SIMPSON THACHER
REPORT FROM WASHINGTON

To read the oral arguments in *Erica P. John Fund, Inc. v. Halliburton Co.*, please click here.

The Supreme Court Considers Loss Causation at Time of Class Certification

April 26, 2011

The Supreme Court heard oral arguments yesterday in *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09-1403, a private securities fraud case in which the Court is expected to address whether a class may be certified even where plaintiffs fail to establish that the alleged misstatements had an impact on the price of the securities at issue. The Court's decision will likely resolve a split concerning whether courts should require plaintiffs to prove loss causation at the time of class certification. The Fifth Circuit in *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007), has expressly allowed defendants to rebut the fraud-on-the-market presumption by disproving loss causation at the class certification stage. The Third and Seventh Circuits have explicitly rejected the Fifth Circuit's approach in *In re DVI, Inc., Sec. Litig.*, No. 08-8033, 08-8045, 2011 WL 1125926 (3d Cir. Mar. 29, 2011), and *Schleicher v. Wendt,* 618 F.3d 679 (7th Cir. 2010), respectively. The Second Circuit also rejected analyzing loss causation as a class certification requirement in *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474 (2d Cir. 2008).

BACKGROUND

On June 3, 2002, the plaintiffs brought suit against Halliburton and its Chief Operating Officer, alleging violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The complaint alleged that the company made a series of material misrepresentations that inflated its stock price. The complaint then identified eight supposed corrective disclosures by the company, each of which was followed by a stock price decline.

In evaluating the plaintiffs' motion for class certification, under *Oscar*, the district court assessed whether the plaintiffs were entitled to a class-wide presumption of reliance based on the "fraud-on-the-market" theory. The "fraud-on-the-market" theory rests on the premise that, in an efficient market, any materially misleading statement or omission is factored into the company's stock price and, once the truth is disclosed, the resulting stock decline demonstrates the market's reliance on the withheld information. In analyzing the plaintiffs' allegations, the district court concluded that there was no connection between the alleged misrepresentations, the alleged corrective disclosures and the ensuing stock decline and, therefore, plaintiffs were not entitled to a class-wide presumption of reliance. Specifically, the alleged disclosures were not derived from, and therefore did not correct, any alleged prior misrepresentations by the company. Though the court stated that *Oscar* "imposes an exceedingly high burden on [p]laintiffs at an early stage of the litigation," the court followed *Oscar* and denied the motion to certify the class.

The Fifth Circuit affirmed on appeal. The court reviewed *de novo* the lower court's legal standard and upheld the application of *Oscar*. Reviewing the lower court's decision with

The Report From Washington is published by the Washington, D.C. office of Simpson Thacher & Bartlett LLP.

respect to the corrective disclosures for an abuse of discretion, the Fifth Circuit upheld the denial of the motion for class certification. It stated: "[W]e are satisfied that the district court here understood the need for the corrective disclosures to reveal the actionable truth about prior misstatements…[p]laintiff largely failed to identify disclosures that had a *corrective* effect linked to a specific misrepresentation, as opposed to simply a *negative* effect[.]" *Archdiocese of Milwaukee Supporting Fund, Inc., v. Halliburton Co.*, 597 F.3d 330, 338 (5th Cir. 2011).

SUMMARY OF THE ARGUMENT

Before the Supreme Court on Monday, Plaintiffs-Petitioners argued that, by requiring the plaintiffs to prove loss causation at the class certification stage, the Fifth Circuit prematurely put at issue a merits question that has no bearing on whether common issues predominate.

"Why could [market efficiency] be disputed at the certification stage, but not the question of price impact?"

JUSTICE KAGAN

Justice Kagan asked: "Why could [market efficiency] be disputed at the certification stage, but not the question of price impact?" Plaintiffs responded that market efficiency bears on the presumption of class-wide reliance, whereas loss causation is a common issue. Justice Alito then asked whether the presumption of reliance in *Basic v. Levinson*, 485 U.S. 224 (1988), can be rebutted at the class certification stage. After the plaintiffs argued that the issue is reserved for trial, Justice Alito replied: "Well, that's pretty thin, isn't it? . . . [I]t's dictum in a footnote in an opinion issued at a time when conditional class certification was permitted."

On the issue of market efficiency, Justice Sotomayor asked: "[D]oesn't a lack of response to a disclosure—couldn't it be in some situations reflective of an inefficient market?" The plaintiffs admitted that this could reflect an inefficient market, but stated that Halliburton already conceded market efficiency. After Justice Sotomayor questioned the plaintiffs as to what evidence relates to loss causation as compared with an inefficient market, the plaintiffs reiterated that no one could reasonably conclude that the market in this case was not efficient under *Basic*.

"[T]he defendant . . . should be permitted at the class certification stage to prove that the allegedly fraudulent statement had no impact on price . . . ."

JUSTICE ALITO

Justice Alito further noted, "there are some economists who say that, even in a market that is generally efficient … there can be instances in which the market does not incorporate certain statements in the price of a stock . . . ." He then asked whether "the defendant … should be permitted at the class certification stage to prove that the allegedly fraudulent statement had no impact on price" to destroy the *Basic* presumption. The plaintiffs responded that this was a class-wide issue, and therefore should not be decided at the class certification stage.

The United States, represented by the Solicitor General's office, argued that the Fifth Circuit erred in requiring proof of loss causation at the class certification stage for three reasons: (1) it is a merits question not appropriate for resolution during class certification; (2) it requires the plaintiffs to prove that they are entitled to the presumption; and (3) it confuses reliance and loss causation.

Justice Scalia commented: "[Y]ou acknowledged that if the cause was the fact that the market was not efficient, that could be raised at the certification stage." The Government stated that the issue of an inefficient market could be raised at class certification under *Basic*. However, the Government argued that whether or not the plaintiffs can prove their case involves class-wide issues that should be dealt with after class certification. Justice Kennedy observed: "The rule isn't . . . that simply because the issue is on a class-

wide basis, it can't be challenged at the certification stage." The Government responded that there can be many reasons that the plaintiffs lose at the merits stages, but that class certification should not require a merits inquiry—notwithstanding the Fifth Circuit's own policy considerations regarding the need to restrain the "*in terrorem* power of class certification." *Oscar,* 487 F.3d at 267.

Justice Alito then asked, "[I]f [defendants] show that the statement was not incorporated in the price … and [plaintiffs are] not claiming that … every member of the class actually relied on the statement … then why doesn't reliance cease to be a common issue[?]" The Government responded by indicating that the plaintiffs would stand or fall together on the merits, to which Justice Alito replied: "Yeah, but the fact that they would lose on the merits doesn't necessarily mean that they are entitled to class certification."

"But what you're just saying in terms of whether the revelation lowered the price has nothing to do with the question of what happened to the typical person."

JUSTICE BREYER

Respondent-Defendant Halliburton argued that the *Basic* presumption is rebutted where there is proof that the market price is not distorted by the alleged misstatements.

In response to questioning by Justice Sotomayor, Halliburton clarified that it was not defending the language in *Oscar* suggesting that loss causation is a separate class certification requirement. Rather, Halliburton contended, price impact is the real issue because, under *Basic*, "any showing that severs the link between the misrepresentation and the stock price defeats that presumption."

Justice Breyer noted that Halliburton's proposed price impact test involved issues that should be dealt with at the merits stage: "But what you're just saying [in] terms of whether the revelation lowered the price has nothing to do with the question of what happened to the typical person … It has to do with whether anybody was hurt. Now, that has nothing to do with the certification stage. That's the win or lose stage." Halliburton maintained that, if the stock price was not distorted by a misrepresentation, it cannot be said that the class relied on the misrepresentation through its effect on the market. Justice Scalia then stated that in the absence of a price impact, "the plaintiff would lose … [b]ut it doesn't mean that there is not a common issue . . . ."

The lack of a price impact "means that the plaintiff would lose. But it doesn't mean that there is not a common issue . . . ."

JUSTICE SCALIA

Justice Sotomayor observed that there is "a difference between saying it's an inefficient market or that the statements had no price impact for some other merits-related reason." Halliburton responded, arguing that district courts should not certify class actions on a presumption of reliance based on a change in the security's price while there is direct proof that there was no price movement.

Chief Justice Roberts asked Halliburton to respond to the objection that plaintiffs do not have discovery at the class certification stage, and therefore should not be required to present proof of loss causation. Halliburton described the discovery issue as a red herring because district courts can grant class discovery.

In rebuttal, the plaintiffs repeated that loss causation and price impact are common issues, and that courts should not decide these merits issues at the class certification stage.

IMPLICATIONS

In *Halliburton*, the Supreme Court is set to decide whether courts may consider at the class certification stage evidence that the alleged misstatements have no impact on the price of security at issue. If the Court were to hold that district courts may consider the issue, defendants would be given the chance to demonstrate that the plaintiffs' alleged

misstatements had no impact on the price of the security at issue and, if so, defeat class certification. On the other hand, if the Court were to hold that the issue of price impact relates solely to the merits of the plaintiffs' claims, and should not be analyzed during the class certification stage, the Court would reverse the Fifth's Circuit's loss causation requirement, but would affirm the status quo in other jurisdictions.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

New York City:

Bruce D. Angiolillo
212-455-3735
bangiolillo@stblaw.com

Michael J. Chepiga
212-455-2598
mchepiga@stblaw.com

Mark G. Cunha
212-455-3475
mcunha@stblaw.com

Paul C. Curnin
212-455-2519
pcurnin@stblaw.com

Michael J. Garvey
212-455-7358
mgarvey@stblaw.com

Paul C. Gluckow
212-455-2653
pgluckow@stblaw.com

David W. Ichel
212-455-2563
dichel@stblaw.com

Peter E. Kazanoff
212-455-3525
pkazanoff@stblaw.com

Joshua A. Levine
212-455-7694
jlevine@stblaw.com

Mary Elizabeth McGarry
212-455-2574
mmcgarry@stblaw.com

Joseph M. McLaughlin
212-455-3242
jmclaughlin@stblaw.com

Lynn K. Neuner
212-455-2696
lneuner@stblaw.com

Barry R. Ostrager
212-455-2655
bostrager@stblaw.com

Thomas C. Rice
212-455-3040
trice@stblaw.com

Mark J. Stein
212-455-2310
mstein@stblaw.com

Alan C. Turner
212-455-2472
aturner@stblaw.com

George S. Wang
212-455-2228
gwang@stblaw.com

David J. Woll
212-455-3136
dwoll@stblaw.com

Jonathan Youngwood
212-455-3539
jyoungwood@stblaw.com

Los Angeles:

Michael D. Kibler
310-407-7515
mkibler@stblaw.com

Chet A. Kronenberg
310-407-7557
ckronenberg@stblaw.com

Palo Alto:

Alexis S. Coll-Very
650-251-5201
acoll-very@stblaw.com

James G. Kreissman
650-251-5080
jkreissman@stblaw.com

Washington DC:

Peter H. Bresnan
202-636-5569
pbresnan@stblaw.com

Peter C. Thomas
202-636-5535
pthomas@stblaw.com

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3119 China World Office 1
1 Jianguomenwai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000