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Supreme Court's *Halliburton* Decision Opens New Line of Defense

In* Halliburton Co. v. Erica P. John Fund, Inc.*, a rebuttable presumption must yield to the evidence at class certification.

On June 23, 2014, the United States Supreme Court sustained the "fraud-on-the-market" doctrine that has long aided the plaintiff's bar in advancing shareholder class action lawsuits. The fraud-on-the-market doctrine presumes that where a company's stock trades in an efficient market, publicly known, material misrepresentations or omissions will be absorbed into the stock price which most investors rely upon in making their investment decisions. Thus, under this doctrine, if a shareholder purchases stock after a company's misstatement is made but before the truth is revealed, the courts will presume that shareholders relied upon the defendant's misrepresentations and omissions when deciding to purchase shares in the company. Critically, if the presumption of reliance applies, plaintiffs do not need to prove they in fact relied on or even knew about the defendant's misrepresentation — an element of a securities fraud claim that otherwise cuts against class certification. In *Halliburton*, notwithstanding developments in economic theory casting doubt on the efficient market hypothesis, the Supreme Court left intact the fraud-on-the-market doctrine and its all-important presumption of shareholder reliance.

The Supreme Court, after sustaining the fraud-on-the-market doctrine in the form of a legal presumption of reliance, then addressed at what stage of the lawsuit a defendant may properly rebut the presumption with evidence that the alleged misrepresentation did not *in fact* impact the share price. In *Halliburton*, plaintiff argued that a defendant's so-called rebuttal evidence on lack of price impact should not be considered until the parties reach the merits of the case, such as trial. Halliburton, the defendant, argued in contrast that lack of price impact evidence should be admissible for purposes of deciding whether the lawsuit should be certified as a class action. The Supreme Court sided with Halliburton. As a result, going forward, defendants in securities fraud cases may submit evidence on lack of price impact in order to defeat class certification.

Background

In *Basic, Inc. v. Levinson*, the Supreme Court held that investors could satisfy the reliance requirement in a private securities fraud action by invoking a rebuttable presumption of reliance under the fraud-on-the-market doctrine.[1] The fraud-on-the-market doctrine establishes a rebuttable presumption that the price of stock trading in an efficient market incorporates all public material information — including material misstatements — and that investors who buy or sell stock at the market price have therefore relied on those misstatements.[2] In order to invoke *Basic*'s presumption of reliance, a plaintiff must establish all of the following:

- That the alleged misrepresentations were publicly known
- That they were material
- That the stock traded in an efficient market
- That the plaintiff traded the stock between the time the misrepresentations were made and when the truth was revealed[3]

Basic also emphasized, however, that the presumption of reliance was rebuttable: "Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance."[4]

In *Halliburton*, Erica P. John Fund (EPJ Fund) brought a putative class action against Halliburton and one of its executives alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.[5] EPJ Fund alleged that Halliburton made misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from construction contracts and its anticipated benefits from a merger with another company.[6] At the district court level, Halliburton presented evidence at the class certification stage that none of its alleged misrepresentations had actually affected its stock price.[7] Halliburton argued that this showing of no "price impact" rebutted *Basic*'s presumption that the members of the proposed class had relied on its alleged misrepresentations by buying or selling stock at the market price.[8] The district court declined to consider this argument and the Fifth Circuit affirmed, holding that Halliburton could use its price impact evidence at the trial on the merits but not at the class certification stage.[9]

The Supreme Court's Decision

The Supreme Court granted Halliburton's petition for certiorari to address two issues: (1) whether the Court should overrule *Basic*'s fraud-on-the-market doctrine and that decision's presumption of reliance in securities fraud class action cases and (2) if not, whether defendants should nonetheless be afforded an opportunity to rebut the presumption prior to class certification by showing lack of price impact.[10]

The Supreme Court Reaffirmed *Basic*'s Presumption of Reliance

The Court declined to overrule *Basic*, reaffirming the presumption of reliance grounded in the fraud-on-the-market doctrine. The Court concluded that Halliburton had failed to establish the required "special justification" for overturning a long-settled precedent,[11] and rejected each of Halliburton's arguments in turn.

The core of Halliburton's argument for overruling *Basic* was that it rested on two premises — the "efficient capital markets hypothesis" and the idea that investors invest in reliance on the integrity of the market price — that had been undermined by subsequent developments in economic theory.[12] First, Halliburton asserted that *Basic*'s presumption was premised upon "a robust view of market efficiency" that was no longer tenable in light of studies showing that public information is often not immediately incorporated into the market price.[13] The Court concluded that such studies did not refute *Basic*'s "fairly modest premise" that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices."[14] The Court further explained that "*Basic* recognized that market efficiency is a matter of degree" and "[d]ebates about the precise *degree* to which stock prices accurately reflect public information are thus largely beside the point."[15]

Second, though the Court accepted Halliburton's assertion that some investors do not invest in reliance on the integrity of the market price, the Court reasoned that *Basic* was premised only on the conclusion that it was "reasonable to presume that *most* investors...will rely on the security's market price as an unbiased assessment of the security's value in light of all public information."[16] The Court explained, "to

indirectly rely on a misstatement in the sense relevant for the *Basic* presumption, [an investor] need only trade stock based on the belief that the market price will incorporate public information within a reasonable time period."[17]

Defendants May Defeat Class Certification by Showing No Price Impact From the Misrepresentation

The Court ultimately agreed with Halliburton's final argument, holding that defendants may defeat the presumption of reliance at the class certification stage through evidence that the misrepresentation did not affect share price.[18] The Court noted that no one disputes that defendants may introduce evidence that a misrepresentation did not affect the stock price (1) at the merits stage to rebut the presumption of reliance and (2) at the class certification stage to counter a plaintiff's showing of market efficiency.[19] The Court also observed that plaintiffs themselves frequently introduce evidence of price impact at the class certification stage, in connection with event studies intended to show market efficiency.[20] The Court found no reason to permit plaintiffs to use this kind of evidence while preventing defendants from showing lack of price impact (and the corresponding inapplicability of the presumption of reliance) so as to defeat class certification.[21]

Concurring Opinions

Justice Ginsberg filed a brief concurring opinion — which Justices Breyer and Sotomayor joined — noting that the ruling "may broaden the scope of discovery available at [class] certification." She also emphasized that "it is incumbent upon the defendant to show the absence of price impact." Finally, Justice Ginsberg wrote that these new procedures should impose "no heavy toll on securities-fraud plaintiffs with tenable claims."[22]

Justices Thomas, Scalia and Alito concurred in the judgment but would have overruled *Basic*, asserting that "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption, and *stare decisis* cannot prop up the facade that remains."[23]

Implications of the Decision

The *Halliburton* decision creates a new key battleground in securities class action litigation. While securities plaintiffs may take solace in the fact that the fraud-on-the-market doctrine endures, the decision provides defendants with a powerful new tool to defeat class certification. This tool will prove a vital line of defense, particularly for companies whose stock is publicly traded on a major exchange and who therefore have difficulty challenging plaintiffs' allegations of market efficiency.

As a result, investing in a robust price impact analysis will often prove critically important to securities defendants. We anticipate that defense counsel will retain expert economists at an early stage in the litigation to prepare price impact analyses, which will provide defendants with key information to assess their best strategy to defend the case. Where defendants elect to challenge the presumption of reliance with price impact evidence at the class certification stage, there likely will be a complex and costly battle of the experts. This battle will also entail a new phase of fact and expert discovery relating to class certification motions.

The district courts will have to resolve conflicting event studies and expert opinions, with plaintiffs and defendants arguing over the proper burden defendants should bear to rebut the presumption of reliance. Plaintiffs will surely advocate that they are entitled to the benefit of the doubt at the class certification stage, such that all conflicting evidence should be resolved in their favor. Defendants, on the other hand, will argue that once they have offered evidence that the alleged misrepresentations did not affect the

market price, the burden should shift back to plaintiffs to show reliance in fact. Ultimately, the force of this new line of defense will hinge upon how the lower courts resolve these questions.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Samuel B. Isaacson
samuel.isaacson@lw.com
+1.312.876.7698
Chicago, Illinois

Robert D. Boley
robert.boley@lw.com
+1.312.993.2614
Chicago, Illinois

Jeff G. Hammel
jeff.hammel@lw.com
+1.212.906.1260
New York, New York

Eric R. Swibel
eric.swibel@lw.com
+1.312.777.7185
Chicago, Illinois

William R. Baker III
william.baker@lw.com
+1.202.637.1007
Washington, D.C.

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Endnotes

[1] 485 U.S. 224, 250 (1988).

[2] *Id.* at 246-47.

[3] *See id.* at 248, n.27.

[4] *Id.* at 248.

[5] *Halliburton Co. v. Erica P. John Fund, Inc*., slip op. at 2, 573 U.S. __ (2014).

[6] *Id.*

[7] *Id.*, slip op. at 3.

[8] *Id.*

[9] *Id.*, slip op. at 4.

[10] *Id.*, slip op. at 1-2.

[11] *Id.*, slip op. at 4.

[12] *Id.*, slip op. at 7-12.

[13] *Id.*, slip op. at 9.

[14] *Id.*, slip op. at 10 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 247 n.24 (1988)).

[15] *Id.*, slip op. at 10-11.

[16] *Id.*, slip op. at 11-12 (quoting *Amgen, Inc. v. Conn. Ret. Plans & Trust Funds*, 568 U.S. __ (2013)).

[17] *Id.*, slip op. at 12.

[18] *Id.*

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

[20] *Id.*, slip op. at 19.

[21] *Id.*, slip op. at 19-20.

[22] *Id.*, *post* at 1 (Ginsburg, J., concurring).

[23] *Id.*, *post* at 2 (Thomas, J., concurring in judgment).