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CLIENT MEMORANDUM

Supreme Court to Address the Viability of the Fraud-On-The-Market Presumption

November 18, 2013

AUTHORS

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On Friday, the Supreme Court granted certiorari in *Halliburton Co. v. Erica P. John Fund, Inc*., No. 13-317. At issue in *Halliburton* is whether the Court should overrule or substantially modify the holding of its 1988 decision in *Basic v. Levinson* "to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory." Should the Court decide to overturn *Basic* (and the 25 years of jurisprudence following that decision), it could drastically alter the landscape of securities fraud class actions by making it more difficult for plaintiffs to certify a class.

To recover damages in a section 10(b) case, a plaintiff must prove reliance on a material misstatement made by defendants. For a class to be certified in a typical securities fraud case, a court must find pursuant to Fed. R. Civ. P. 23(b)(3) that "questions of law or fact common to class members predominate over any questions affecting only individual members." One method of establishing reliance is through proof of direct reliance—showing that investors were aware of a company's statement and engaged in a relevant transaction based on that specific misrepresentation. But because such a showing is individualized in nature, proving direct reliance at trial would require proof from each member of the proposed class, which would defeat a Rule 23(b)(3) class given that individualized issues of reliance would predominate over classwide issues.

To address this problem, the Supreme Court established in *Basic* a rebuttable presumption that individual investors have relied on material misstatements when the security at issue was traded on an impersonal, well-developed market. The

Supreme Court explained that under the efficient market hypothesis, "the market price of shares traded on well-developed markets reflects all publicly available information and, hence, any material misrepresentations." Incorporating that hypothesis into securities law, the Court held that where investors rely on the market price of securities, it can be presumed that plaintiffs have relied on the material misstatement.

Last term, the Supreme Court ruled in a 6-3 decision in *Amgen v. Connecticut Retirement Plans & Trust Funds* that investors seeking to certify a class in a securities fraud action need not prove materiality in order to avail themselves of the *Basic* fraud-on-the-market presumption of reliance. The *Amgen* majority also held that a defendant's evidence rebutting the fraud-on-the-market presumption through proof of immateriality "is no barrier to finding that common questions predominate" and, thus, no barrier to class certification. However, three dissenters in *Amgen*—Justices Scalia, Kennedy, and Thomas—all agreed that the *Basic* decision was "questionable" and signaled that they would be open to revisiting *Basic*'s fraud-on-the-market presumption. Justice Alito, who had joined the majority opinion, separately filed a concurrence that questioned the "economic premise" of the fraud-on-the-market theory and suggested that "reconsideration of the *Basic* presumption may be appropriate." Thus, four justices indicated that they were ready to reconsider *Basic*'s fraud-on-the-market presumption. And, they will now get their chance to do so in *Halliburton*.

Conclusion

Halliburton likely will have broad implications for securities fraud class actions. If the Court were to overturn *Basic*, plaintiffs would no longer be able to use the fraud-on-the-market theory to establish reliance on a classwide basis, making securities class actions significantly more difficult to pursue. But even if the Court does not go so far as to overturn *Basic*, *Halliburton* may still be significant for clarifying whether a defendant can rebut the fraud-on-the-market presumption of reliance to defeat class certification.

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