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U.S. Supreme Court to Consider Critical Issue for Securities Fraud Class Actions

Possible Overruling of *Basic*'s "Fraud-on-the-Market" Presumption Could Spell Major Changes for Current Regime

SUMMARY

On November 15, 2013, the U.S. Supreme Court granted *certiorari* in the case of *Halliburton Co.* v. *Erica P. John Fund, Inc.*, No. 13-317, raising the prospect that the Court will overrule or significantly limit the legal presumption that each member of a securities fraud class action relied on the statements challenged as fraudulent in the lawsuit. Without this so-called "fraud-on-the-market" presumption, putative class action plaintiffs will be unable to maintain a securities fraud class action unless they can clear the logistically difficult hurdle of proving that each individual shareholder actually relied on the challenged statements when making its purchase or sale of securities. At least four Justices have recently indicated that the Court should reconsider the validity of that doctrine, suggesting that the ultimate opinion in *Halliburton* could lead to a significant change in securities class action law. Even if the Court ultimately affirms fraud-on-the-market or some variant of the doctrine, the Court may expand defendants' ability to defeat what in practice has evolved into a virtually irrefutable presumption of reliance. Furthermore, the uncertainty caused by the pendency of the *Halliburton* appeal may warrant staying securities class actions and may reduce the settlement value of pending 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 Exchange Act does not explicitly give private parties the right to bring securities fraud claims, courts have held that such a private right is implicit.[1] 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 class wide basis, meaning that plaintiffs would need to show that each class member actually considered (and believed) the alleged fraudulent statements when buying or selling its shares. This was because "in a modern securities market many, if not most, individuals who purchase stock from third parties on an impersonal exchange will be unaware of statements made by the issuer of those securities." *Amgen Inc.* v. *Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184, 1208 (2013) (citations omitted) (Thomas, J. dissenting). "As a result, such purchaser-plaintiffs [were] unable to meet the traditional reliance requirement because they [could not] establish that they engaged in a relevant transaction . . . based on [a] specific misrepresentation." *Id.* (internal quotation marks omitted).

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 may be rebutted by a defendant,[2] an investor bringing a securities fraud claim may prove reliance without a showing that it actually was aware of and considered an allegedly material misrepresentation in making its purchase or sale of a security if that representation was made publicly and if the security it related to is traded in an efficient market. The presumption hinges on an economic theory that posits "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*, 133 S. Ct. at 1190. Absent this presumption it would be difficult for most securities fraud class action claims to be certified under Federal Rule of Civil Procedure 23, because individual questions of investors' reliance on the purported misrepresentation would outweigh common class-wide issues.

After *Basic* simplified the reliance requirement, securities fraud class actions increased dramatically, both in terms of cases brought and amounts paid in settlement. For example, "more than 3,050 private class-action securities-fraud lawsuits were filed between 1997 and 2012, generating settlements amounting to more than $73.1 billion," a growth tied directly to the Court's change in how reliance had to be proved. *Halliburton Co.* v. *Erica P. John Fund, Inc.*, Brief for Former SEC Commissioners and Officials and Law Professors as *Amici Curiae*. In 2012 alone, more than 150 federal securities fraud class action suits were filed, a number that actually represented a "sharp[]" drop over recent years. Cornerstone Research, *Securities Class Action Filings, 2012 Year in Review* (2013). The threat of class action plaintiffs seeking

[1] *Superintendent of Ins.* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

[2] There has been significant disagreement among the courts as to the manner in which a defendant can rebut the fraud-on-the-market doctrine. One method that seems to have been generally accepted, however, is if a defendant "demonstrate[s] [at the class certification stage] that plaintiffs' proffered proof of market efficiency falls short of the mark." *IBEW Local 90 Pension Fund* v. *Deutsche Bank AG*, 2013 WL 5815472, at *20 (S.D.N.Y. 2013). If there is no market efficiency, there can be no presumption that the price of the security at issue incorporates the statements alleged to be fraudulent.

multibillion settlements has also been suggested as a significant factor in foreign corporations declining to issue stock on U.S. markets, and "may best explain the declining competitiveness of the U.S. capital markets." John C. Coffee, *Securities Policeman to the World? The Cost of Global Class Actions*, New York Law Journal (2008).

HALLIBURTON AND *AMGEN*

In *Halliburton*, plaintiffs brought a putative class action against Halliburton and its CEO on behalf of all investors who bought Halliburton common stock between June 1997 and December 2001, alleging that (i) Halliburton misrepresented its liability in asbestos litigation, the revenue it expected to receive from construction contracts, and the benefits it expected to flow from a merger, and (ii) plaintiffs were injured when these statements were revealed to be false and Halliburton's share price declined. In a prior 2011 appeal, the U.S. Supreme Court reversed a dismissal decision and remanded the case to the U.S. Court of Appeals for the Fifth Circuit, ruling that the plaintiffs did not need to prove affirmatively that the alleged misstatements in fact affected the share price before obtaining class certification. *Erica P. John Fund, Inc*. v. *Halliburton Co.*, 131 S. Ct. 2179 (2011).

Subsequently, in *Amgen*, decided in February 2013, the Supreme Court held that securities fraud class action plaintiffs also do not need to prove the materiality of alleged misstatements in order to receive class certification. Amgen, the defendant, had raised the issue of massive litigation risks forcing companies to settle meritless claims if they go beyond the class certification stage. Dismissing this concern, Justice Ginsberg's majority opinion stated that because "Congress ha[d] homed in on the[se] precise policy concerns" when it enacted the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998, it would not be "appropriate for the judiciary to make its own further adjustments" to the rules of class certification. *Amgen*, 133 S. Ct. at 1201. Notably, however, four Justices (Scalia, Kennedy, Thomas, and Alito) went out of their way to note that Amgen had not challenged the validity of the "fraud-on-the-market" doctrine, and those Justices expressed doubts about the legal and economic foundations of the doctrine.[3]

Following the Supreme Court's 2011 decision in the *Halliburton* matter, the case was remanded to the trial court. Halliburton argued that the plaintiff was 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 the "fraud-on-the-market" doctrine was inapplicable and there could be no class-wide basis for proving reliance. The trial court rejected this argument and certified a class and the Court of Appeals affirmed the trial court's decision. Halliburton

[3] *Amgen*, 133 S. Ct. at 1204 (Alito, J., concurring) ("I join the opinion of the Court with the understanding that the petitioners did not ask us to revisit *Basic*'s fraud-on-the-market presumption. As the dissent observes, more recent evidence suggests that the presumption may rest on a faulty economic premise.") (citations omitted); *id.* at 1209 (Thomas, J., dissenting) ("The *Basic* decision itself is questionable.").

sought review of the decision by the Supreme Court, asking that the Court consider both the “price effect” question that the trial court had rejected, and also directly challenging *Basic*’s “fraud-on-the-market” presumption. On November 15, 2013, the Court granted *certiorari* on both issues.

POTENTIAL IMPLICATIONS

The *Basic* fraud-on-the-market presumption is the primary factor behind the dramatic growth of securities fraud class action litigation in the United States over the past several decades. As Justice Thomas explained in his dissent in *Amgen*, the *Basic* presumption is what “makes securities-fraud class actions possible” because it “convert[s] the inherently individual reliance inquiry into a question common to the class.” *Amgen*, 133 S. Ct. at 1209.

As noted above, the *Basic* presumption, and indeed the existence of a private right of action under 10(b) and Rule 10b-5, are judicially created doctrines. As such, the Supreme Court, demonstrating skepticism of judge-made rules that facilitated the growth in securities fraud class actions, has acted on several occasions since *Basic* to curtail aspects of such suits. In particular, for two decades there has been a solid five-Justice majority that has held that the Section 10(b) private cause of action should be construed narrowly, and the Court has rejected efforts to expand the reach of Section 10(b) through judge-made rules. In *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994), the Court held that private plaintiffs, as opposed to the SEC, could not bring claims against “aiders and abettors.” Subsequently, in *Stoneridge Investment Partners LLC* v. *Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Court reaffirmed its decision in *Central Bank* and clarified that plaintiffs could not seek to include secondary actors as defendants by claiming that they were involved in a “scheme to defraud” investors along with primary actors. More recently, in *Morrison* v. *National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010), the Supreme Court held that the U.S. securities laws do not apply to purchases or sales of securities outside the U.S., previously the source of a large number of securities fraud class actions. Similarly, although the Court made it harder for defendants to have securities fraud claims dismissed prior to class certification in the first *Halliburton* decision and in *Amgen*, the concurring and dissenting opinions in *Amgen* openly evinced reservations about the continuing validity of *Basic*.

After the clear invitation from the concurring and dissenting Justices in *Amgen* to challenge the continuing validity of *Basic*’s “fraud-on-the-market” presumption, the Court’s acceptance of Halliburton’s petition for *certiorari* suggests that the Court might be prepared to overrule or significantly limit *Basic*. The Court’s certification also asked whether it should “substantially modify” the *Basic* presumption, raising the possibility that the Court would make the presumption in some way more difficult for plaintiffs to use without eliminating it entirely, suggesting that a compromise amongst the Justices might be a possibility. It should be noted that the grant of *certiorari* included the alternate question of whether price distortion had to be proven prior to certification, meaning that the Court could ultimately choose to decide the case on that more limited ground and not reach the question of the continuing viability of *Basic*.

If the Court were to eliminate or significantly limit the "fraud-on-the-market" presumption, absent future action from Congress reinstating this theory through legislation, the decision would alter substantially the federal securities fraud class action landscape. In that event, the need for individual determinations of investor reliance would make securities fraud class certification difficult or practically infeasible in most cases, as common class-wide issues would no longer outweigh individual issues.

Regardless of whether the Supreme Court decision in *Halliburton*—which by Court tradition should be issued by July 2014—keeps, modifies, or eliminates the presumption, the very pendency of *Halliburton* creates substantial uncertainty that may justify changes to the path of pending securities class actions. For example, courts may need to assess whether the high costs of discovery for or briefing of class certification are warranted given that the entire legal framework for class certification could soon be altered dramatically. Although potential damages in a securities fraud action may reach billions of dollars on a class-wide basis, the damages sought by the actual plaintiff are often a small fraction. Accordingly, courts might consider imposing a stay of all discovery, as well as other proceedings, on the ground that the amount and expense of discovery justified for a class action is hardly justifiable for an individual action. *See* Fed. R. Civ. P. 26(b)(2)(C)(iii) ("[T]he court must limit the frequency or extent of discovery [if] . . . the burden or expense of the proposed discovery outweighs its likely benefit, considering the needs of the case, the amount in controversy, the parties' resources, the importance of the issues at stake in the action, and the importance of the discovery in resolving the issues"). And, of course, plaintiffs and defendants might be motivated to settle pending securities fraud class actions at discounted levels given the possibility that the Supreme Court will place significant additional barriers to securities fraud class actions.

It should be noted that elimination or curtailment of the fraud-on-the-market doctrine would not affect the SEC's ability to bring enforcement actions, as the SEC does not need to prove reliance under Section 10(b) and Rule 10b-5.[4] Elimination of the doctrine likely would also not affect plaintiffs' ability to bring securities class actions under Section 11 and Section 12 of the Securities Act of 1933, which, in most instances, allows investors who purchase securities directly in a public offering to sue for damages caused by material misstatements in the registration statement or prospectus without proving reliance.[5]

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[4] *SEC* v. *Straub*, 921 F. Supp. 2d 244, 257 (S.D.N.Y. 2013).

[5] *See Hildes* v. *Arthur Andersen LLP*, 2013 WL 4405688, at *4 (9th Cir. 2013) (collecting cases).

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