June 25, 2014

On June 23, the Supreme Court issued its much-awaited decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (U.S. June 23, 2014). The Court declined Halliburton's invitation to eliminate the fraud-on-the-market presumption first adopted in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) ("*Basic*"), but it significantly eased the presumption's impact on defendants. Defendants may now rebut the presumption by presenting evidence at class certification that alleged misrepresentations and subsequent corrections had no price impact. The 9-0 decision was authored by Chief Justice Roberts, with Justices Thomas, Alito, and Scalia concurring only in the judgment.

A *Basic* Presumption

In securities fraud class actions, one of the most important elements is plaintiffs' "reliance" on the alleged misrepresentations. Because Federal Rule of Civil Procedure 23(b)(3) requires a plaintiff to demonstrate that common questions "predominate" over individual issues to achieve class certification, individual reliance issues would thus appear to preclude class certification in securities fraud cases. To address this, the *Basic* Court adopted the fraud-on-the-market theory, which affords plaintiffs a "rebuttable presumption" of reliance on defendants' alleged public, material misrepresentations if the stock trades in an efficient securities market. The *Basic* majority reasoned that in an efficient market a stock's price incorporates all public, material information, including misrepresentations, and investors presumptively rely on that price when they trade. The *Basic* decision also allowed defendants to rebut the presumption, including by showing that the alleged misrepresentations did not affect the stock's price, *i.e.*, had no "price impact."

The *Halliburton* decision

In *Halliburton*, the plaintiff alleged that Halliburton had made fraudulent misrepresentations that artificially inflated its stock price, which declined when the truth was revealed. The plaintiff invoked the fraud-on-the-market presumption in seeking class certification. In 2011, the Supreme Court reversed a lower court's decision denying class certification in the case, holding that plaintiffs need not prove that the alleged misrepresentations caused their losses prior to class certification. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011).

On remand, Halliburton again opposed class certification, this time contending that it could rebut the fraud-on-the-market presumption by demonstrating the absence of price impact. The U.S. Court of Appeals for the Fifth Circuit affirmed the district court's rejection of this argument and grant of class certification, holding that Halliburton could not rebut the fraud-on-the-market presumption at class certification with price impact evidence, but could present this evidence at trial. The holding deepened an existing circuit split on this issue. The Supreme Court granted certiorari (1) to resolve the circuit split over whether price impact evidence could rebut the fraud-on-the-market presumption at class certification; and (2) more fundamentally, to consider whether to overrule or modify the presumption itself.

The Fraud-on-the-Market Presumption Remains Viable

In *Halliburton*, the Court retained the fraud-on-the-market presumption, rejecting Halliburton's arguments that the presumption was no longer tenable because (1) substantial empirical evidence established that capital markets are not efficient (*i.e.*, market prices

often do not incorporate public information immediately or rationally); and (2) investors often do not rely on the accuracy of stock prices when investing. However, the Court found that these arguments did not undermine the presumption, which was based on the "fairly modest" premise that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock prices." The Court also was satisfied that most investors rely directly or indirectly on price integrity and that Halliburton had not demonstrated a fundamental shift in economic theory that negated this premise.

Defendants May Rebut the Presumption Via Price Impact Evidence at Class Certification

The Supreme Court did, however, agree with Halliburton that it should be able to present evidence of a lack of price impact to rebut the fraud-on-the-market presumption. Cooley had advocated for this exact result in an **amicus brief filed on behalf of the Washington Legal Foundation**.

The Court held that when defendants can present evidence that their alleged misrepresentations did not impact the stock price, "*Basic*'s fraud-on-the-market theory and presumption of reliance collapse[.]" Moreover, defendants already are entitled to present evidence of no price impact at class certification to counter plaintiffs' showing of market efficiency, a prerequisite for the fraud-on-the-market presumption. The Court reasoned that precluding defendants from rebutting the presumption at class certification could lead to "bizarre results." A court might be compelled to apply the fraud-on-the-market presumption even where the record evidence established that the alleged misrepresentations had no price impact, meaning that investors could not logically be deemed to have relied indirectly on the misrepresentations by virtue of having relied on the integrity of the market price.

Because Halliburton was deprived of the opportunity to present evidence of no price impact to defeat the fraud-on-the-market presumption at class certification, the Court vacated the judgment below and remanded for further proceedings.

Practical Considerations

In affirming the continued existence of the fraud-on-the-market presumption, *Halliburton* preserved the decades-old *Basic* framework for securities fraud cases: to receive the benefit of the presumption, plaintiffs must prove that the alleged misrepresentations were public and material, and that the stock traded in an efficient market. Yet *Halliburton* is likely to have a significant effect on many cases that reach the class certification stage. Because most securities fraud cases in which a class is certified settle quickly thereafter, the price impact defense was beyond most defendants' reach in circuits that deferred consideration of the defense until trial. In permitting defendants instead to rebut the reliance presumption at class certification, the Court has materially advanced defendants' ability to defend against weak securities fraud cases in which the alleged misrepresentations did not affect the share price.

As such, *Halliburton* may have an interesting ripple effect, at least for some cases. First, it may reduce the overall number of securities class actions filed by deterring the plaintiffs' bar from bringing cases with weak or nonexistent price impact evidence. Second, it may increase the length of cases that are filed, as defendants who have been unsuccessful in dismissing the action may be encouraged by *Halliburton* to seek at least some discovery on class certification issues before being willing to consider a settlement. Finally, where the evidence supports defendants' arguments against class certification, *Halliburton* will create more uncertainty for plaintiffs at the class certification stage and, as a result, may increase the likelihood that defendants will obtain a favorable pre-certification settlement.

If you have questions about this *Alert*, please contact a member of your Cooley team or one of the attorneys listed above from the Securities Litigation group.

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