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Halliburton: The Supreme Court Upholds Fraud-on-the-Market but Allows Defendants to Disprove Price Impact

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In *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317 (June 23, 2014) (*Halliburton II*), the Supreme Court declined to "overrule or substantially modify" *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the case that enshrined the "fraud-on-the-market" presumption that has allowed securities fraud cases to proceed as class actions on the premise that purchasers of securities that trade on an efficient market generally rely on the integrity of market prices. But the Supreme Court's decision does give defendants a new weapon for defeating such cases at the class certification stage by allowing a defendant to rebut the fraud-on-the-market presumption if it can prove that the alleged misrepresentations did not affect the price of the security. This middle-ground ruling will likely lead to increased and accelerated use of financial consultant experts, who will submit competing "event studies" to demonstrate that alleged misrepresentations did, or did not, have a "price impact."

An important facet of this decision is its interplay with the Supreme Court's earlier pronouncement in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 568 U. S. ___ (2013). In *Amgen*, the Court ruled that a class plaintiff need not show the materiality of alleged misstatements at the class certification stage. In *Halliburton II*, the Court has now permitted defendants to defeat certification by showing lack of price impact, which in many instances is akin to disproving materiality; after all, if a misrepresentation has no price impact, the most likely explanation is that the market did not consider the misrepresentation to be material. Considering *Amgen* and *Halliburton II* together, defendants will likely get more traction at the class certification stage with quantitative economic analyses that disprove price impact than with qualitative arguments that negate materiality. But it remains to be seen how courts will construe these battles of economic experts at the class certification stage.

Case Background

For decades, the *Basic* presumption has allowed some securities fraud plaintiffs to show a necessary element of a securities fraud claim – that they have relied on material misstatements by defendants – on a classwide, rather than individual basis. *Basic* permits that presumption of reliance on the theory that: first, the market price of stocks traded on an efficient market generally will reflect all publicly available information, including all material misstatements; and, second, most investors rely on the integrity of that market price. Without the *Basic* presumption of reliance, securities fraud cases could not proceed as class actions because each investor would need to show that he or she individually relied on the alleged misrepresentations, and thus common questions would not predominate.

After many twists and turns, the *Halliburton II* case became a vehicle for challenging the *Basic* presumption. The lead plaintiff, Erica P. John Fund, Inc. (EPJ Fund), brought a putative securities class action against Halliburton and one of its executives asserting violations of Section 10(b) of the Securities Exchange Act of 1934 and its accompanying Securities and Exchange Commission Rule 10b-5. As alleged, Halliburton made a series of misrepresentations in an effort to inflate the price of its stock, followed by a series of corrective disclosures that caused Halliburton's stock price to drop.

Before the district court, EPJ Fund moved to certify a class of all investors who purchased Halliburton stock in the relevant period. In its initial certification decision, the district court determined that EPJ Fund had satisfied all but one requirement of certifying a securities class action. Specifically, the district court concluded that EPJ Fund had not proven "loss causation" – *i.e.*, that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses – and therefore did not qualify for *Basic*'s presumption of reliance at the class certification stage. The Fifth Circuit affirmed.

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (*Halliburton I*), the Supreme Court vacated the Fifth Circuit's decision. There, the Court ruled that a showing of loss causation was not a prerequisite to application of the fraud-on-the-market theory. This was because the loss causation element of a 10b-5 claim (which concerns an inquiry into whether a misrepresentation caused an economic loss subsequent to the investment decision) was analytically distinct from the reliance element (which concerns the investor's decision to engage in the transaction itself). The fraud-on-the-market presumption concerns only the latter. Thus, the Court vacated the lower court rulings and remanded for further proceedings.

On remand, Halliburton argued that class certification was still inappropriate because the evidence showed that none of its alleged misstatements actually affected the market price of its stock. In other words, according to Halliburton, "it had rebutted *Basic*'s presumption that the members of the proposed class had relied on its alleged misrepresentations simply by buying or selling its stock at the market price." Thus, Halliburton argued, a class could not be certified because each investor would need to show individually that he or she relied on the alleged misstatements. The district court rejected this argument, and the Fifth Circuit affirmed.

The Supreme Court granted *certiorari* to decide two questions: (1) whether the Court should overrule or substantially modify the holding of *Basic*, to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory and (2) whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.

The Court Affirms the *Basic* Presumption

As for the first question, the Supreme Court began by noting that, before overturning a long-standing precedent, the Court requires "special justification" and explaining that merely arguing that the *Basic* precedent was wrongly decided would be insufficient. The Court then rejected each of Halliburton's arguments for overruling *Basic*.

<u>First</u>, Halliburton argued that the *Basic* presumption was inconsistent with congressional intent. In Halliburton's view, because a 10b-5 claim is an implied right of action, it must borrow its reliance requirement from its most analogous express cause of action, which it claimed to be Section 18(a) of the Securities Exchange Act, which in turn requires individual reliance. The Court rejected that argument by observing that the dissent in *Basic* had made the same argument, and Halliburton had provided the Court "no new reason" to accept the argument now.

<u>Second</u>, Halliburton argued that the fraud-on-the-market presumption rested upon the faulty economic premise that efficient markets reflect all publicly available information. The Court disagreed and held that *Basic* proceeded from "the fairly modest premise that 'market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.'"

<u>Third</u>, Halliburton challenged a premise of *Basic* that investors rely on the integrity of the market price. In doing so, Halliburton identified "a number of classes of investors for whom 'price integrity' is supposedly 'marginal or irrelevant.'" In response, the Court held that it is enough that most investors do rely on the integrity of the markets and noted that even Halliburton's highlighted investors were not indifferent to market integrity.

<u>Fourth</u>, Halliburton argued that *Basic* was inconsistent with the Court's recent jurisprudence. For example, Halliburton argued that, in its recent 10b-5 jurisprudence, the Court had declined to expand the private right of

action. But the Court held that *Basic* merely provided a particular means of proving reliance and was consistent with the 10b-5 action's original legal scope. Similarly, Halliburton argued that recent class action cases required plaintiffs to prove, and not merely plead, that their proposed class satisfies the requirements of Rule 23. However, the Court held that the *Basic* presumption did not relieve plaintiffs of complying with Rule 23, but instead set forth requirements that plaintiffs must prove in order to obtain the fraud-on-the-market presumption.

Fifth, the Court addressed Halliburton's arguments that *Basic* had led to harmful consequences by explaining that arguments of alleged harmful impact are best left to Congress, which can enact and, in recent years has enacted, legislation to curb some alleged securities class action abuses.

Rebutting the *Basic* Presumption

Having declined to overrule the *Basic* presumption, the Court then addressed the second question: whether a defendant should be permitted to rebut the presumption with proof that the alleged misrepresentations did not have any "price impact," without waiting for the merits hearing, *i.e.*, at the class certification stage.[1]

The Court held that a defendant should be permitted to do so because disproving "price impact" is a logical extension of the prior practice of disproving general market efficiency. The Court noted that proof of market efficiency typically has taken the form of event studies proving (or disproving) that the price of particular securities have responded generally to public statements in the market claimed to be efficient. The Court concluded that a logical extension of these efficiency analyses would be to demonstrate whether the specific misrepresentations at issue in the lawsuit had a "price impact" on the security. And if the misrepresentations did not have any price impact, then that would defeat the presumption that investors could prove reliance on market integrity.

Notably, in reaching this conclusion, the Court distinguished its earlier ruling in *Amgen, supra*. In *Amgen*, the Court held that the question of materiality – even as a prerequisite to the application of the fraud on the market theory – need not be shown by plaintiffs at the class certification stage. In *Halliburton II*, the Court distinguished price impact from materiality on the ground that materiality is a discrete issue that can be confined to the merits stage of a lawsuit, while price impact is necessarily a part of the class certification decision. This is because courts already have to consider price impact evidence in deciding whether a market is efficient in incorporating public statements. Thus, unlike materiality, evidence of price impact is necessarily before the court on class certification. And, because that is necessarily the case, it would not make sense to limit that evidence artificially by preventing a defendant from disproving price impact. Thus, the Court concluded that defendants would be permitted to rebut the presumption of reliance by disproving price impact at the class certification stage.

Possible Implications of the Court's Decision

The most important result of the *Halliburton II* ruling is that defendants will be permitted to prove, at the class certification stage, that particular misstatements did not have any price impact. The possibility of defeating class certification with respect to such statements will be an important new focus of securities class action defendants. Such a showing will likely require expert evidence and, in particular, the expert event studies that are commonly used by plaintiffs and defendants alike to prove, or disprove, overall market efficiency. These event studies, moreover, will likely need to be re-tooled so that they are aimed not only at addressing the generalized efficiency of a particular market, but also at proving or disproving more specifically the price impact of the particular statements at issue in the case. From a practical standpoint, therefore, the key effect of *Halliburton II* will be to increase the need for, and cost of, expert evidence at the class certification stage.

Further, because *Halliburton II* gives defendants an additional opportunity to defeat class certification – based on a showing of lack of price impact – a defendant's settlement calculus will likely need to change to account for new potential outcomes. For example, although it remains to be seen how the lower courts will implement *Halliburton II* in practice, it is likely that litigation surrounding market efficiency will come to focus more on whether particular alleged misstatements had price impact. Thus, not only will defendants have the opportunity to defeat class certification wholesale, they will also have the opportunity to pick off or eliminate certain statements or categories of statements, thereby narrowing the case that is certified. Case assessment and strategy should now take these possible outcomes into account. On the other hand, should defendants try and fail to prove lack of market impact at the certification stage, this too will enter the calculations for both sides as to settlement value.

In all events, securities defendants will need to closely monitor how the lower courts interpret *Amgen* and *Halliburton II* in assessing their litigation strategies in securities cases. *Halliburton II* has provided defendants with an additional tool to avoid non-meritorious cases, and, in doing so, has increased both the costs and potential benefits of challenging market impact at the certification stage.

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[1] The Court had first addressed and rejected Halliburton's argument that a putative class plaintiff should be required itself to affirmatively prove price impact with respect to particular misstatements. In the Court's view, such a requirement would be akin to overruling *Basic* itself since, once *Basic*'s prerequisites are shown, a plaintiff is entitled to a presumption that he relied on a market price incorporating all material information, and need not show price impact of particular statements to prove reliance.

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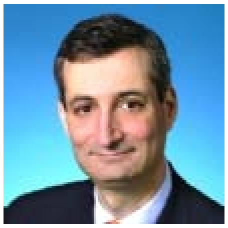

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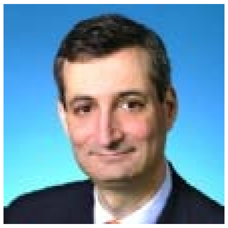

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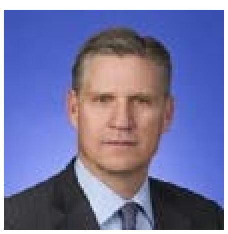

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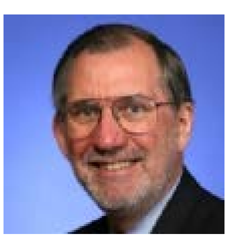

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