Securities Law Update

6/15/2011

Halliburton: US Supreme Court Resolves Circuit Split on Loss Causation

In *Erica P. John Fund, Inc. v. Halliburton Co.* (No. 09-1403), the U.S. Supreme Court reversed the Fifth Circuit Court of Appeals and held that a securities fraud plaintiff need not establish "loss causation," *i.e.*, that the defendant's alleged misrepresentation caused the plaintiff an economic loss, in order to obtain class certification. In so ruling, the Court resolved a split among the Fifth Circuit and the precedents of other Circuits, several of which had already declined to require securities fraud plaintiffs to prove loss causation at the class certification stage. This decision removes a major hurdle for class action plaintiffs in the Fifth Circuit. In Circuits other than the Fifth Circuit, the *Halliburton* decision should have little impact on securities fraud class action cases.

Perhaps more importantly, however, the Court's decision in *Halliburton* left open potential questions presented by the Fifth Circuit's ruling regarding "price impact," *i.e.*, whether the defendant's misrepresentation affected the price of the security purchased by the plaintiff. These questions had previously been decided by the Fifth Circuit and others, and include whether: (i) in reviewing a plaintiff's request for class certification, district courts should examine evidence of "price impact;" and if so, (ii) the plaintiff has the burden of proving such price impact, a defendant has the burden instead of rebutting a presumption of price impact, or the district court should undertake some other analysis of price impact.

The plaintiff in *Halliburton* filed suit on behalf of a class of all investors who purchased the company's stock between June 3, 1999, and December 7, 2001. The plaintiff alleged that Halliburton had made various misrepresentations designed to inflate the company's stock price, including alleged misrepresentations concerning its financial results and condition, its exposure to asbestos litigation, and the benefits of a merger, in violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The plaintiff further alleged that Halliburton later made a number of corrective disclosures that caused its stock price to drop, and consequently, the plaintiff and other investors in the proposed class to lose money.

The district court denied the plaintiff's motion for class certification. Among other things, under Rule 23, putative class plaintiffs must prove that "questions of law or fact common to class members predominate over questions affecting only individual members." More than twenty years earlier, in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the U.S. Supreme Court held that securities fraud plaintiffs can invoke the "fraud on the market" presumption to establish class-wide reliance on the defendant's alleged misrepresentation in seeking class certification.

Under *Basic*, if the plaintiff establishes that: (i) the security he or she purchased was traded in an efficient market that rapidly incorporated all public information into the price of that security; and (ii) unbeknownst to the plaintiff and other investors, the defendant's alleged misrepresentation affected (*i.e.*, artificially increased) the market price of the security, there is a rebuttable presumption that the plaintiff and other investors in the proposed class relied on the integrity of the security's market price as affected by the alleged misrepresentation in making their purchases. The presumption can be defeated by a "showing that severs the link between the alleged representation and either the price received (or paid) by the plaintiff, or his decision to trade." *Id*. at 248.

Subsequently, in *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005), the Court held that securities fraud plaintiffs must establish "loss causation" to recover their alleged losses, that is, a "causal connection between the [defendant's alleged] material misrepresentation and the loss" suffered by the plaintiff and other investors.

In *Halliburton*, the plaintiff attempted to prove that when the truth concealed by the company's alleged misrepresentations was revealed to the market, its stock price dropped. The district court found that the suit met all of the requirements of Rule 23(b)(3), but that the plaintiff failed to satisfy the requirement in the Fifth Circuit that securities fraud plaintiffs prove "loss causation" in order to obtain class certification under the fraud on the market theory. In this context, the district court found that the plaintiff's expert failed to show that the company's corrective disclosures, rather than other bad news unrelated to the alleged fraud, caused Halliburton's stock price to drop.

On appeal, the Fifth Circuit affirmed the decision of the district court. 597 F.3d 330 (2010). Based on Fifth Circuit precedent, the court rejected the plaintiff's reliance on the fraud-on-the-market theory, stating that "it is not enough merely to show that the market declined after a statement reporting negative news." 597 F.3d at 336. "[T]he main concern when addressing the fraud-on-the-market presumption of reliance is whether allegedly false statements actually inflated the company's stock price." *Id.* "We therefore require plaintiff to show that a loss occurred from the decline in stock price because the truth made its way into the marketplace, rather than for some other reason, such as a result of changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other factors independent of the fraud." *Id*. (citations omitted).

In contrast, several other Circuits disagreed with the Fifth Circuit's approach. Relying on *Basic*, the Second Circuit has held that the materiality standard requires only "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *In re Salomon Analyst Metromedia Lit.*, 544 F.3d 474, 481 (2008). This standard does not require plaintiffs to prove that alleged misrepresentations "had a measurable effect on the stock price." *Id.* at 482. Nevertheless, a merits inquiry concerning loss causation remained appropriate as a component of the predominance requirement of FRCP 23(b)(3). Defendants in the Second Circuit were therefore free to establish "the absence of a price impact" to rebut the presumption of reliance. *Id.* at 484.

By comparison, the Seventh Circuit rejected the rulings of both the Second and Fifth Circuits. According to the Seventh Circuit, "[j]ust as plaintiffs need not establish loss causation before a class can be certified, so they need not establish that the false statements or misleading omissions are material." *Schleicher v. Wendt*, 618 F.3d 679, 687 (2010). The *Schleicher* court went on to conclude that although the Second Circuit has determined that materiality is a condition to class certification, that Circuit "misreads *Basic*." *Id.*

In resolving the conflict among the Circuits, the U.S. Supreme Court held that class certification does not require proof of loss causation. The Court began its analysis by acknowledging the basic underpinnings of Rule 23(b)(3)'s predominance requirement as well as the fundamental elements of a claim under Section 10(b) and Rule 10b-5 — reliance being the key element for purposes of *Halliburton* — against which the predominance analysis must be evaluated. Focusing on the reliance element, the Court recognized its holding in *Basic* — that the fraud-on-the-market doctrine permits the presumption that "the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations" — therefore justifies the presumption that "an investor relies on public misstatements whenever he buys or sells stock at the price set by the market." Slip Op. at 5.

According to the Court, any requirement of loss causation as a component of fraud-on-the-market reliance, and by extension, class certification analysis, is unwarranted. "[W]e have never before mentioned loss causation as a precondition for involving *Basic's* rebuttable presumption of reliance. . . . Loss causation addresses a matter different from whether an investor relied on a misrepresentation presumptively or otherwise, when buying or selling a stock." The Court proceeded to contrast "loss causation" with "transaction causation," and confirmed that transaction causation is the focus of the fraud-on-the-market doctrine and the inquiry at the class certification stage. "Loss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory." Slip Op. at 7-8. Accordingly, the Court reversed the ruling of the Fifth Circuit.

The Court's ruling in the *Halliburton* case resolves the split among the Circuits on the issue of loss causation as a component of fraud-on-the-market reliance at the class certification stage. However, whether characterized as an element of reliance or otherwise, the standard adopted by the Fifth Circuit focused on finding some proof of harm associated with an alleged fraud. On this issue, the U.S. Supreme Court not only reaffirmed that loss causation remains an element of a plaintiff's claim, but also that proving loss causation requires evidence that the disclosure correcting the defendant's alleged misrepresentation, and not some other factor, caused the decline in a company's share price. The Court also reaffirmed that the *Basic* presumption of "fraud on the market" reliance is rebuttable, and that the presumption applies only "so long as" the alleged misrepresentation "was reflected in the market price at the time of [the] transaction." The issue of how proof of harm — characterized as "price impact" in the *Halliburton* decision — applies in the context of class certification, if at all, appears to remain an open question.

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