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Securities Litigation

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Supreme Court Holds That Proof of Loss Causation Not Required at Class Certification

The Supreme Court held Monday that plaintiffs in securities fraud class actions are not required to prove loss causation at the class certification stage of the litigation. The unanimous opinion, authored by Chief Justice Roberts, reverses the 2010 decision of the Fifth Circuit Court of Appeals in *Erica P. John Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010).

Background

Petitioner Erica P. John Fund (the Fund), a purported Halliburton stockholder, alleged that Halliburton made a series of false and misleading statements during a class period from June 1999 to December 2001. The alleged misstatements concerned three separate issues: (i) Halliburton's asbestos liabilities; (ii) the benefits of Halliburton's merger with Dresser Industries; and (iii) Halliburton's accounting decisions regarding certain fixed-price contracts.

Asbestos Disclosures. In 1998, Halliburton merged with Dresser Industries and as a result inherited liability for numerous asbestos claims. Most of the asbestos claims were related to the Harbison-Walker Refractories Company, a former Dresser subsidiary. Halliburton's reported reserves for asbestos liabilities were approximately $30 million as of May 2001. Later that year, Halliburton announced that it was increasing its asbestos reserves by $50 to $60 million in response to Harbison-Walker demanding additional financial assistance. Subsequent to that reserve increase, Halliburton disclosed multiple asbestos jury verdicts against Dresser for which Halliburton would bear additional financial responsibility. Plaintiffs claim that Halliburton knew or recklessly disregarded that its original asbestos reserves were understated.

Merger Disclosures. In September 1999, an analyst reported that Halliburton was projecting an annual $500 million financial benefit as a result of the Dresser merger. Less than one month later, the company announced that, partly due to lagging profits from certain Dresser business units, it did not expect third quarter earnings to be as high as previously anticipated. In addition, Halliburton stated in its 1999 Annual Report that the Dresser merger "is now behind us." But in October 2000, Halliburton CEO David Lesar announced the company's decision to significantly restructure its operations to address, among other things, losses related to the Dresser merger. Halliburton then announced that it would take a $25 million charge resulting from losses related to the Dresser merger. Plaintiffs allege that Halliburton's early positive statements concerning the Dresser merger were false and misleading.

If you have any questions about the *Halliburton* decision, please contact your Katten Muchin Rosenman LLP attorney, or any of the following members of Katten's **Securities Litigation Practice**.

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Accounting Issues. Finally, the Fund alleged that Halliburton made misleading statements related to its reported revenue on fixed-price contracts with its customers. The Fund claimed that Halliburton improperly recorded revenue from cost overruns on fixed-price deals as "probable of collection" despite the fact that the customers had not approved and agreed to pay these costs. Halliburton's CEO disclosed in October 2000 that the company's restructuring was due in part to cost overruns from its construction operations.

Procedural History

The Fund filed a class action lawsuit in the Northern District of Texas asserting, among other things, claims under § 10(b) of the Securities Exchange Act of 1934. At class certification, the Fund argued that common questions predominated because, under *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) and the fraud-on-the-market theory, the stockholder plaintiffs were entitled to a class-wide presumption of reliance.

The district court denied the Fund's class certification motion because the Fund failed to prove loss causation as required by the Fifth Circuit's decision in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007). To establish loss causation, the Fund needed to show that the corrective disclosures revealed Halliburton's fraud. According to the district court, Halliburton made unrelated negative statements contemporaneously with each "corrective disclosure" identified by the Fund (e.g., that the company was lowering its earnings guidance). The Fund failed to establish loss causation because it did not demonstrate that the stock price decline was caused by the corrective disclosures rather than by the unrelated negative news. The Fifth Circuit affirmed, finding that the district court correctly applied *Oscar* and its loss causation requirement.

The Supreme Court granted *certiorari* to resolve the conflicting circuit court requirements at the class certification stage (other courts had declined to follow the Fifth Circuit's approach). The Court held oral arguments in April 2011.

Summary

To establish a section 10(b) claim, a plaintiff must prove (1) a material misrepresentation (or omission); (2) scienter; (3) a connection with the purchase or sale of a security; (4) reliance; (5) economic loss; and (6) loss causation. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). The fraud-on-the-market theory, first adopted by the Supreme Court in *Basic*, established a rebuttable presumption of reliance in securities fraud cases. Under that theory, courts presume that in an efficient market, material information is promptly reflected in an issuer's stock price, and all investors trading in such a market in turn rely on the integrity of the stock price. The presumption relieves plaintiffs from having to prove reliance on an individualized basis and facilitates class certification as common questions will more likely predominate.

The parties in *Halliburton* disputed the proper role of loss causation at the class certification stage. The Fund argued that the Fifth Circuit's requirement that plaintiffs show loss causation to achieve class certification violates Federal Rule of Civil Procedure 23 by forcing plaintiffs to prove the merits of their case at that stage of the litigation rather than at trial. Halliburton argued that if the stock price was not affected by the alleged misstatements, the Fund was not entitled to a presumption of reliance.

In *Halliburton*, the Supreme Court held that the Fund was not required to prove loss causation in order to certify a class of stock purchasers under Rule 23 of the Federal Rules of Civil Procedure. To invoke *Basic's* presumption of reliance, plaintiffs must demonstrate only 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 of the alleged misrepresentation and the time the truth was revealed.

Justice Roberts stated that the Fifth Circuit's loss causation rule "is not justified by *Basic* or its logic" emphasizing that the Court "never before mentioned loss causation as a precondition for invoking *Basic's* rebuttable presumption of reliance." The Court observed that "[l]oss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock."

The Court rejected the Fifth Circuit's approach because it improperly mixed the separate and discrete concepts of "transaction causation" and "loss causation." Transaction causation—whether an investor purchased a security as a result of the

misrepresentation—goes to the issue of reliance. Loss causation—whether the misrepresentation also caused the loss at issue—is a separate element of a § 10(b) claim unrelated to the reliance inquiry. Specifically, the Court concluded that:

> Such a rule 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. 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. Loss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory.

Although the Court rejected the Fifth Circuit's loss causation rule, it declined to "address any other question about *Basic*, its presumption, or how and when it may be rebutted."

Implications

The *Halliburton* decision is not surprising, as the Fifth Circuit's framework had been widely criticized by courts and commentators. The decision makes clear that courts may not conflate the requirements of Rule 23 with the merits and force plaintiffs to prove at class certification any substantive element of the § 10(b) claim that is unrelated to the Rule 23 inquiry.

In recent years, class certification motions in the securities class action context often have involved complex mini-trials with each side submitting event studies and expert testimony concerning the reasons for a stock price decline. One interesting aspect of the Court's holding in *Halliburton* is whether it will end these mini-trials by completely removing all loss causation issues from the class certification battleground. Although plaintiffs are not required to affirmatively prove loss causation under *Halliburton*, the extent to which defendants may come forward with evidence affirmatively disproving loss causation potentially remains as an open issue.

For example, the Second Circuit has held that defendants must be given an opportunity—at the class certification stage—to come forward with evidence "severing the link" between the alleged misrepresentation and the decline in the share price. See *In re Salomon Analyst Multimedia Litig.*, 544 F.3d 474, 483-84 (2d Cir. 2008). The Supreme Court's *Halliburton* opinion cites *Salomon* with approval. If *Salomon* is still viable, the *Halliburton* opinion may mean only that defendants have the burden of persuasion at class certification as a procedural point, but as a practical matter both sides still may be forced to present substantial expert evidence at the Rule 23 stage.

Similarly, in *In re Flag Telecom Holdings, Ltd. Sec. Litig.*, 574 F.3d 29, 39 (2d Cir. 2009), the Second Circuit considered whether a district court could appoint as an "adequate" class representative an "in-and-out purchaser" who "conceivably" could show a sale subsequent to the truth "leaking" into the market. *Id*. at 37-38. In rejecting the district court's "conceivably" standard, the Second Circuit carefully analyzed plaintiffs' proffered expert report and found that it failed to sufficiently demonstrate that information which "leaked" into the market actually corrected a prior misleading disclosure. *Id*. at 41. *Halliburton* leaves open the issue of whether loss causation-type issues, such as those involving "in-and-out purchasers" and "slow leakage" theories, can be introduced at class certification on the issue of whether a proposed class representative will be an "adequate" representative or has claims "typical" of the class.

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