Class Action & Securities Litigation Alert

MINTZ LEVIN
Mintz Levin Cohn Ferris Glovsky and Popeo PC

JUNE 9, 2011

U.S. Supreme Court Unanimously Rejects Fifth Circuit's Requirement That Plaintiffs in a Securities Fraud Litigation Prove Loss Causation in Order to Obtain Class Certification

BY KEVIN M. MCGINTY, PETER M. SAPAROFF, JOHN F. SYLVIA, AND ALEC J. ZADEK

On June 6, 2011, the Supreme Court, in *Erica P. John Fund v. Halliburton Co.*, 563 U.S. ___ (2011), held that securities fraud plaintiffs do not need to prove loss causation in order to obtain class certification. Prior to this decision, the Fifth Circuit imposed an exceedingly high burden on plaintiffs at the class certification stage, requiring a plaintiff to prove that the defendant's conduct caused an economic loss. The decision rejected the Fifth Circuit's practice and supported the Second, Third, and Seventh Circuits' holdings that proof of loss causation is not a prerequisite to invoking the fraud-on-the-market presumption of reliance.

The Fraud-on-the-Market Theory

In general, when a plaintiff alleges a securities fraud based on violations of § 10(b) of the Securities Exchange Act of 1934 and the Securities and Exchange Commission's Rule 10b-5, the plaintiff has the burden of proving (1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase and sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[1] In addition to these requirements, when plaintiffs proceed as a class, it is their burden to prove that common issues predominate over individual ones. [2]

In securities fraud class actions, the predominance requirement presents a potential obstacle to class certification because proving that class members reasonably relied on the specific misrepresentations that are the subject of the lawsuit would ordinarily require individual factual inquiries that would overwhelm questions of fact that are common to the class as a whole. [3] In *Basic v. Levinson*, 485 U.S. 224 (1988), the Supreme Court accepted the fraud-on-the-market theory as a practical resolution to this problem. Under the fraud-on-the-market theory, if the subject security trades in an efficient market, there is a rebuttable presumption that the price of the security incorporates all material information about that security that is available to the market and that investors accordingly relied upon the misstatements or omissions of the issuer. [4]

In order to invoke the fraud-on-the-market theory of reliance, plaintiffs must first prove that the security traded in an efficient market; that the misrepresentations were publicly made; and the misrepresentations were material. Once a plaintiff invokes the fraud-on-the-market theory, "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." [5]

Loss Causation

The Supreme Court has described loss causation as the "casual connection between the material misrepresentation and the loss. . . ." [6] As one of the elements of a securities fraud claim based on violations of § 10(b) or Rule 10b-5, securities fraud plaintiffs must prove this connection in order to succeed on their claim. The burden of proving loss causation is not satisfied by proof that a material misstatement or omission inflated the purchase price of a stock. [7] Rather, the plaintiff must prove "that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss." [8]

Application of Loss Causation to the Fraud-on-the-Market Theory

Loss causation, while a well-established requirement for recovery of damages in a case alleging securities fraud, has not traditionally been relevant to class certification. Prior to the Supreme Court's decision, the Fifth Circuit was the only court of appeals to make proof of loss causation a precondition to invoking the fraud-on-the-market theory at the class certification. In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007), the Fifth Circuit held that a securities fraud plaintiff must prove loss causation before it could invoke the fraud-on-the-market presumption. Loss causation, the court explained, "speaks to the semi-strong efficient market hypothesis on which classwide reliance depends . . . ." [9]

In *Erica P. John Fund v. Halliburton Co.*, the Fifth Circuit applied the loss causation requirement established by *Oscar Private Equity* to deny certification of a securities class action brought against Halliburton Co. and one of its executives (collectively "Halliburton") on behalf of all investors who purchased Halliburton common stock between June 3, 1999 and December 7, 2001. The plaintiff alleged that Halliburton deliberately 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. The district court, applying Fifth Circuit precedent, denied class certification because the plaintiff could not prove loss causation. But for the plaintiff's inability to prove loss causation, the court would have certified the class. [10]

On appeal, the Fifth Circuit affirmed the decision. The court reasoned that the applicability of the fraud-on-the-market presumption required proof not only that the price at which securities were purchased was affected by the effect of fraudulent misrepresentations or omissions on an efficient market, but also that there was a causal link between such misrepresentations or omissions in the form of a price change associated with correction of the misleading statements. This requirement—one which no other circuit court imposed—constituted an exceedingly high burden for plaintiffs seeking class certification.

Other circuits declined to follow the reasoning of the Fifth Circuit. The Second Circuit, for example, held that, "plaintiffs do not bear the burden of showing an impact on price" when moving for class certification. [11] The court explained, "[t]he point of *Basic* is that an effect on market price is *presumed* based on the materiality of the information and a well-developed market's ability to readily incorporate that information into the price of securities." [12] Although the Second Circuit's opinion did not specifically address the Fifth Circuit's precedent, the court's holding conflicted with it.

While the plaintiff's *petition for certiorari* was pending, the Seventh Circuit weighed-in on the application of loss causation to the fraud-on-the-market theory. In *Schleicher v. Wendt*, 618 F.3d 679 (7th Cir. 2010), the Seventh Circuit explicitly disapproved of the Fifth Circuit's standard:

> *Oscar Private Equity* represents a go-it-alone strategy by the [F]ifth [C]ircuit. It is not [13]

> compatible with this circuit's decisional law . . . and we disapprove its holding.

Most recently, the Third Circuit also addressed this issue, and reached a similar conclusion to that held by the Seventh Circuit:

> We do not think plaintiffs must establish loss causation as a prerequisite to invoking the presumption of reliance in the first instance. Accordingly, we decline to require plaintiffs to demonstrate loss causation at class certification. [14]

In order to resolve the conflict among the circuits as to whether securities fraud plaintiffs must prove loss causation prior to obtaining class certification, the Supreme Court granted the plaintiff's *petition for certiorari*. [15]

The Supreme Court Unanimously Rejected the Fifth Circuit's Loss Causation Requirement

The Supreme Court unanimously held that the Fifth Circuit erred by imposing the requirement that plaintiffs must prove loss causation prior to class certification. Specifically, the Court held, "[the Fifth Circuit's] requirement is not justified by *Basic* or its logic . . . ." "Such a rule" the Court said, "contravenes *Basic's* fundamental premise—that an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction." [16] The Court also provided guidance to courts applying the fraud-on-the-market theory, noting that before invoking the rebuttable presumption of reliance, plaintiffs must demonstrate that the alleged misrepresentations were publicly known, that the stock traded in an efficient market, and that the relevant transaction took place between the time the misrepresentations were made and the time the truth was revealed. [17]

Whether or not correction of misrepresentations resulted in a change in the price of securities simply is not relevant to the question of whether the price at which the security was purchased may be deemed to have incorporated such misrepresentation, thereby permitting a plaintiff to establish class wide reliance by proof common to the class as a whole. Accordingly, the Supreme Court vacated the Fifth Circuit's decision and remanded the case for further proceedings.

Implications of ***Erica P. John Fund v. Halliburton Co.***

The Supreme Court's decision removes a significant obstacle to securities class actions within the Fifth Circuit and provides guidance to all jurisdictions applying the fraud-on-the-market theory. It also provides an outer bound to the extent to which federal courts may examine merits issues at the class certification stage. As far back as its decision in *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156 (1974), the Supreme Court cautioned against conditioning decisions under Rule 23 on an evaluation of which party would be likely to prevail on the merits. The Court subsequently explained in *General Telephone Co. of the Southwest v. Falcon*, 457 U.S. 147 (1982), that courts must engage in a "rigorous analysis" of whether the requirements of Rule 23 have been met before a class may be certified and that such analysis should address merits-related issues to the extent necessary to determine whether the requirements of the rule have been satisfied.

Recent circuit court decisions applying *Falcon* have directed trial courts to go beyond allegations in plaintiffs' complaints in order to evaluate whether merits issues may be tried and resolved by proof that is common to the class as a whole. Although the Court does not cite *Eisen* or *Falcon*, its decision nonetheless makes clear is that the trial court's obligation to evaluate how merits issues will be tried does not allow a trial court to condition class certification on proof that the plaintiff can satisfy a substantive element of the plaintiff's cause of action.

This ruling does not, as the Supreme Court points out, diminish the significance of loss causation as a substantive requirement for the recovery of damages in a securities fraud case. Nor does this decision eliminate other potentially successful grounds for defeating class certification by challenging

the fraud-on-the-market presumption, including establishing that the subject securities are not traded in an efficient market.

If you would like to discuss the *Erica P. John Fund* decision or other matters concerning securities or class action litigation, please contact any member of Mintz Levin's Securities Litigation or Class Action Practice Groups.

Click here to view Mintz Levin's Class Action attorneys.

Click here to view Mintz Levin's Securities Litigation Attorneys.

Endnotes

1 *See, e.g.*, *Erica P. John Fund v. Halliburton Co.*, 563 U.S. ___, ___, slip op., at 4 (2011).

2 FED. R. CIV. P. 23(b)(3).

3 *Basic, Inc. v. Levinson*, 485 U.S. 224, 242 (1988).

4 *See, e.g, In re Salomon Analyst Metromedia Litig.,* 544 F.3d 474, 481 (2d Cir. 2008).

5 *Basic*, 485 U.S.at 248.

6 *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005).

7 *Id.* at 342-343.

8 *Erica P. John Fund v. Halliburton Co.*, 563 U.S. ___, ___, slip op., at 7 (2011) (emphasis in original).

9 *Oscar Private Equity Inv. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007).

10 *Erica P. John Fund v. Halliburton Co.*, 563 U.S. ___, ___, slip op., at 2 (2011).

11 *In re Salomon Analyst Metromedia Litig.,* 544 F.3d at 483.

12 *Id.* (emphasis in original).

13 *Schleicher v. Wendt,* 618 F.3d 679, 687 (7th Cir. 2010).

14 *In re DVI, Inc. Sec. Litig.*, ___ F.3d ___, 2011 WL 1125926, at *7 (3d Cir. Mar. 29, 2011).

15 *Erica P. John Fund v. Halliburton Co.*, 563 U.S. ___, ___, slip op., at 3 (2011).

16 *Id.* at 6.

17 *Id.* at 5-6.

1185-0611-NAT-LIT