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Securities Alert

Supreme Court Revises Rules for Private Securities Class Actions

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On June 23, 2014, in its widely anticipated ruling in *Halliburton Co. v. Erica P. John Fund*, the U.S. Supreme Court revised the ground rules for private securities class actions under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, holding that a defendant company may argue, at the class certification stage, that an alleged misrepresentation had no "price impact" and, therefore, that the plaintiff shareholder cannot be presumed to have relied on any "fraud on the market."

Background: "Fraud on the Market" Theory and *Basic v. Levinson*

The modern era of securities class actions began with *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), a landmark ruling in which the Supreme Court held that a plaintiff-investor could show that he or she relied on a defendant-issuer's misrepresentation in deciding to buy or sell securities by invoking a presumption, known as the "fraud on the market" presumption, that the prices of securities traded in an efficient market reflect all public material information — including any misrepresentation. Over the years, that presumption has proven highly controversial among securities lawyers and economists alike. The defendants in *Halliburton* argued, unsuccessfully, that *Basic* should be overturned.

The "fraud on the market" presumption from *Basic* allows a plaintiff to satisfy the reliance requirement for a Section 10(b) or Rule 10b-5 claim by showing that he or she relied on the integrity of an efficient, public market, rather than on a particular misrepresentation by the defendant. In order to take advantage of this presumption, a plaintiff (or class of plaintiffs) must prove:

- public knowledge of the misrepresentation,
- materiality,
- an efficient market, and
- a purchase or sale after the misrepresentation was made but before the truth was revealed.

The presumption is rebuttable, not conclusive. If a defendant can show that the misrepresentation did not, in fact, affect the price of the securities or influence the purchase or sale by the plaintiff, the presumption will not apply, and the plaintiff will be required to prove direct reliance to maintain his or her securities fraud claim.

The Court Declines to Overturn the *Basic* Case

Halliburton argued that the "fraud on the market" presumption, which is more than 25 years old, reflects deeply flawed, and now widely discredited, economic theory. But the Supreme Court declined to wade into the ongoing academic controversy concerning the efficient market hypothesis. The Court explained that, by establishing a rebuttable presumption of reliance, *Basic* did not take sides in that dispute; it simply put the burden on the defendant to overcome the *presumption* that an efficient market incorporates all material information into the prices for securities. A defendant can, for example, prove that the relevant market was not efficient or that the misrepresentation had no price impact. Thus, in *Halliburton*, the Supreme Court rejected the proposal to overturn *Basic* and eliminate the "fraud on the market" presumption.

The Holding: Defendants Can Show Lack of Price Impact at Class Certification Stage

Instead, the Supreme Court accepted a more modest but superbly practical suggestion — before the trial court certifies a plaintiff class, allow the defendant to rebut the presumption of reliance with evidence showing the *lack* of any price impact. Class certification is a seminal inflection point where defendants, facing significant pre-trial and trial costs and potentially ruinous damages, can become extremely amenable to settlement irrespective of the ultimate merits of the case. Accordingly, the Court vacated the lower courts' rulings (certifying the plaintiff class in the securities action against Halliburton) and remanded to give Halliburton an opportunity to challenge the "fraud on the market" presumption by showing that its alleged misrepresentations did not affect the price of its securities.

A Unanimous Judgment, But a Divided Court

The decision in *Halliburton*, authored by Chief Justice Roberts, was hardly unanimous. Three justices (Ginsburg, Breyer and Sotomayor) concurred, but with some caution. Because the defendant must show the absence of any price impact to overcome the presumption of reliance, they noted that the decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." But if it becomes an obstacle to such claims, these justices may reconsider. Meanwhile, three other justices (Thomas, Scalia and Alito) concurred in the judgment. These three would have overturned *Basic* altogether and required all plaintiffs to prove direct reliance.

Although *Halliburton* will probably not be the last word from the Supreme Court on securities class actions, it is an important development. Most commentators predict that the decision will add a new issue to already intensive litigation at the class certification stage, giving defendants one more way to try to knock out private securities claims before burdensome merits discovery begins. As a result, the decision may also alter settlement dynamics, leading to earlier and more favorable resolutions for defendants.

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