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U.S. Supreme Court Holds "Loss Causation" Not a Prerequisite to Class Certification in Fraud-on-the-Market Cases

In *Erica P. John Fund Inc.* v. *Halliburton Co.*, No. 09-1403 (June 6, 2011), the Supreme Court of the United States decided that in seeking class certification, a plaintiff in an action under the federal securities laws is not required to prove facts demonstrating loss causation.[1] In so holding, the Supreme Court rejected a contrary rule, adopted only by the Fifth Circuit, that proof of loss causation is a prerequisite to class certification. *Halliburton* was the Supreme Court's first significant re-examination of the "fraud-on-the-market" theory of reliance adopted in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988).

The Supreme Court, however, decided only the narrow issue of whether loss causation is a prerequisite to class certification. According to arguments advanced by the *Halliburton* defendant before the Supreme Court, the Fifth Circuit had intended to rule only that in order to obtain class certification, a plaintiff in an action under the federal securities laws must prove "price impact." "Price impact" refers to proof that the defendant's alleged misrepresentation in fact distorted the market price of the security at issue in the case. The Supreme Court rejected the *Halliburton* defendant's characterization of the Fifth Circuit's decision. The Supreme Court viewed the Fifth Circuit as having required proof of "loss causation," as the Supreme Court's cases have defined that concept, and held only that this aspect of the Fifth Circuit's decision was erroneous. The Supreme Court thus left open what were arguably the most important issues potentially presented by *Halliburton*. Those issues involve (i) whether a district court should examine evidence of price impact at the class certification stage, and (ii) whether, if so, at that stage a plaintiff has the burden of affirmatively proving price impact; a defendant instead has the burden of rebutting a presumption of price impact; or an intermediate structure of shifting burdens may apply.

As further discussed below, the Supreme Court's 1988 decision in *Basic* ruled that if a plaintiff in a class action under the federal securities laws makes certain threshold showings, the plaintiff may be entitled to a presumption of reliance. This presumption, in turn, can assist the plaintiff in obtaining class certification. Very substantial arguments can be made that when a plaintiff invokes the presumption of reliance, a district court should examine the issue of price impact at the class certification stage.

The Second and Third Circuits have held that when a district court examines the issue of price impact at the class certification stage, the defendant has the burden of disproving price impact. In contrast, the reasoning in decisions by the Fifth Circuit suggests that at the class certification stage, the plaintiff has the burden of affirmatively proving price impact. (The

[1] This firm represented the Securities Industry and Financial Markets Association on the *amicus* brief it submitted to the Supreme Court in this matter.

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Supreme Court's *Halliburton* decision reversed a decision by the Fifth Circuit, but the aspect just described of the Fifth Circuit's jurisprudence may well survive *Halliburton*.) And advocates for some plaintiffs in securities actions have argued that at the class certification stage, a district court should not consider evidence bearing on price impact at all. That assessment, these advocates have argued, should instead occur only on motions for summary judgment or at trial. It has been further argued that the Seventh Circuit follows this approach, although the Seventh Circuit's actual stance appears to be debatable.

Halliburton declines to decide these issues. But for obvious reasons, the Supreme Court is generally reluctant to reserve questions that the Justices believe have been definitively settled by the Supreme Court's existing jurisprudence. The Court's announcement that an issue remains open, after all, invites lower courts to take the Supreme Court at its word, and to approach the issue declared to be open by consulting fundamental underlying principles. After the Supreme Court has pointedly indicated that an issue is open, it makes markedly less sense for the lower federal courts to hunt for answers resolving the issue in stray phrases employed by the Supreme Court in that Court's prior decisions.

Halliburton, which conspicuously declined to decide the price impact issues, thus can be read to imply that the language of the *Basic* decision does not dictate how those issues should be resolved. If litigants and the lower federal courts do read *Halliburton* in that way, the decision may encourage more aggressive arguments by defendants in the lower federal courts, or at least in Circuits where the issue is currently open, that a plaintiff has the burden of proof on price impact at the class certification stage. *Halliburton* may also encourage lower federal courts to evaluate issues relating to price impact by revisiting the economic and legal underpinning of *Basic* in light of developments during the twenty-three years since *Basic* was decided. Those developments include a much deeper and more nuanced understanding by economists of the likelihood that statements by issuers or other market participants will have a non-transient effect on the market price of a security. Decisions by the lower federal courts that take a fresh look at the price impact issues in light of *Halliburton*, in turn, may set the stage for the Supreme Court to address those issues in another case.

1. The Supreme Court's 1988 Decision in *Basic*

The *Basic* decision inaugurated the modern era of class actions asserting claims for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. *Basic* addressed the following problem. In general, when a plaintiff attempts to bring a class action asserting claims under Section 10(b) and Rule 10b-5, the plaintiff will seek certification of the class under Rule 23(b)(3) of the Federal Rules of Civil Procedure. Rule 23(b)(3) requires a plaintiff to show, among other things, that "questions of law or fact common to class members predominate over any questions affecting only individual members."

Reliance (also called "transaction causation") is an element of a claim under Section 10(b) and Rule 10b-5. As traditionally understood, reliance requires proof that a particular plaintiff in fact relied on an alleged misrepresentation in purchasing or selling a security. Put otherwise, a plaintiff was traditionally required to show that in the absence of the alleged misrepresentation, the plaintiff would not have purchased or sold the security. Reliance, understood in this way, is inherently an individual issue: actual reliance necessarily depends on the knowledge and state of mind of each particular investor.

If, however, each member of a plaintiff class must establish reliance through proof relating to that individual class member's knowledge and state of mind, the class cannot be certified under Rule 23(b)(3). That is so, as the Supreme Court acknowledged in *Basic*, because if reliance is an individual issue, it would follow that common issues do not "predominate" for purposes of Rule 23(b)(3), and the plaintiff class cannot satisfy the criteria for certification.

Basic created a framework under which a plaintiff in a class action under Section 10(b) and Rule 10b-5 can establish indirect reliance through class-wide rather than individual proof. If a plaintiff establishes reliance through class-wide proof, the plaintiff will have overcome the obstacle that reliance otherwise presents to satisfying the "predominance" requirement for class certification.

More specifically, the *Basic* Court decided that reliance can be proven indirectly as well as directly. The *Basic* Court focused on situations where (i) a defendant's misrepresentation has distorted the market price of a security, and (ii) an investor then buys or sells a security in reliance on the supposed integrity of a market price that, unknown to the investor, has been distorted by the misrepresentation. In such circumstances, according to *Basic*, the investor's direct reliance on a distorted market price may constitute indirect reliance on the underlying misrepresentation.

Founded on this reasoning, the *Basic* Court created a rebuttable presumption leading to a finding of indirect reliance. In order to invoke this presumption, a plaintiff must show that the members of the plaintiff class traded in an efficient market—in other words, a market that rapidly incorporates all public information about a security into the price of that security. (If a market is not efficient, there is no reason to conclude that a misrepresentation—or even a material misrepresentation—is likely to affect the market price of a security, and the syllogism underlying *Basic* thus does not apply.) Under *Basic*, investors who trade in an efficient market, and who satisfy certain additional requirements, are entitled to a rebuttable presumption of reliance. If a plaintiff successfully invokes the presumption, the plaintiff can prove indirect reliance through class-wide proof, and thus can prove reliance in a way that is consistent with the "predominance" requirement for class certification under Rule 23(b)(3).

The *Basic* Court also emphasized, however, that the presumption of reliance was "rebuttable." Under *Basic*, the presumption of reliance can be defeated by "[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." 485 U.S. at 248.

2. *Halliburton*

More than two decades of litigation under *Basic* have led to the emergence of substantial questions in the lower courts about the presumption of reliance it established. The *Halliburton* case involved the relationship between the *Basic* presumption and another causation-related requirement, that of "loss causation." As the Supreme Court explained in *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336, 342 (2005), loss causation is the "causal connection between the material misrepresentation and the loss" suffered by investors. In *Halliburton*, the Fifth Circuit affirmed the district court's denial of class certification for failure to establish loss causation. *See Archdiocese of Milwaukee Supporting Fund, Inc.* v. *Halliburton Co.*, 597 F.3d 330, 334 (5th Cir. 2010) ("In order to obtain class certification on its claims,

Plaintiff was required to prove loss causation, i.e., that the corrected truth of the former falsehoods actually caused [Halliburton's] stock price to fall and resulted in [plaintiff's alleged] losses.").

The plaintiff in *Halliburton* claimed that Halliburton Co. made false statements about potential liability in asbestos litigation, accounting of revenue in certain businesses, and the benefits of a merger. *Id.* The plaintiff further claimed that when the truth concealed by these alleged misstatements was revealed to the market, the price of Halliburton's stock fell in response. The plaintiff endeavored to prove that theory through an expert analysis of changes in the price of Halliburton stock on the dates of purported corrective disclosures. *Id.* at 339. The district court, however, deemed the expert report insufficient to show that the putative corrective disclosures—as opposed to other, non-fraud-related bad news—caused the price of Halliburton's stock to decline. *Id.* at 336, 338. The district court therefore denied plaintiff's motion for class certification, and the Fifth Circuit affirmed. *Id.* at 344.

The Supreme Court vacated the judgment of the Fifth Circuit. The Supreme Court held that in order to invoke the *Basic* presumption of reliance at the class certification stage, a plaintiff is not required to prove loss causation. In explaining its decision, the Supreme Court emphasized the difference between reliance, which is the subject of the *Basic* presumption, and loss causation, which the Court regarded as having "no logical connection" to the fraud-on-the-market theory adopted in *Basic*. Op. at 7-8. The Court held that reliance focuses on "facts surrounding the investor's decision to engage in the transaction," and that under *Basic*, "an investor presumptively relies on a defendant's misrepresentation if that 'information is reflected in [the] market price' of the stock at the time of the relevant transaction." *Id.* at 6-7 (quoting *Basic*, 485 U.S. at 247). "Loss causation, by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss." *Id.*

"[A] subsequent economic loss" within the meaning of this passage typically refers to a decline in the price of a security after the plaintiff has purchased the security. As the Court noted, such a loss may be caused by factors other than the revelation of information that the defendant's misrepresentation had previously concealed from the market. The point of the loss causation inquiry is to bar a plaintiff from recovering losses that were caused by these other factors, as opposed to losses caused by the misrepresentation itself. But, the Court held, "[t]he fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory." *Id.* at 7.

The Court also rejected Halliburton's argument that what the Fifth Circuit actually required was proof of price impact, as opposed to loss causation. Halliburton conceded that Rule 10b-5 plaintiffs need not prove "loss causation" in the conventional sense to invoke *Basic's* presumption of reliance. Halliburton nonetheless urged affirmance on the ground that the Fifth Circuit properly required the district court to consider proof of price impact, i.e., proof that "the alleged misrepresentations affected the market price in the first place." *Id.* at 8. "Halliburton's theory [wa]s that if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation merely because he purchased stock at that price"; "loss causation," as used by the Fifth Circuit, was simply "shorthand" for this

alternative analysis. *Id.* at 8-9. The Court, however, refused to accept "Halliburton's wishful interpretation of the Court of Appeals' opinion." *Id.* at 9. The Court noted the Fifth Circuit's repeated use of the words "loss causation" and quoted the Court of Appeals' requirement that plaintiffs prove "'that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses.'" *Id.* (quoting *Archdiocese of Milwaukee Supporting Fund, Inc.*, 597 F.3d at 334). According to the Court, it was required to "take the Court of Appeals at its word. Based on those words, the decision below cannot stand." *Id.*

3. Price Impact: The Critical Undecided Issue in *Halliburton*

By focusing solely on the loss causation issue, the Court's decision in *Halliburton* avoids questions that have divided the lower courts and were presented by the parties in their briefs. In particular, there is disagreement among the lower courts concerning whether a defendant may attack the presumption of reliance at the class certification stage by introducing evidence that the alleged misrepresentations had no impact on the price of the relevant security, and therefore did not distort that price at the time the members of the class entered into transactions in the security. The Second and Third Circuits allow a defendant to attempt to rebut the *Basic* presumption of reliance by introducing evidence that the alleged misrepresentation did not affect the market price of the security at issue. *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 485 (2d Cir. 2008); *In re DVI, Inc. Sec. Litig.*, Nos. 08-8033, 08-8045, 2011 WL 1125926, at *8 (3d Cir. Mar. 29, 2011). The Seventh Circuit's position is not completely clear, although the Seventh Circuit appears to have rejected placing the initial burden of proving price impact on the plaintiff at the class certification stage. *See Schleicher* v. *Wendt*, 618 F.3d 679, 685 (7th Cir. 2010). In the Fifth Circuit's view, the plaintiff must prove at the class certification stage that the defendant's misrepresentation affected the market price of the underlying security. *Archdiocese of Milwaukee Supporting Fund, Inc.*, 597 F.3d at 335. The Supreme Court's opinion in *Halliburton* does not foreclose the Fifth Circuit from adhering to that view. Op. at 8 n.*.

The Supreme Court's *Halliburton* opinion is carefully limited to the loss causation question. In that respect, the opinion conforms to statements by the Chief Justice proposing renewed emphasis on the principle that the Supreme Court should not ordinarily decide a case on broader grounds than the case itself fairly requires. The *Halliburton* opinion, however, seems to contain clues intimating how the Court might resolve price impact issues in future cases. According to the Court, "*Basic*'s fundamental premise" is this: "an investor presumptively relies on a misrepresentation *so long as it was reflected in the market price* at the time of his transaction." *Id.* at 7 (emphasis added). Previously in the opinion, the Court explained that "[u]nder *Basic*'s fraud-on-the-market doctrine, an investor presumptively relies on a defendant's misrepresentation *if that 'information is reflected in [the] market price' of the stock at the time of the relevant transaction*." *Id.* (quoting *Basic*, 485 U.S. at 247) (emphasis added). These sentences recognize that *Basic* has no logical application if an alleged misrepresentation does *not* affect the market price of a security. And these sentences also appear to suggest that the *Basic* presumption applies only "so long as" or "if" price impact is shown. The sentences do not describe price impact as itself presumed; they appear to describe price impact as a threshold requisite for application of the presumption.

At a minimum, these sentences indicate that *Basic*'s premise can be defeated by evidence of no price impact. They also suggest that the issue should be resolved at the class certification

stage, because applicability of the *Basic* presumption is a prerequisite to class certification. Halliburton Co. conceded before the Supreme Court that under Halliburton's interpretation of *Basic*, a defendant has the initial burden of producing evidence rebutting price impact at the class certification stage. "According to Halliburton, a plaintiff must prove price impact only after *Basic*'s presumption has been successfully rebutted by the defendant." *Id.* at 8 n.*. Halliburton derived that proposed framework (although the Supreme Court did not say so) from Rule 301 of the Federal Rules of Evidence, which deals with the effect of a presumption. The Supreme Court noted this concession, but expressly declined to adopt it. In other words, the Supreme Court appears to have left open the possibility, among others, that it may place the initial burden of proving price impact on plaintiff in a future case.

The Supreme Court's opinion in *Halliburton* is likely to intensify the battle in the lower courts over the proper analytic approach to consideration of evidence bearing on price impact at the class certification stage. *Halliburton*, despite its circumspect veneer, may have stoked the flames by signaling the Supreme Court's willingness to re-examine aspects of the framework initially sketched in *Basic*, and in that way may have brought nearer the day when the Court will need to resolve the critical issues that *Halliburton* left open.

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Charles E. Davidow
202-223-7380
cdavidow@paulweiss.com

Brad S. Karp
212-373-3316
bkarp@paulweiss.com

Daniel J. Kramer
212-373-3020
dkramer@paulweiss.com

Walter Rieman
212-373-3260
wrieman@paulweiss.com

Richard A. Rosen
212-373-3305
rrosen@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

TORONTO
One Yonge Street, Suite 1801
Toronto, ON M5E 1W7
Canada
+1-416-504-0520

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410

Contributing authors include John H. Longwell and Andrew W. Amend.