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The Supreme Court Adopts Middle Ground in Challenge to Legal Theory Key to Class Action Securities Litigations

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Yesterday, in *Halliburton Co. v. Erica P. John Fund* (13-317), the Supreme Court held that investors may continue to invoke a rebuttable presumption that they relied on an alleged misrepresentation when they purchased securities in an efficient market. However, the Court also ruled that defendants may rebut the presumption of reliance at the class certification stage by showing the alleged misrepresentation did not actually impact the stock price. The Supreme Court's "middle ground" approach will likely result in district courts conducting more evidentiary hearings at the class certification stage, with district court judges carefully evaluating the evidence of price impact (or lack thereof) and declining to certify those cases where the court finds the alleged misrepresentation did not distort the market price of the stock.

THE FRAUD-ON-THE-MARKET PRESUMPTION ADOPTED IN *BASIC INC. V. LEVINSON*

Investors can recover damages in a private securities fraud action only if they prove that they relied on the defendant's misrepresentation in deciding to buy or sell a company's stock. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.), a plurality of the Supreme Court held that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would" prevent securities fraud plaintiffs "from proceeding with a class action, since individual issues" of reliance would "overwhelm[ ] the common ones." The *Basic* Court thus endorsed a "fraud-on-the market" theory, which permits securities fraud plaintiffs to invoke a rebuttable presumption of reliance on public, material misrepresentations regarding securities traded in an efficient market. However, the *Basic* Court ruled that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."

The fraud-on-the-market theory endorsed by the *Basic* Court has two constituent premises. First, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." Second, "most publicly available information is reflected in [the] market price [of a security.]" In endorsing the theory, the Court cited empirical studies that "tended to confirm" that the "market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."

Recently, in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct.

1184 (2013) (Ginsburg, J.), where the Court held that plaintiffs do not have to prove materiality to invoke the presumption, four Justices voiced reservations concerning the continued viability of *Basic*'s fraud-on-the-market presumption. Justice Alito, concurring, observed that "recent evidence suggests that the [fraud-on-the-market] presumption may rest on a faulty economic premise" and suggested that "reconsideration of the *Basic* presumption may be appropriate." Justice Thomas, dissenting, joined by Justices Kennedy and Scalia, observed that "[t]he *Basic* decision itself is questionable" and noted that the *Basic* dissent's concerns with the economic theories underlying the fraud-on-the-market presumption "remain valid today."

Halliburton asked the Court to overrule *Basic* and require plaintiffs to prove actual reliance. Alternatively, Halliburton asked the Court to afford defendants an opportunity to rebut the presumption of reliance and defeat class certification with evidence that the alleged misrepresentation did not distort the market price of the stock.

CASE BACKGROUND

The underlying litigation in *Halliburton Co. v. Erica P. John Fund* (13-317) involves securities fraud claims brought against Halliburton Company and its CEO (collectively, "Halliburton") in connection with alleged misstatements concerning Halliburton's revenues, projected liability for asbestos claims, and the anticipated cost savings and efficiencies of a 1998 merger.

This is the second Supreme Court disposition of the case. In 2011, the Supreme Court unanimously held that the Fifth Circuit had "erred by requiring proof of loss causation for class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (Roberts, C.J.). The Supreme Court remanded the action for consideration of additional arguments in opposition to class certification.

In the district court on remand, Halliburton argued that the class should not be certified because the evidence showed that the alleged misrepresentations did not affect the price of the company's shares. The district court declined to consider this evidence, finding that defendants may not rebut the fraud-on-the-market presumption at the class certification stage by showing an absence of price impact. Halliburton appealed. Relying on the Supreme Court's decision in *Amgen*, 133 S. Ct. 1184, the Fifth Circuit agreed, holding that "price impact fraud-on-the-market rebuttal evidence should not be considered at class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 435 (5th Cir. 2013) (Davis, J.).

SUMMARY OF THE DECISION

The Supreme Court unanimously held that defendants must have an opportunity to rebut the *Basic* presumption of reliance at the class certification stage with evidence that the alleged misstatement did not distort the market price of the stock. The Court was divided 6-to-3 on whether to jettison the *Basic* presumption altogether and require that plaintiffs prove actual reliance. Chief Justice John G. Roberts Jr., writing for the majority, concluded that the *Basic* presumption should be preserved. Justices Anthony M. Kennedy, Ruth Bader Ginsburg, Stephen G. Breyer, Sonia Sotomayor, and Elena Kagan joined the majority opinion. In a concurring opinion joined by Justices Antonin Scalia and Samuel A. Alito Jr., Justice Clarence Thomas wrote that *Basic* should be overruled entirely.

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- Chief Justice Roberts

THE COURT DECLINES TO ELIMINATE BASIC'S PRESUMPTION OF RELIANCE

At the outset, the Court observed that Halliburton faced a high standard for overruling *Basic*. "Before overturning a long-settled precedent, however, we require 'special justification,' not just an argument that the precedent was wrongly decided." The Court found that Halliburton had not met that heightened showing.

First, the Court declined Halliburton's invitation to revisit the issue of whether the *Basic* presumption is consistent with Congress's intent in passing the Securities Exchange Act of 1934. "The *Basic* majority did not find that argument persuasive then, and Halliburton has given us no new reason to endorse it now."

Second, the Court rejected Halliburton's argument that the economic theory upon which the *Basic* presumption rests can no longer withstand scrutiny. "The academic debates discussed by Halliburton have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital markets hypothesis acknowledge that public information generally affects stock prices…Halliburton has not identified the kind of fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities."

Third, the Court dismissed Halliburton's argument that *Basic* is at odds with recent decisions construing the Rule 10b-5 implied right of action and class certification standards. The Court explained that in *Central Bank* and *Stone Ridge* it was asked to extend Rule 10b-5 to new categories of defendants and that doing so "would have eviscerated the requirement that a plaintiff prove that he relied on a misrepresentation made *by the defendant*." The *Basic* presumption, by contrast, "does not eliminate that requirement but rather provides an alternative means of satisfying it." The Court similarly found that *Basic* is consistent with the recent holdings in *Walmart* and *Comcast* that plaintiffs must prove, not simply plead, that common questions of reliance predominate over individual ones.

Finally, the Court concluded that the policy concerns raised by Halliburton, such as the proliferation of strike suits where plaintiffs leverage class certification to obtain large settlements from defendants, are more properly addressed to Congress.

THE COURT HOLDS DEFENDANTS CAN REBUT THE BASIC PRESUMPTION WITH EVIDENCE THAT THE ALLEGED MISSTATEMENT DID NOT AFFECT THE STOCK PRICE

Halliburton proposed two alternatives to overruling *Basic*. The first alternative would require plaintiffs to prove that a defendant's misrepresentation actually affected the stock price in order to invoke the *Basic* presumption. The second proposed alternative would allow defendants to rebut the presumption of reliance with evidence of a lack of price impact before class certification.

The Court declined to put the burden on plaintiffs to prove price impact on the grounds that it would "effectively jettison half of [the *Basic* presumption]." Distinguishing between materiality (a merits inquiry) and price impact (which "has everything to do with the issue of predominance at the class certification stage"), the Court ruled that defendants must be given the opportunity to defeat the presumption at the class certification stage through evidence that an alleged misrepresentation did not actually affect the market price of the stock. The Court observed that in many

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misrepresentation-based cases the parties already introduce competing price impact evidence at the class certification stage to address the question of whether the market is efficient – a prerequisite for invoking the *Basic* presumption. The Court recognized it would be a "bizarre result" not to allow such evidence for the purpose of rebutting the *Basic* presumption altogether. "Evidence of price impact will be before the court at the certification stage in any event…[W]e see no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact."

Because the courts below had denied Halliburton the opportunity to show lack of price impact at the class certification stage, the Court vacated the judgment of the Fifth Circuit and remanded the case for further proceedings consistent with the opinion.

JUSTICE GINSBURG'S CONCURRING OPINION

Justice Ginsburg (joined by Justices Breyer and Sotomayor) penned a very brief concurring opinion to express the view that the Court's decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." Justice Ginsburg recognized, however, that "[a]dvancing price impact consideration from the merits stage to the certification stage may broaden the scope of discovery available at certification."

JUSTICE THOMAS'S CONCURRING OPINION

"[W]hen we err in areas of judge-made law, we ought to presume that Congress expects us to correct our own mistakes—not the other way around."

- Justice Thomas

Justice Thomas authored an opinion (joined by Justices Scalia and Alito) concurring in the judgment but concluding that *Basic* should be overruled and that plaintiffs should be required to prove actual reliance. "Logic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains."

The concurrence first attacks the theories underpinning the *Basic* presumption. "The first assumption – that public statements are 'reflected' in the market price – was grounded in an economic theory that has garnered substantial criticism since *Basic*. The second assumption – that investors categorically rely on the integrity of the market price – is simply wrong."

Second, the concurrence credits Halliburton's argument that the *Basic* presumption conflicts with the Court's more recent cases clarifying Rule 23's class-certification requirements, including the *Wal-Mart* and *Comcast* decisions that hold a party seeking to maintain a class action "must affirmatively demonstrate his compliance with Rule 23."

Third, the concurrence observes that "the realities of class-action procedure make rebuttal based on an individual plaintiff's lack of reliance virtually impossible." That is because at the class certification stage "rebuttal is only directed at the class representative, which means that counsel only needs to find one class member who can withstand the challenge."

Finally, the concurrence finds that principles of *stare decisis* do not dictate the preservation of *Basic,* particularly given the fact that the *Basic* presumption is judge-made law. Nor is it appropriate, the concurrence posits, to "draw from Congress' silence on this matter an inference that Congress approved of *Basic*." "[W]hen we err in areas of judge-made law, we ought to presume that Congress expects us to correct our own mistakes – not the other way around."

IMPLICATIONS

The middle course adopted by the Supreme Court retains the presumption that is the linchpin to certification of most misrepresentation-based 10b-5 claims while affording defendants a meaningful opportunity to prevent certification through event studies and other evidence demonstrating that an alleged misrepresentation had no price impact. In *Dura*, the Supreme Court required 10b-5 plaintiffs to show that a stock drop is attributable to fraud and not "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price," and lower courts have frequently relied on event studies for this purpose. Similarly, the Supreme Court's embrace of direct analysis at the class certification stage of the market impact of a specific alleged misstatement reinforces the importance of a thoughtful event study, and should result in denial of certification where defendants can show that an alleged misrepresentation did not distort the market price. The decision should also result in a shift in the focus at the class certification stage from the overall efficiency of a market as a whole to the effect of the specific alleged misstatement. Once a defendant has come forward with evidence that the alleged misrepresentation had no price impact, the onus will be on plaintiffs to refute that evidence. It remains to be seen whether Justice Ginsburg will be proved right in her prediction that the decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims."

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

New York City:
Bruce D. Angiolillo
212-455-3735
bangiolillo@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

Nicholas Goldin
212-455-3685
ngoldin@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

Linda H. Martin
212-455-7722
lmartin@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

Mary Kay Vyskocil
212-455-3093
mvyskocil@stblaw.com

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

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

Jonathan K. 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

Cheryl J. Scarboro
202-636-5529
cscarboro@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

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

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

Palo Alto
2475 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
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

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

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

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