U.S. Supreme Court Rules on Critical Reliance Issue for Securities Class Actions

Court Reaffirms Basic’s Fraud-on-the-Market Presumption but Allows Defendants To Rebut that Presumption at Class Certification Stage

SUMMARY

In its much anticipated opinion in *Halliburton v. Erica P. John Fund, Inc.*, the U.S. Supreme Court declined to overrule the fraud-on-the-market presumption of classwide reliance in securities fraud cases. The Court, however, clarified current law by holding that defendants may rebut that presumption at the class certification stage (as well as the later merits stage) by showing that the alleged misstatements at issue had no impact on the price of the issuers’ securities. That holding provides defendants with a potentially powerful tool for defeating class certification in certain cases.

SECURITIES FRAUD CLASS ACTIONS – A SHORT HISTORY

The Securities Exchange Act of 1934 allows the government to prosecute securities fraud pursuant to Section 10(b) and Securities and Exchange Commission ("SEC") Rule 10b-5 promulgated thereunder. Although the text of the Exchange Act does not give private plaintiffs the right to bring securities fraud claims, courts have afforded private parties that right. Prior to the Supreme Court’s adoption of the fraud-on-the-market presumption, however, shareholder securities fraud class actions were difficult for plaintiffs to maintain because they could not prove reliance on a classwide basis, requiring a showing that each class member individually considered (and believed) the alleged fraudulent statements when buying or selling securities.

In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court endorsed the fraud-on-the-market presumption of reliance. Under this presumption, which a defendant may rebut, an investor bringing a securities fraud claim may prove reliance without a showing that it actually was aware of and considered
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an allegedly material misrepresentation in making its purchase or sale of a security if (i) that misrepresentation was made publicly and (ii) the security is traded in an efficient market. The presumption hinges on an economic theory that “an efficient market will reflect all publicly available information about a company; accordingly, a buyer of the security may be presumed to have relied on that information in purchasing the security.” *Amgen, Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1190 (2013). Absent this presumption certification under Federal Rule of Civil Procedure 23 would be difficult (if not practically impossible) for most securities fraud class actions, because individual questions of investors’ reliance on the purported misrepresentation would outweigh common classwide issues. *See id.* at 1199 (if “a plaintiff cannot invoke the fraud-on-the-market presumption,” then “[i]ndividualized reliance issues would predominate in such a lawsuit, and “[t]he litigation, therefore, could not be certified under Rule 23(b)(3) as a class action”).

HALLIBURTON

In a 2011 appeal of a putative class action brought on behalf of purchasers of Halliburton common stock, the Supreme Court reversed a decision denying class certification and remanded the case, ruling that the plaintiff did not need to prove affirmatively that the alleged misstatements caused plaintiffs’ losses before obtaining class certification. *See Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011). In light of that holding, the Court explained that it did not need to “address any other question about *Basic*, its presumption, or how and when it may be rebutted.” *Id.* at 2187.

On remand, Halliburton argued that the plaintiff should be required to show the alleged misrepresentations had a “price effect” on the company’s stock (i.e., the price of the stock changed or was distorted due to the representations), because if there had been no price effect then the fraud-on-the-market doctrine would be inapplicable and there could be no classwide basis for proving reliance. The trial court rejected this argument and certified a class, and the Court of Appeals affirmed.

Halliburton sought review of the decision by the Supreme Court, and in November 2013, the Court granted *certiorari*. In doing so, the Court agreed to hear argument both on whether it should overrule *Basic* and on whether it should substantially modify the *Basic* presumption. At oral argument in March 2014, the Court focused on the circumstances in which plaintiffs should be able to invoke, or defendants should be able to rebut, a presumption of reliance at the class certification stage.

TODAY’S DECISION

As our memorandum on the oral argument predicted, the Supreme Court today declined to overrule *Basic*’s fraud-on-the-market presumption of reliance. In an opinion by Chief Justice Roberts, the Court reasoned that Halliburton had not shown the “special justification” needed to overturn established precedent.2 In the Court’s view, the academic debate over the efficiency of capital markets—which the *Basic* Court itself acknowledged—had not refuted “the modest premise underlying the presumption of
reliance,” which is that “public information generally affects stock prices.”3 There are “[d]ebates about the precise degree to which stock prices accurately reflect public information,” the Court observed, but that is not “the kind of fundamental shift in economic theory” sufficient to justify overruling its prior precedent.4

The Court also declined to require plaintiffs to affirmatively demonstrate price impact in order to invoke the Basic presumption at the class certification stage.5 It held, however, that defendants may rebut the Basic presumption at the class certification stage by showing an absence of price impact, i.e., that the alleged misstatements at issue did not impact stock prices.6 “While Basic allows plaintiffs to establish [price impact] indirectly,” the Court reasoned, “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.”7

Notably, the Court further explained that, although the materiality of alleged misstatements is to be proven at the merits stage rather than the class certification stage under Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds, 133 S. Ct. 1184 (2013), that is not true of the other prerequisites for invoking the Basic presumption. Plaintiffs must prove those other prerequisites—publicity, market efficiency, and market timing—at the class certification stage.8

**IMPLICATIONS**

Today’s decision provides defendants with an additional mechanism for opposing class certification in securities fraud actions. Although the Supreme Court left the Basic presumption standing, it clarified that lower courts have been misapplying that presumption in certain respects. First, the Court emphasized that under its recent decisions in Wal-Mart Stores, Inc. v. Dukes, 131 S. Ct. 2541 (2011), and Comcast Corp. v. Behrend, 133 S. Ct. 1426 (2013), “plaintiffs wishing to proceed through a class action must actually prove—not simply plead—that their proposed class satisfies each requirement of Rule 23.”9 As a result, in order to invoke the Basic presumption, plaintiffs must prove the prerequisites for that presumption—publicity, market efficiency, and market timing—at the class certification stage.10 Today’s decision thus clarifies the limits on the Court’s earlier decision in Amgen.

Second, the decision explains that some lower courts had incorrectly held that defendants “could not introduce evidence of price impact at the class certification stage.”11 The Court observed that, “to maintain the consistency of the [Basic] presumption with the class certification requirements” of Rule 23, “defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”12 Even in cases in which plaintiffs are able to invoke the presumption, the Court noted that defendants may rebut reliance with respect to any individual plaintiff “by showing that he did not rely on the integrity of the market price in trading stock.”13 Those holdings provide defendants with grounds for defeating certification in cases when there is little or no evidence of price impact—or narrowing classes when putative class members have not in fact relied on the integrity of market prices.

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Although the Court’s decision to allow defendants to challenge price impact at the class certification stage might seem like a minor procedural step, it could have important implications for securities class actions; given the potentially large damages at stake, most securities fraud cases that survive the class certification stage settle shortly after certification is granted and thus before the defendants have the opportunity to use the “price impact” defense. Accordingly, although issuers likely will need to wait until lower court decisions determine the contours of today’s opinion, it appears the Court has given issuers a realistic chance of using a powerful tool for defeating class certification in cases where the alleged misstatement did not move the issuer’s share price.

Finally, the Court’s statement that the principle of stare decisis is entitled to “special force” in cases that involve substantive doctrines of federal law is significant. Although the breadth of the Court’s holding is not clear, its discussion indicates that deference to precedent in statutory-interpretation cases also applies in cases in which the Court has expounded a substantive doctrine of federal law in an area in which Congress has legislated.

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ENDNOTES

2 Slip op. at 7.
3 Id. at 10.
4 Id. at 10-11.
5 Id. at 18.
6 Id.
7 Id. at 21; see id. at 23 (“[D]efendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.”).
8 Id. at 14; see id. at 22 (“[T]he publicity and market efficiency prerequisites must be proved before class certification.”).
9 Id. at 14.
10 Id.
11 Id. at 21.
12 Id.
13 Id. at 15.
14 Id. at 12.
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