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U.S. Supreme Court: Investors Can Seek Class Action Status Without Proving Loss Causation

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In *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. __ (June 6, 2011), the U.S. Supreme Court resolved a split in the lower courts as to whether securities fraud plaintiffs must prove loss causation to obtain class certification, ruling in a unanimous opinion that such proof is not a prerequisite to obtaining class certification in a securities fraud case. The investors alleged that the company made various misrepresentations designed to inflate its stock price in violation of Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. The district court found that the suit could not proceed as a class action because the plaintiff did not show loss causation, which the Fifth Circuit required of securities fraud plaintiffs seeking class certification. The Fifth Circuit affirmed the denial of class certification, *see* 597 F.3d 330 (5th Cir. 2010), but the Supreme Court reversed.

Although this ruling will affect class certification proceedings in the Fifth Circuit, the narrow scope of the opinion—coupled with the fact that several other circuits had already rejected the requirement of showing loss causation at the class certification stage—makes it unlikely that this decision will have a significant effect outside the Fifth Circuit or the securities fraud context.

Background

The Erica P. John Fund's (EPJ Fund's) class action complaint asserted that Halliburton made false statements about "(1) the scope of its potential liability in asbestos litigation, (2) its expected revenue from certain construction contracts, and (3) the benefits of its merger with another company." *Halliburton*, 563 U.S. ___, slip op. at 2. It further alleged that Halliburton later issued corrective disclosures that caused the stock price to drop and, consequently, investors to lose money. *Id.*

The Supreme Court's Decision

The sole question before the Supreme Court was whether the claims of the EPJ Fund satisfied Federal Rule of Civil Procedure 23(b)(3), which requires a court to find "that the questions of law or fact common to class members predominate over any questions affecting only individual members" in order to certify a class. *Halliburton*, 563 U.S. ___, slip op. at 3–4 (*quoting* Fed. R. Civ. P. 23(b)(3)). The Supreme Court noted that the answer to this question "begins, of course, with the elements of the underlying cause of action . . . [and] a securities fraud action often turns on the element of reliance," i.e., whether the plaintiff relied on the alleged misrepresentation or omission in making the investment decision. *Halliburton*, 563 U.S. __, slip op. at 4. Before *Halliburton*, the circuit courts were split as to

whether proving loss causation was necessary to obtain class certification in a Rule 10b-5 action.

In *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988), the Supreme Court articulated the "fraud-on-the-market theory" as giving rise to a rebuttable presumption of reliance in certain securities fraud cases. The fraud-on-the-market theory holds that the market price of shares is a function of all publicly available information about the company and its business, which necessarily includes any misrepresentations. Accordingly, when shares are traded on well-developed and efficient securities markets, a misstatement may defraud the entire market by affecting the price of the stock. Under this theory, the Supreme Court held that a stock purchaser is entitled to a presumption of reliance on the market price of the stock whenever he or she "buys or sells stock at a price set by the market," even if the purchaser did not directly rely on any misstatements. *Id*. at 244. To invoke this presumption of reliance, plaintiffs must demonstrate that the alleged misrepresentations were publicly known, that the stock traded in an efficient market, and that the purchase or sale took place between the time the misrepresentations were made and the truth was revealed. *Id*. at 241–48.

In *Halliburton*, the Supreme Court held that the Fifth Circuit had impermissibly imposed an additional burden by requiring plaintiffs to prove loss causation at the class certification stage as a precondition to *Basic*'s rebuttable presumption of reliance. *Halliburton*, 563 U.S. __, slip op. at 6. In rejecting this requirement, the Supreme Court explained that loss causation "requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss." *Id.* at 7. Although the Fifth Circuit held that an inability to prove loss causation would necessarily prevent a plaintiff from invoking the rebuttable presumption of reliance, the Supreme Court stated:

> Such a rule contravenes *Basic*'s fundamental premise—that an investor presumptively relied on a misrepresentation so long as it was reflected in the market price at the time of his transaction. The fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory.

Id.

The Limited Significance of *Halliburton*

Halliburton is perhaps most notable for its brevity and the narrowness of its holding. The opinion does not address any other "questions about *Basic*, its presumption, or how and when it may be rebutted." *Id*. at 9. The Court also left the door open for Halliburton to challenge class certification on grounds other than the plaintiffs' inability to prove loss causation, noting that "[t]o the extent Halliburton has preserved any further arguments against class certification, they may be addressed in the first instance by the Court of Appeals on remand." *Id*. Moreover, the Court did not offer any hint that it was prepared to reconsider the presumption of reliance or the fraud-on-the-market theory more generally.

In short, this decision can best be understood as a very specific answer to a very specific question—whether securities fraud plaintiffs must factually prove loss causation before a class may be certified. *Halliburton* will of course affect class certification proceedings in Fifth Circuit securities actions. However, given that several other circuits (the Second, the Third, and the Seventh) had already rejected the Fifth Circuit's approach, *Halliburton*, 563 U.S. ___, slip op. at 3, it is unlikely to have a major effect on litigation in other jurisdictions.

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