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CLIENT MEMORANDUM

Halliburton II: Fraud-on-the-Market Presumption Survives but Supreme Court Makes it Easier to Rebut Presumption

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In a highly-anticipated decision (*Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton* II")),[1] the Supreme Court declined to overturn *Basic Inc. v. Levinson* but held that securities class action defendants may rebut the fraud-on-the-market presumption of reliance before the class certification stage by showing a lack of price impact. Although not the judicial earthquake that some were expecting, the holding in *Halliburton* II deals a serious blow to securities fraud class action plaintiffs. It effectively ensures that evidence of price impact before class certification will become a major battleground in securities fraud class action cases.

Background on *Basic* and the Fraud-on-the-Market Theory

To recover in a private action under Section 10(b) and Rule 10b-5, a plaintiff must prove reliance on a material misrepresentation made by a defendant. For a class to be certified in a typical securities fraud case, a court must find pursuant to Federal Rule of Civil Procedure 23(b)(3) that questions common to the class "predominate" over questions affecting individual class members. Historically, securities fraud plaintiffs struggled to satisfy this requirement because, if proof of actual reliance were required, individual issues of each plaintiff's knowledge of and reliance on particular misrepresentations would overwhelm the common ones.

[1] 573 U.S. ___ (2014).

To address this problem, in *Basic*, the Supreme Court established a rebuttable presumption that individual investors rely on a material misrepresentation when the security at issue is traded on an impersonal, well-developed market. The 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."[2] The Court held that "[b]ecause most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations . . . may be presumed for purposes of a Rule 10b-5 action."[3] Thus, the fraud-on-the-market presumption made it possible for investors to obtain class certification without having to prove that each individual class member actually knew of the alleged misstatements when determining whether to purchase or sell the security at issue.

Halliburton II

The issues before the Court in *Halliburton* II were (1) whether the Court should overrule or modify *Basic*'s presumption of reliance and (2), if not, whether defendants should be afforded the opportunity in securities class action cases to rebut the presumption at the class certification stage by showing a lack of price impact.

The Court's opinion – authored by Chief Justice John Roberts (joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor and Kagan) – declined the defendant's invitation to overrule *Basic*.[4] The Court started its analysis by brushing off the defendant's argument that "the *Basic* presumption is inconsistent with Congress's intent," noting that "the dissenting Justices" in *Basic* "made the same argument" and the "*Basic* majority did not find that argument persuasive then."[5] The defendant here, the Court explained, "has given us no new reason to endorse it now."[6] The Court next turned to the defendant's "primary argument" for overruling *Basic*—namely, "that the decision rested on . . . premises that can no longer withstand scrutiny."[7] One such premise is the much-maligned "efficient capital market hypothesis." The defendant argued that empirical studies demonstrate that capital markets are not fundamentally efficient. Although acknowledging "debate among economists about the degree to which the market price of a company's stock reflects public information about the company," the Court found that the "academic debates . . . have not refuted the modest premise underlying the presumption of reliance. Even the foremost critics of the efficient-capital markets hypothesis acknowledge that public information generally affects stock prices."[8]

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[2] 485 U.S. at 246.

[3] *Id.* at 247.

[4] Justice Thomas (joined by Justices Scalia and Alito) wrote a concurring opinion in which he argued that "*Basic* should be overruled." 573 U.S. ___, ___ (2014) (slip op., at 2) (Thomas, J., concurring).

[5] 573 U.S. at ___, ___ (slip op., at 7 & 8).

[6] *Id.* (slip op., at 8).

[7] *Id.*

[8] *Id.* (slip op., at 9-10).

The Court also rejected the defendant's argument that *Basic* cannot be reconciled with recent Supreme Court decisions governing class certification. The defendant argued that *Basic* relieves Rule 10b-5 plaintiffs of the burden of establishing predominance, instead "allowing courts to presume that common issues of reliance predominate over individual ones."[9] The Court found that *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": "publicity, materiality, market efficiency, and market timing."[10] The Court explained that the "burden of proving those prerequisites still rests with plaintiffs and (with the exception of materiality) must be satisfied before class certification."[11]

In the event that the Court declined to overrule *Basic*, the defendant proposed two alternatives for remedying the "decision's most serious flaws."[12] The Court rejected the first proposal – requiring "plaintiffs to prove that a defendant's misrepresentation actually affected the stock price" (*i.e.*, price impact) "in order to invoke the *Basic* presumption"[13] – finding it "would radically alter the required showing for the reliance element of" a Rule 10b-5 claim.[14] Requiring plaintiffs to prove price impact directly, the Court found, would do away with one of the principal premises underlying the *Basic* presumption: that "if a plaintiff shows that the defendant's misrepresentation was public and material and that the stock traded in a generally efficient market, he is entitled to a presumption that the misrepresentation affected the stock price."[15]

The Court's most significant holding was with respect to the defendant's second proposal.[16] The Court agreed that "defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price."[17] The Court emphasized that there is no dispute that defendants may introduce (i) evidence at the merits stage to rebut the *Basic* presumption or (ii) price impact evidence at the class certification stage, "so long as it is for the purpose of countering a plaintiff's showing of market efficiency, rather than directly rebutting the presumption."[18] Indeed, the Court stated, plaintiffs routinely "introduce evidence of the *existence* of

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[9] *Id.* (slip op., at 14).

[10] *Id.*

[11] *Id.*

[12] *Id.* (slip op., at 16).

[13] *Id.*

[14] *Id.* (slip op., at 17).

[15] *Id.*

[16] Of note, the Court declined to adopt the "midway" position advocated by several law professors as *amicus curiae*, which became a focus of the questioning at oral argument. The law professors argued that the Court should impose an additional hurdle on plaintiffs by requiring them to prepare an event study demonstrating price impact at the class certification stage.

[17] *Id.* (slip op., at 18).

[18] *Id.* (slip op., at 18-19).

price impact in connection with 'event studies'—regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events."[19]

The Court found that allowing a defendant to "submit price impact evidence prior to class certification" but not allowing a defendant to "rely on that same evidence prior to class certification for the particular purpose of rebutting the presumption altogether . . . makes no sense, and can readily lead to bizarre results."[20] The Court provided the specific example of a defendant's event study before class certification that refutes the plaintiff's claim of general market efficiency. If the district court were to determine that "despite the defendant's study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit," the evidence at the certification stage would effectively show "an efficient market, on which the alleged misrepresentation had no price impact."[21] The notion that "the plaintiff's action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed . . . is inconsistent with *Basic*'s own logic."[22]

Under *Basic*, the Court explained, the prerequisites for invoking the fraud-on-the-market presumption "constitute an indirect way of showing price impact."[23] "But an indirect proxy should not preclude direct evidence when such evidence is available."[24] The Court found that while *Basic* allows a plaintiff to establish price impact – "an essential precondition for any Rule 10b-5 class action" – indirectly, "it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply."[25]

Unlike materiality, another *Basic* prerequisite, which "is a discrete issue that can be resolved in isolation from the other prerequisites" and thus "can be wholly confined to the merits stage,"[26] price impact "is *Basic*'s fundamental premise."[27] Price impact "has everything to do with the issue of predominance at the class certification stage."[28] Because evidence "of price impact will be before the court at the certification stage," the Court explained that its choice in the case "is not

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[19] *Id.* (slip op., at 19).

[20] *Id.*

[21] *Id.* (slip op., at 20).

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.* (slip op., at 21).

[26] *Id.* (slip op., at 22).

[27] *Id.* (internal quotation marks omitted).

[28] *Id.*

between allowing price impact evidence at the class certification stage or relegating it to the merits."[29] Rather, the choice "is between limiting the price impact inquiry before class certification to indirect evidence, or allowing consideration of direct evidence as well."[30] The Court concluded that there is "no reason to artificially limit the inquiry at the certification stage to indirect evidence of price impact. Defendants may seek to defeat the *Basic* presumption at that stage through direct as well as indirect price impact evidence."[31]

Conclusion

It is now a virtual certainty that extensive analysis on price impact will become the norm in most securities fraud class action cases. Parties will devote significant resources to this issue at the class certification stage. Moreover, district courts likely will hold evidentiary hearings at the class certification stage to determine if there is sufficient evidence to support a finding of price impact before certifying an investor class. And, while it is now plain that a defendant can show that a misrepresentation did not affect the price of stock, an issue on the horizon is whether a defendant can do this by showing that the alleged corrective disclosure did not affect the price.

If you have any questions regarding this memorandum, please contact Todd G. Cosenza (212 728-8677, tcosenza@willkie.com), Robert A. Gomez (202 303-1150, ragomez@willkie.com) or the Willkie attorney with whom you regularly work.

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[29] *Id.*

[30] *Id.*

[31] *Id.* (slip op., at 22-23).