alleged misstatements to invoke *Basic*'s presumption of reliance at class certification.[v] Failure to prove materiality, according to the *Amgen* decision, did not mean individualized issues regarding materiality would predominate; rather, it meant the class as a whole could not recover at all.[vi]

In light of the Fifth Circuit's ruling, Halliburton petitioned the Supreme Court to address two legal questions: (1) "Whether th[e] [Supreme] Court should overrule or substantially modify the holding of *Basic Inc. v. Levinson*, 485 US 224 (1988), to the extent that it

Contacts (cont.)

San Francisco
Jeffrey S. Facter
+1.415.616.1205
jfacter@shearman.com

Stephen D. Hibbard
+1.415.616.1174
shibbard@shearman.com

Patrick D. Robbins
+1.415.616.1210
probbins@shearman.com

Washington, D.C.
Kristen Hutchens
+1.202.508.8157
kristen.hutchens@shearman.com

Mark D. Lanpher
+1.202.508.8120
mark.lanpher@shearman.com

recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory" and (2) "Whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock."[vii] On November 15, 2013, the Supreme Court granted Halliburton's *certiorari* petition.[viii]

B. The *Halliburton II* Opinions

Chief Justice John Roberts delivered the opinion of the Supreme Court, which Justices Anthony Kennedy, Ruth Bader Ginsburg, Stephen Breyer, Sonia Sotomayor, and Elena Kagan joined. As outlined in greater detail below, while the Court declined to overrule or substantially modify the Court's prior holding in *Basic*, it accepted Halliburton's argument that defendants must be afforded an opportunity before class certification to rebut the *Basic* presumption, including through evidence that an alleged misrepresentation did not actually affect the stock's market price. The Fifth Circuit's decision was vacated, and the case was remanded for further proceedings consistent with the Court's opinion.

Justice Ginsburg filed a one-paragraph concurring opinion, which Justices Breyer and Sotomayor joined, to clarify that they joined in the Roberts' opinion with the understanding that it should "impose no heavy toll on securities-fraud plaintiffs with tenable claims."[ix] Justice Clarence Thomas filed an opinion concurring in the judgment, which Justices Antonin Scalia and Samuel Alito joined, to make plain their view that *Basic* was wrongly decided and should be overruled.

I. The Court Declines to Overrule *Basic*

The Court rejected Halliburton's numerous arguments for why *Basic* should be overruled, stating that Halliburton had not shown a "special justification," *Dickerson v. United States* (530 US 428, 433 (2000)), for overruling *Basic*'s presumption of reliance.[x]

First, the Court rejected Halliburton's contention that *Basic* should be overruled because it rests on two premises that no longer withstand scrutiny by distinguished economists and other academics: (i) that efficient markets automatically and accurately update stock prices to reflect all public information and (ii) that all investors rely on stock prices when transacting.[xi] The Court noted that the extent of the disagreement was more limited than Halliburton contended and stated that it was addressed through the Court's clarification of defendants' right to rebut the presumption and their ability to challenge specific plaintiffs on their use of the presumption.[xii] Second, the Court applied the deference of *stare decisis* to *Basic* and rejected Halliburton's arguments that the *Basic* presumption produces a number of serious and harmful consequences for businesses and the courts and that the presumption is inconsistent with recent Supreme Court decisions narrowing the Rule 10b-5 cause of action and requiring that Rule 23 requirements be proved before a class is certified under Rule 23.[xiii] With respect to the significant consequences argument, the Court stated that such concerns are more appropriately addressed to

Congress and noted that Congress has passed legislation following *Basic* to curb the number of class actions filed by securities plaintiffs.[xiv] The Court also disagreed that the presumption violates recent Supreme Court precedent governing the scope of Rule 10b-5 liability and the requirements of Rule 23.[xv] Third, the Court rejected Halliburton's argument that the *Basic* presumption is inconsistent with Congress's intent in passing the Securities Exchange Act of 1934.[xvi] The Court reasoned that the same argument was raised and dealt with in *Basic*, and Halliburton provided no reason to accept the argument now.[xvii] Nearly all of these issues were strongly contested in the concurrence authored by Justice Thomas.

II. The Court Permits Defendants to Rebut the Presumption with Price Impact Evidence at Class Certification Stage

The Court allowed, however, that *Basic*'s fraud-on-the-market presumption could be rebutted "in a number of ways, including by showing that the alleged misrepresentation did not actually affect the stock's price – that is, that the misrepresentation had no 'price impact.'"[xviii] The Court further stated that "*Basic* recognized that market efficiency is a matter of degree and accordingly made it a matter of proof."[xix] *Basic* thus "affords defendants an opportunity to rebut the presumption by showing, among other things, that the particular misrepresentation at issue did not affect the stock's market price."[xx] The Court accordingly held that defendants could make such a rebuttal at the class certification stage, including by introducing direct evidence (such as event studies, which we expect to be even more widely and consistently used at class certification) to show that defendants' alleged misrepresentations had no impact on the price of the stock (and thus the *Basic* presumption did not apply).[xxi] The Court reasoned that such a showing was appropriate at the class certification stage in part because it is already undisputed that defendants can introduce price impact evidence at the class certification stage for purpose of rebutting plaintiffs' claim of market efficiency, which is only part of an "indirect proxy" for showing price impact.[xxii] It would be nonsensical, therefore, to disallow such evidence to the extent it provided direct evidence of the same thing – *i.e.*, evidence of price impact, or lack of price impact. Furthermore, the Court noted, plaintiffs must prove that the requirements of Rule 23 are met before a class can be certified. Distinguishing the need to prove price impact at the class certification stage from *Amgen*'s holding that there is no need to prove materiality at the class certification stage, the Court held that (unlike materiality) price impact cannot be disassociated from the issue of predominance.[xxiii] Indeed, "[t]he fact that a misrepresentation 'was reflected in the market price at the time of [the] transaction'—that it had price impact—is '*Basic*'s fundamental premise.'"[xxiv] Accordingly, "defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock."[xxv]

C. Significance of *Halliburton II*

The decision in *Halliburton II* continues to allow plaintiffs to meet their burden in establishing the fraud-on-the-market presumption through indirect methods such as by establishing general market efficiency (and the other *Basic*-presumption elements). Thus, plaintiffs may continue to rely on tests set forth in *Cammer v. Bloom*[xxvi] and *Krogman v. Sterritt*[xxvii] (which address whether market efficiency sufficient to invoke the fraud-on-the-market presumption has been shown) to bring their motions for certification. *Halliburton II* also makes clear, however, that defendants can rebut that presumption by focusing on the impact of specific, alleged misrepresentations rather than merely challenging the efficiency of the market for the securities more broadly.[xxviii] How that impact (or lack of impact) is to be analyzed is unclear. The Court clearly refers to and endorses the use of event studies.[xxix] But its reliance on the importance of actual price impact may well mean that in cases in which the price does not move in reaction to alleged misrepresentations, such as where the challenged statements merely confirm expectations, plaintiffs may have difficulty obtaining class certification. Plaintiffs can be expected to point to subsequent stock drops as evidence of price impact at the time of the alleged misrepresentation, and it remains to be seen whether, and to what extent, such arguments can succeed.

Halliburton II also raises new issues. The Supreme Court has clearly rejected an all-or-nothing view of efficiency in favor of a more nuanced and situational analysis.[xxx] This more rigorous and thoughtful approach may well affect the adjudication of other aspects of securities litigation—such as loss causation and the truth-on-the-market defense. Furthermore, the Court expressly noted that even material information disclosed in an efficient market might not affect a security's price,[xxxi] and the Court reasoned that even investors who believe that information is not properly reflected in a security's price when they invest in the security (such as so-called value investors) can be entitled to the presumption because they implicitly believe that the information will be fully incorporated at some point in the future.[xxxii] The added uncertainty created by such acknowledgments will raise issues that will be addressed again and at length in class certification litigation in the coming months and years.

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[i] *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, 573 US ___, 2014 WL 2807181, at *7 (June 23, 2014) ("*Halliburton II*") (citing *Basic Inc. v. Levinson*, 485 US 224, 248, n.27 (1998)).

[ii] *Halliburton II*, 2014 WL 2807181, at *14.

[iii] *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2183, 2186 (2011) ("*Halliburton I*").

[iv] See *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 3:02–CV–1152–M, 2012 WL 565997, at *2 (N.D. Tex. Jan. 27, 2012).

[v] *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 435 (5th Cir. 2013) ("The *Amgen* Court's analysis leads to the conclusion that price impact fraud-on-the-market rebuttal evidence should not be considered at class certification.").

[vi] *Amgen Inc. v. Conn. Ret. Plans and Trust Funds*, 133 S. Ct. 1184, 1191 (2013).

[vii] Petition for a Writ of Certiorari, *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317, 2013 WL 4855972, at *i (Sept. 9, 2013).

[viii] *Halliburton Co. v. Erica P. John Fund*, No. 13-317, 2013 WL 4858670, at *1 (US Nov. 15, 2013).

[ix] *Halliburton II*, 2014 WL 2807181, at *18.

[x] *Id.* at *6.

[xi] *Id.* at *9-12.

[xii] *Id.* at *9-10.

[xiii] *Id.* at *11-12.

[xiv] *Id.* at *13 (citing the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998).

[xv] *Id.* at *11-12.

[xvi] *Id.* at *8.

[xvii] *Id.*

[xviii] *Id.* at *4.

[xix] *Id.* at *14.

[xx] *Id.* at *14-17. An event study, in the context of securities class actions, identifies a particular event (or series of events) and uses statistical methods to analyze whether that event (or series of events) affected the price of the security at issue, net of general market and industry factors.

[xxi] *Id.* at *15-16.

[xxii] *Id.*

[xxiii] *Id.* at *16-17.

[xxiv] *Id.* at *17 (quoting *Halliburton I*, 563 US, at ___ (slip op., at 7)).

[xxv] *Id.* at *17.

[xxvi] To analyze market efficiency, courts use the *Cammer* factors, which are as follows: (1) the average weekly trading volume of the securities at issue; (2) the number of securities analysts reporting on or following the securities; (3) the extent to which market makers traded in the securities; (4) the extent to which the issuer was/is eligible to file an SEC Registration Form S-3; and (5) the demonstration of a cause and effect relationship between the unexpected, material disclosures and changes in the securities' price. *Cammer v. Bloom*, 711 F. Supp. 1264, 1286-87 (D.N.J. 1989).

[xxvii] Courts sometimes also use the *Krogman* factors, which are as follows: (1) the company's market capitalization; (2) the size of the bid-ask spread; and (3) the percentage of shares available to the public. *Krogman v. Sterritt*, 202 F.R.D. 467, 478 (N.D. Tex. 2001).

[xxviii] *Halliburton II*, 2014 WL 2807181, at *17 ("As explained, we see no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact. Defendants may seek to defeat the *Basic* presumption at that stage through direct as well as indirect price impact evidence.").

[xxix] *See, e.g.*, *id.* at *15 (After all, plaintiffs themselves can and do introduce evidence of the *existence* of price impact in connection with "event studies"—regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events.").

[xxx] *Halliburton II*, 2014 WL 2807181, at *14.

[xxxi] *Id.*

[xxxii] *Id.* at 10.