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ALERT MEMORANDUM

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In *Halliburton*, Supreme Court Affirms *Basic* but Grants Defendants New Means for Defeating Class Certification in Securities Fraud Actions

Last week, the U.S. Supreme Court issued *Halliburton Co. v. Erica P. John Fund, Inc.*, in which it declined to overrule or modify its 1988 decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) ("*Basic*"). *Basic* adopted the "fraud-on-the-market theory" to create a rebuttable presumption of reliance for purposes of Section 10(b) fraud claims. Without the fraud-on-the-market doctrine, each member of a putative Section 10(b) class would have to show reliance individually, making such class actions nearly impossible to certify. While *Halliburton* declined to overrule *Basic,* it made clear, for the first time, that defendants can defeat class certification if they can show that the challenged misstatements had no "price impact." The Court did not explicitly define that term; it appears to mean (although this may well be the subject of litigation going forward) that if the defendants can demonstrate that the challenged statement did not cause a price movement (essentially, that there is no loss causation), class certification will be defeated, and the case will likely be dismissed. But to take advantage of this new condition to class certification, the defendant must shoulder the burden of proof at the class certification stage (at the later stages of summary judgment and trial, the burden is on the plaintiff to show loss causation). Accordingly, while defendants will not be able to employ the *Halliburton* price-impact defense to class certification in every case, those cases where they can may not last beyond the class certification stage.

Background

The *Halliburton* decision was much anticipated because it presented the Supreme Court with the opportunity to reconsider or modify its prior decision from 1988 in *Basic*. In the Supreme Court's 2013 decision in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184 (U.S. 2013) ("*Amgen*"), four justices – Scalia, Thomas and Kennedy in their dissents, and Alito in a concurrence – had signaled a desire to revisit *Basic*'s original "fraud-on-the-market" theory and presumption of reliance, and there was the possibility that the Court would entirely overrule, or at least substantially modify, its *Basic* decision.

In order to certify a class under Rule 23(b)(3) of the Federal Rules of Civil Procedure, a plaintiff must show that questions of law and fact common to the entire class predominate over individualized issues specific to each class member. The challenge for securities cases, *Basic* recognized, was the element of reliance, which was understood traditionally to be an individualized issue of whether each separate investor directly relied on the alleged misstatements in making a purchase or sale decision. In response to this challenge, *Basic* created a legal mechanism for showing reliance that would facilitate securities class actions by holding that where a plaintiff

shows there was a fraud on the market – that misstatements alleged to be material were made publicly, that the market for the company's stock is efficient, and that transactions occurred between the time of the alleged misstatements and a corrective disclosure – the plaintiff is entitled to a rebuttable presumption of reliance, thereby facilitating class certification since such proof would be common to all class members.

The fraud-on-the-market theory is premised on the view that in an efficient market, all publicly available material information about a company is promptly reflected in the company's stock price, and investors who purchase or sell the stock based on the market price do so in reliance on the integrity of the market and the market price. Thus, according to the theory, whenever investors purchase or sell stock at the market price in an efficient market, their reliance on any public information – including public material misstatements – may be presumed for purposes of Rule 23. While *Basic* made clear that the reliance presumption can be rebutted, in *Amgen* the Court held that a challenge to the materiality of the statement could not be made at the class certification stage. And in 2011, the first time the *Halliburton* case was before the Supreme Court (*Halliburton I)*, it ruled that a plaintiff need not show loss causation (that the alleged misstatements caused the purported loss) at the class certification stage. The combination of *Amgen* and *Halliburton I* notably limited the tools available to defendants challenging class certification.

After the Supreme Court remanded *Halliburton I*, Halliburton argued that class certification was still inappropriate because the evidence it had previously introduced to disprove loss causation also showed that none of the alleged misrepresentations actually had any impact on the price of Halliburton's stock price. It further argued that this evidence rebutted the *Basic* presumption, and that a class should therefore not be certified because issues of reliance would need to be proven on an individual basis, precluding class certification. The District Court declined to consider the argument, and on appeal the Fifth Circuit affirmed, finding that the issue of price impact, like materiality under *Amgen,* was not appropriately considered at the class certification stage and had to be reserved for the merits stage of the case.

The Supreme Court's Opinion

Chief Justice Roberts' opinion for the Court declined to either overrule or modify *Basic* in the way Halliburton requested. The Court did agree with Halliburton, however, that a defendant should be permitted to present rebuttal evidence of no price impact at the class certification stage in order to show that a plaintiff is not entitled to the presumption of reliance.

First, the Court rejected Halliburton's arguments that *Basic* should be overruled or substantially modified principally on the grounds of *stare decisis*. Before overturning a long-settled precedent, the Court explained, there must be a "special justification," not

just an argument that the precedent was wrongly decided, and Halliburton had failed to make that showing. The main arguments that Halliburton put forth in support of overruling *Basic* were that (i) the *Basic* presumption is inconsistent with Congress's intent in passing the Exchange Act, and that the proper analogue to Section 10(b) is Section 18(a), which creates an express private cause of action based on misrepresentations, but requires proof of direct – "eyeball" – reliance; and (ii) the *Basic* decision rested on two now invalid premises, namely the "efficient capital markets hypothesis" and the notion that investors invest in reliance on the integrity of the market price. The Court rejected all of these arguments, explaining that they presented issues that were previously contemplated by *Basic* and either taken into account by the decision or rejected by it. Thus, the Court concluded that none of these arguments so discredits *Basic* as to constitute "special justification" for overruling the decision. In Justice Thomas' Concurrence in the Judgment, joined by Justices Scalia and Alito, he firmly disagreed with the Court's reasoning, arguing that *Basic* should be overruled because "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the façade that remains."

Second, the Court agreed with Halliburton that, even if plaintiffs need not directly prove price impact to invoke the *Basic* presumption of reliance, defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price. The Court reasoned that a defendant is already entitled to present evidence of no price impact at the merits stage and even at the class certification stage for purposes of countering a plaintiff's showing of market efficiency. Given this circumstance, a restriction that defendants may not rely on that same evidence at the class certification stage to rebut the presumption of reliance altogether "makes no sense, and can readily lead to bizarre results." The Court thus explained: "Under *Basic's* fraud-on-the-market theory, market efficiency and the other prerequisites for invoking the presumption constitute an indirect way of showing price impact." That is, *Basic* already in effect requires plaintiffs to show price impact, but permits them to do so indirectly through the proof relevant to whether the market in which the stock trades is efficient. The Court then explained that "an indirect proxy should not preclude direct evidence when such evidence is available. . . . While *Basic* allows plaintiffs to establish th[e] precondition [of price impact] indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply."

Implications of the Court's Decision

While the Supreme Court did not go as far as Halliburton had sought, the Court's decision does give defendants a new tool at the class certification stage with which to defeat class certification. Defendants will now have the ability to come forward then

with evidence to show no statistically significant price movement in response to specific challenged statements. Where a defendant prevails in demonstrating no price impact, that will defeat plaintiff's invocation of the presumption of reliance, and no class will be certified. In addition, that should result in dismissal of the action: proof that there is no price impact will mean that even the named plaintiff will not be able to show essential elements of a Section 10(b) claim – reliance (at least not without proof of "eyeball" reliance) and damages (because no price impact will mean no loss causation). Further, in combination with the U.S. Supreme Court's 2013 decision in *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013) – in which the Court held that a plaintiff seeking certification of a damages class under Rule 23(b)(3) must establish through "evidentiary proof" that damages can be measured on a class-wide basis – even if a defendant is unable to prove no price impact, its evidence may be sufficient to show that the plaintiff has no viable theory of loss causation, and thereby defeat class certification on that ground.

Further, while *Halliburton*'s focus is on misstatement cases, the Court's analysis and language indicate a broader application to omission cases. The Supreme Court held in *Affiliated Ute Citizens of the State of Utah v. U.S.*, 406 U.S. 128 (1972) that, in omission cases, where the defendant is alleged to have failed to disclose a material fact that it had a duty to disclose, "positive proof of reliance" is not required and plaintiffs are entitled to a rebuttable presumption of reliance where they can show that the omission was material. In *Halliburton*, however, the Court emphasized that "price impact is an essential prerequisite for *any* rule 10b-5 class action." (emphasis added). That appears to mean that, even in omissions class actions, a defendant can defeat class certification (and likely obtain dismissal of the action) by showing no price impact.

If you have any questions, please feel free to contact any of your regular contacts at the firm. You may also contact our partners and counsel listed under "Litigation and Arbitration" located in the "Practices" section of our website at http://www.clearygottlieb.com.

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