Supreme Court To Reconsider “Fraud-on-the-Market” Presumption in Securities Fraud Class Actions

On March 5, 2014, the U.S. Supreme Court heard oral arguments in the much anticipated case of Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317. The Halliburton case presents a critical issue regarding the viability of maintaining a private securities fraud lawsuit as a class action: whether the plaintiffs are permitted to invoke the “fraud-on-the-market” presumption to establish that there are common issues of reliance sufficient to certify a class.

The fraud-on-the-market presumption was first recognized by the Supreme Court in its 1988 decision in Basic Inc. v. Levinson, 485 U.S. 224 (1988) and is a cornerstone to the viability of pursuing allegations of securities fraud on a class-wide basis. Last year, however, four Justices signaled that they might be receptive to a challenge to the continued validity of the fraud-on-the-market presumption. The Halliburton case also presents a related issue of whether a defendant may rebut the presumption at the class certification stage by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.

At oral argument, the Justices’ questions suggest there is not a majority in support of overturning Basic altogether; however, several Justices signaled that while they were interested in keeping the Basic fraud-on-the-market presumption, they may favor tightening the standards that plaintiffs would have to meet to qualify for the presumption. Accordingly, the Court’s decision, which should be issued before the end of the Supreme Court’s term this summer, may not sound the death knell for securities class actions, but could have significant ramifications for how securities class actions are litigated.

Background and Procedural History
The Halliburton case has a long history, which includes one prior trip to the Supreme Court. The case was filed in June 2002 and alleged that Halliburton made material misstatements relating to (1) exposure to asbestos liability and the reserves associated with that liability,


2 See The Supreme Court Rejects Fifth Circuit’s Loss Causation Test as a Prerequisite to Obtaining Class Certification in Section 10(b) Cases, Arnold & Porter LLP Advisory (June 2011), available at http://www.arnoldporter.com/resources/documents/Advisory-The%20Supreme_Court_Rejects_Fifth_Circuit’s_Loss_Causation_Test_Prerequisite_Obtaining_Class_Cert_Section_10b5_Cases.pdf.
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(2) accounting of revenue associated with cost over-runs on fixed-price construction and engineering contracts, and (3) its benefit from a merger. The district court initially declined to certify a proposed class, holding that the plaintiffs had failed to establish loss causation – i.e., that the stock losses were related to any of Halliburton’s alleged misstatements – and the Fifth Circuit affirmed.³ In a unanimous decision, the Supreme Court reversed, holding that proof of loss causation was a merits determination, not a requirement for class certification.⁴ The Supreme Court noted that the lower courts had confused “price impact” (i.e., whether the alleged misrepresentations distorted the price of the securities at the time they were purchased by the plaintiffs) with loss causation (i.e., whether the correction of those misrepresentations caused the price of the stock to drop after the corrections were disclosed).

On remand, the district court certified the class relying on Basic. In Basic, the Supreme Court held that if the securities trade in an efficient market, plaintiffs are entitled to a rebuttable fraud-on-the-market presumption to establish the element of reliance, obviating the need to demonstrate that each shareholder relied on an alleged misrepresentation in purchasing securities. The Basic court assumed that in an efficient securities market, all public information about a company (including alleged misrepresentations) is incorporated into and reflected in the price of the securities traded in the market, and that an investor who buys or sells securities at market price relied on the price as an indication of a company’s value. Accordingly, under Basic, in order to obtain certification of a class in an action alleging fraud on the market, plaintiffs need only show that (1) the stock at issue was traded in an efficient market, (2) the defendant’s misrepresentations were made to the public, and (3) plaintiffs bought or sold the stock in between when the misrepresentations were made and when they were corrected.

On interlocutory appeal of the district court’s order granting class action certification pursuant to Federal Rule of Civil Procedure 23(f), the Fifth Circuit affirmed. The Supreme Court granted Halliburton’s petition for a writ of certiorari.

The Issues Before the Court
In its briefs, Halliburton argued that Basic was wrongly decided and that the Court should jettison the “fraud-in-the-market” presumption and require plaintiffs to show actual reliance. In support of its position, Halliburton contended that (1) Basic improperly substituted any need for actual reliance with an unproven economic theory of efficiency, (2) recent economic research has overwhelmingly condemned the market efficiency assumptions made in Basic, (3) investors frequently buy and sell stocks with no regard to whether stock prices reflect their intrinsic value, and (4) the Basic consideration of whether a market is or is not efficient ignores the reality that certain markets may be both efficient and inefficient in different ways.⁵ In addition, Halliburton contended that stare decisis should not prevent the Court from overruling Basic in light of lower courts’ difficulty in applying the requirements of Basic, and the Court’s recent decisions limiting both the implied cause of action under Section 10(b) of the Securities Exchange Act and the certification of class actions in general.

Halliburton also argued that, in the alternative, plaintiffs seeking to benefit from the fraud-on-the-market presumption of reliance should be required to submit evidence that the market acted efficiently in the particular case. According to Halliburton, placing the burden of proof on the plaintiff to introduce evidence of price impact – that the price of the defendant’s securities was measurably affected by its misrepresentations – is more consistent with both the requirement under Federal Rule of Civil Procedure 23 that plaintiffs establish their eligibility for class treatment, as well as Basic’s “fundamental premise” that an investor will presumptively rely on a misrepresentation where it is actually reflected in the market price of the security. Halliburton also argued that it should have been allowed to submit evidence rebutting the fraud-on-the-market presumption at the time of class certification.

The plaintiffs argued against overturning or limiting Basic, contending that the decision was based not on unproven

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³ 597 F.3d 330 (5th Cir. 2010).
⁵ This analysis echoes various statements from Justice Alito’s concurring and Justice Thomas’ dissenting opinions in last term’s decision in Amgen Inc. v. Conn. Ret. Plans & Trust Funds that Basic was “questionable” and “may rest on a faulty economic premise.”
economic theory, but on common sense – i.e., the idea that investors in general are likely to consider the price of a security as a reflection of its value in determining whether to purchase it. In addition, the plaintiffs invoked *stare decisis*, arguing that *Basic* is a long-standing precedent, involved statutory interpretation, has been cited favorably in numerous subsequent decision of the Court, and has been left untouched by Congress – all factors that militate in favor of not overruling a prior precedent of the Court. As for Halliburton’s argument regarding allowing evidence rebutting price impact at the certification stage, the plaintiffs countered that doing so would do little more than increase the cost of certification by requiring litigation of a merits-based decision, at a time when plaintiffs’ access to discovery is more limited.

The United States government as *amici* supporting plaintiffs argued that there was “no good reason to overrule *Basic*” because “investors typically do, and reasonably may, rely on the integrity of the market price, even when they lack the time or expertise to scrutinize the raw materials that inform the judgments of market professionals,” and Congress had “acquiesced” in the presumption.

**Oral Argument and Potential Significance of Decision**

At oral argument, the questions regarding whether *Basic* should be overturned outright were primarily directed at Halliburton and did not dominate the argument. Justices Ginsburg, Breyer, Sotomayor, and Kagan each asked questions that suggested an aversion towards overruling *Basic*. For example, in response to Halliburton’s argument that *Basic* was premised on a flawed economic theory, Justice Ginsburg noted that “in *Basic*, Justice Blackmun said that there is this economic theory, but also the motivation for the Exchange Act and probability and common sense would lead to . . . this rebuttable presumption. So he wasn’t relying strictly on an economic theory.” Justice Breyer similarly appeared to defend the presumption, asking Halliburton what was wrong with saying that the contention that a market incorporated certain information is a common issue for all class plaintiffs. And Justice Kagan asked what has changed since *Basic*, noting that the Court generally requires “something that makes the question fundamentally different” to overrule a prior decision and that this is especially true where, as here, “Congress has had every opportunity, and has declined every opportunity, to change *Basic* itself.” Justices Scalia and Alito, however, questioned whether Congress’s failure to overturn *Basic* signified its agreement with the fraud-on-the-market presumption.

The Justices also explored the practical implications of their decision, such as the burden that would be imposed by litigating the issue of price impact at the certification stage. For example, Justice Sotomayor asked the plaintiffs whether proving price impact is more or less burdensome than proving market efficiency, which is one of the prerequisites in *Basic* for benefiting from the fraud-on-the-market presumption. Similarly, the Justices asked about the outcome of cases that progress beyond the certification stage. For example, Justice Alito asked “how often defendants have been successful in rebutting the presumption,” and Justice Scalia asked “what percentage of these cases continue once there has been class certification.”

Most notably, several Justices seemed open to what Justice Kennedy referred to as a “midway position” advanced in an amicus brief submitted by law professors. The brief argued that the requirement in *Basic* of proving market efficiency should be replaced with a requirement that plaintiffs show, through an economic “event study,” that the alleged misstatement actually affected the market price of the stock. While the plaintiffs stressed that requiring such a showing would impose severe costs and evidentiary constraints on plaintiffs (especially in cases like this that involved multiple alleged misstatements at various points in time), the United States conceded that requiring this showing would have less dramatic consequences on the securities industry than overruling *Basic* (and that it would be a “net gain” for securities plaintiffs in the end).

Although it is unclear how the Supreme Court will rule in the *Halliburton* case, the questioning at oral argument and the Court’s general practice with respect to *stare decisis* in statutory interpretation cases suggests that it may not entirely do away with *Basic*’s fraud-on-the-market theory of reliance.
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But even a more narrow decision may have significant consequences in limiting securities fraud class actions. For example, if the Court adopts the “midway position” and allows defendants to litigate the validity of plaintiffs’ “event study” in conjunction with class certification, more class certification denials may result.

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