Client Alert

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Halliburton Co. v. Erica P. John Fund, Inc.: The US Supreme Court Confirms That Defendants in Securities Fraud Cases May Rebut Alleged Price Impact at the Class Certification Phase

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The US Supreme Court's decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, Slip op., No. 13-317 (Jun. 23, 2014), unanimously held that *before* certifying a class in a securities fraud case, federal courts must allow defendants to challenge plaintiffs' claim that alleged misrepresentations or omissions impacted securities prices. Because proving price impact is a necessary element of a securities action, this ruling, written by Chief Justice Roberts, provides defendants with an important weapon to defeat class certification—a critical milestone in any class action case that generally occurs before the bulk of pre-trial discovery. Thus, after *Halliburton*, at the class certification stage, parties will not be able to rely solely on legal arguments that class certification elements have been met or rebutted; rather, they must also be prepared to present factual evidence going to the merits of the case through fact and/or expert witnesses.

In a 6-3 ruling, the Court also refused to overrule the so-called fraud-on-the-market presumption, created over 25 years ago,[1] which allows plaintiffs in securities fraud actions to allege that in an efficient market the price of a security reflects the overall mix of material public information—meaning that plaintiffs can claim that the entire class uniformly relied on this information so that plaintiffs do not have to make individualized proof of reliance. A rejection of the fraud-on-the-market presumption, which was urged by Justices Thomas, Alito and Scalia, would have effectively ended the availability of class treatment of securities fraud actions. Although the decision is an important victory for the plaintiffs' class action bar in that respect, such victory is tempered by the Court continuing its trend of permitting defendants to litigate fact issues at the class certification phase and thereby potentially dispose of class action cases before expensive and full-blown pre-trial discovery.

Background

The Erica P. John Fund, Inc. ("EPJ Fund") sued Halliburton and one of its executives ("Halliburton") for securities fraud. EPJ Fund alleged that Halliburton deliberately falsified its financial results by misrepresenting facts about the company's asbestos liability exposure and its capital reserves and insurance coverage for that liability. EPJ Fund claimed that Halliburton's share price dropped by more than 40 percent when the company issued corrective disclosures.

1 *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

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In seeking class certification, EPJ Fund argued that class-wide reliance on Halliburton's misrepresentations was established by the fraud-on-the-market presumption. The district court disagreed, holding that then–Fifth Circuit precedent required plaintiffs to prove that the alleged misrepresentations caused the plaintiffs' injury ("loss causation"). Ultimately, however, the Supreme Court vacated that ruling, holding that plaintiffs did not—at the class certification phase—have to prove loss causation.[2]

On remand, the district court certified the class, and the Fifth Circuit affirmed. Both courts rejected Halliburton's new argument that plaintiffs could not invoke the fraud-on-the-market presumption because the same evidence defendants previously used to attack loss causation also demonstrated that Halliburton's misrepresentations did not impact the price of its stock. The Fifth Circuit held that "price impact evidence could be used at the trial on the merits to refute" this presumption, but not at the class certification phase.[3] This was the issue that then went back up to the Supreme Court.

Federal Rule 23, Fraud-on-the-Market and Halliburton

To establish securities fraud under section 10b of the Securities Exchange Act of 1934 (and SEC Rule 10b-5), a plaintiff must prove "(1) a material representation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[4] To certify a class, plaintiffs also must meet the requirements of Rule 23 of the Federal Rules of Civil Procedure, which includes a requirement under Rule 23(b)(3) that "questions of law or fact common to class members predominate over any questions affecting only individual members." Class certification in a securities fraud case is significant because this means that individual plaintiffs are advancing damage claims on behalf of potentially thousands of injured parties, greatly multiplying the potential damages. Courts recognize that certification often results in "hydraulic" pressure for defendants to settle, regardless of the merits.[5]

The fraud-on-the-market presumption is a significant tool for plaintiffs in securities fraud cases because it eliminates the need to prove reliance as to each individual plaintiff, a task that would destroy any class action case. To invoke the fraud-on-the-market presumption, a plaintiff must establish that (1) the security traded in an open, efficient market; (2) the alleged misrepresentations were publicly made; and (3) relevant transactions took place between the time the misrepresentations were made and the time of the corrective disclosures.

Before *Halliburton*, there was a split among the US Circuit Courts of Appeal as to whether securities fraud defendants could introduce evidence at the class certification stage showing a lack of price impact as a means to directly rebut the fraud-on-the-market presumption, rather than just to counter a plaintiff's showing of market efficiency.[6]

The Supreme Court's Decision

Halliburton urged the Supreme Court to overrule *Basic v. Levinson* and "instead require every securities fraud plaintiff to prove that he actually relied on the defendant's misrepresentation in deciding to buy or sell a company's stock."[7] Halliburton argued that the fraud-on-the-market presumption contravenes both congressional intent as expressed in the text of the securities laws and the Court's recent class action certification decisions, and that developments in economic theory have undermined the premises for the rule.[8] Having recently upheld the fraud-on-the-market presumption, however, Chief Justice Roberts, writing for a 6-3 majority, found these challenges unpersuasive and declined to overrule *Basic*.[9]

Although affirming the availability of the fraud-on-the-market presumption, the Court also held that this presumption "does not relieve plaintiffs of the burden of proving—*before* class certification—that the predominance requirement of Rule 23(b)(3) is met."[10] In other words, "*Basic* does not…allow plaintiffs simply to plead that common questions of reliance predominate over individual ones, but rather sets forth what they must prove to demonstrate such predominance."[11]

2 *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185-86 (2011).

3 *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 433-35 (5th Cir. 2013).

4 *Amgen Inc. v. Conn. Ret. Plans and Trust Funds*, 568 U.S. __, __ (2013) (slip op. at 3-4).

5 *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 164 (3d Cir. 2001) (noting that class certification can "plac[e] inordinate or hydraulic pressure on defendants to settle, avoiding the risk, however small, of potentially ruinous liability").

6 *Halliburton*, slip op. at 4 ("Op.").

7 Op. at 4.

8 Op. at 7-13. Justice Thomas's concurring opinion accepted each of these arguments against preserving the rule.

9 In dicta, the majority advised that the fact that defendants could rebut the presumption "with respect to an individual plaintiff by showing that he did not rely on the integrity of the market price in trading stock," and thereby "pick off the occasional class member…does not cause individual questions to predominate." Op. at 14-15. Although dicta, this statement is likely to negatively impact defendants advancing similar arguments concerning the predominance requirement.

10 Op. at 14.

11 Op. at 14.

The Court then recognized for the first time that "defendants should…be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price."[12] In *Basic*, the Supreme Court had advised that "any 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."[13] Prior to *Halliburton*, though, the Court had not addressed whether this evidence could be introduced at class certification, rather than later, at the summary judgment or trial stage, to rebut the fraud-on-the-market presumption. While it was reasonably clear that this type of evidence could be introduced at class certification for the purpose of showing that a security did not trade in an efficient market, prior to *Halliburton* there was an open question as to whether this evidence could be presented at class certification "for the particular purpose of rebutting the presumption altogether."[14]

The Supreme Court held that "artificially limiting" the use of direct rebuttal evidence at class certification "makes no sense, and can readily lead to bizarre results."[15] The Court posited a situation in which a defendant introduced at the class certification phase evidence concerning market efficiency that also established that the purported misrepresentations had no price impact. The Court explained that if such evidence could only be considered to determine market efficiency, then theoretically the plaintiff could carry its burden to establish market efficiency—and thus have a class certified—even though absent price impact the fraud-on-the-market theory should not apply and common reliance should not be presumed.[16] The Court noted that this result contradicts the logic of *Basic* because market efficiency is just "an indirect way" for plaintiffs to show price impact, and "an indirect proxy should not preclude direct evidence when such evidence is available."[17]

Implications

Halliburton is significant because of the Court's price-impact holding. This decision continues a recent trend by the Supreme Court encouraging the litigation and resolution of fact issues as part of the class certification process—as opposed to at trial after pre-trial discovery. *Halliburton* is consistent with last year's ruling in *Comcast v. Behrend*, in which the Court held that plaintiffs seeking class certification must establish through "evidentiary proof" that damages are capable of class-wide resolution in order to satisfy the predominance requirement of Rule 23(b).[18] The Court firmly rejected the notion that arguments and evidence "pertinent to the merits determination" are off-limits at the class certification stage. Similarly, in *Wal-Mart Stores, Inc. v. Dukes*, the Court affirmed that at the class certification stage federal courts must resolve all factual disputes bearing on the Rule 23 requirements for certification.[19]

Halliburton confirms that it is becoming progressively more challenging for plaintiffs in class action cases to plead and advance their cases. Also, by increasing the evidentiary burdens on plaintiffs (and the need to rebut evidence presented by defendants), *Halliburton* will make it more expensive for class action plaintiffs to move their cases forward by requiring plaintiffs to spend money prior to class certification to hire experts who can testify on price impact and damages. Given that most securities class action cases are handled on a contingent-fee basis, with plaintiffs' counsel only receiving payment upon some recovery or settlement, the front-loading of expert and other fees needed to justify class certification is likely to make plaintiffs' counsel choose more carefully which securities cases to bring—and may continue the recent trend of fewer securities fraud cases being filed.

Halliburton also underscores the importance of defendants in securities fraud class action investing early on in pre-certification discovery and damage theory development.[20] Early expert retention will become an even more important tool in assessing and managing the risk exposure of a securities fraud action, and defendants should assume that the class certification phase will be something of a mini-trial on which claims and classes rise or fall. As such, defendants also should be prepared to assess early-on how much time they will need for the pre-certification discovery period and expert preparations so that they may take maximum advantage of the opportunities presented by the *Halliburton* ruling.

12 Op. at 18.

13 485 U.S. at 248.

14 Op. at 19.

15 Op. at 19, 22.

16 Op. at 19-20.

17 Op. at 20.

18 133 S. Ct. 1426, 1432-33 (2013).

19 *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541, 2551 (2011) ("Rule 23 does not set forth a mere pleading standard. A party seeking class certification must affirmatively demonstrate his compliance with the Rule—that is, he must be prepared to prove that there are in fact sufficiently numerous parties, common questions of law or fact, etc.").

20 Indeed, Justice Ginsburg filed a concurring opinion noting the likely expansion of pre-certification discovery, though she dismissed the prospect as imposing "no heavy toll on securities-fraud plaintiffs with tenable claims."

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