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Directors' and Officers' Liability:

Loss Causation Proof Not Required to Obtain Class Certification

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A unanimous U.S. Supreme Court on June 6 ruled that private federal securities fraud plaintiffs do not need to prove loss causation in order to obtain class certification. In *Erica P. John Fund Inc. v. Halliburton Co.*,[1] the high Court drew a firm line between two separate elements of a private securities fraud claim: (i) reliance on alleged misrepresentations or omissions, and (ii) loss causation. The availability of the fraud-on-the-market presumption of reliance is a linchpin to class certification in most private securities fraud suits. Without the presumption, reliance on alleged misrepresentations is an individual issue that in most cases will overwhelm any common issues and preclude class certification.

What is the evidentiary predicate for presuming class-wide reliance on alleged material misrepresentations? The Supreme Court stated that plaintiffs invoking the fraud-on-the-market presumption of reliance must "prove" that alleged misrepresentations were publicly known, that the relevant security traded on an efficient market, and that the plaintiffs traded in the stock between the time the alleged misrepresentations were made and the time the truth was publicly revealed.

For several years the U.S. Court of Appeals for the Fifth Circuit also required securities plaintiffs seeking to trigger the presumption to establish loss causation at the class certification stage. *Halliburton* overturned this line of cases, but its narrow rationale focused on what is not required, and did not provide guidance on several related issues including the role of materiality in, and the standard for use of expert testimony at, the class certification stage, and how and when the presumption of reliance may be rebutted. Nor did the Court foreshadow how it may resolve

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broader class action issues set to be decided this term, most prominently the host of issues presented in the *Wal-Mart* case.

Presumption of Reliance

Reliance or "transaction causation" by the plaintiff on the defendant's alleged material misrepresentations or omissions is an essential element of the 10b-5 implied right of action. Allegations and proof of reliance supply the necessary causal connection between a defendant's alleged misconduct and a plaintiff's decision to trade. Plaintiffs typically invoke the fraud-on-the-market theory in securities class actions because the theory, when applicable, allows them to avoid the need to prove subjective reliance on alleged misrepresentations, based on the interposition of the market between the buyer and seller.

The fraud-on-the-market presumption of reliance arose as a practical response to the difficulties of proving direct reliance in the context of modern securities markets, where impersonal trading rather than a face-to-face transaction is the norm. The theory is based on the hypothesis that the market price of a security traded on an efficient market reflects all publicly available information. In the landmark *Basic Inc. v. Levinson*[2] decision, the Supreme Court reasoned that although many traders in securities do not personally review all the public filings, statements and media coverage of an issuer, they do rely on informed traders and market makers to digest such information, and through their trading activities, affect a security's price. Consequently, *Basic* held that when an investor purchases a security at a price that has been inflated by false or misleading information, and when the investor does so in the reasonable belief that the market price reflects available information, the element of reliance may be presumed. If the court presumes class-wide reliance, it helps facilitate class certification. If applicable at trial and unrebutted, the presumption is that each class member, relying on the integrity of the market price, purchased the stock at an inflated price.

In a series of decisions over a four-year period, the Fifth Circuit adopted a rule that if securities plaintiffs seek to invoke a presumption of reliance, plaintiffs must demonstrate on a motion for class certification not only market efficiency and a material public misrepresentation but also loss causation, i.e., that the market price of the stock was actually affected upon revelation of the truth, in order to raise an inference that the alleged false statement actually inflated the stock price. Noting that economic theory does not support the notion that every material misrepresentation moves a stock trading in an efficient market, in *Oscar Private Equity Investments v. Allegiance Telecom Inc.*,[3] the Fifth Circuit held that at least when unrelated negative statements are announced contemporaneous with a corrective disclosure, plaintiffs must adduce empirical evidence at the certification stage "showing that the corrective disclosure was more than just present at the scene."

The court reasoned that "[b]ecause Rule 23 mandates a complete analysis of fraud-on-the-market indicators, district courts must address and weigh factors both for and against market efficiency." Where facts exist that might undermine the fraud-on-the-market presumption, the Fifth Circuit reasoned, a plaintiff must prove its entitlement to invoke it. Thereafter, the Fifth Circuit stated without qualification that plaintiff must establish loss causation by a preponderance of the evidence in order to obtain certification even in cases in which only one negative disclosure is at issue.[4]

Under the Fifth Circuit's approach, if a plaintiff was unable to show that the issuer's stock price increased in response to an alleged misrepresentation (and assuming the efficiency of the market in which the stock trade was not questioned), the first step in determining whether a stock-price decline demonstrates loss causation is to identify an actionable misrepresentation, i.e., plaintiff must identify an allegedly false, non-confirmatory positive statement made before the stock-price decline. The next step is to determine whether there is a link between an actionable, non-confirmatory positive statement and a corrective disclosure that (a) revealed the falsity of the prior misrepresentation; and (b) caused a decline in the stock price.

In *Halliburton*, plaintiffs alleged the company and its former CEO made false and misleading public statements concerning (i) the company's potential asbestos-related liability; (ii) the company's accounting practices; and (iii) the benefits of a merger with Dresser Industries. Applying its standard, the Fifth Circuit affirmed a district court determination that plaintiff failed to show that any of the three complained-of categories of misrepresentations moved the market, precluding use of the fraud-on-the-market presumption of reliance.

The first category—statements that Halliburton's potential asbestos-related liability reserves were adequate—fell short because none of the company's corrected reserve estimates demonstrated that prior estimates were deliberately misleading: "[M]erely raising…reserves does not show that prior reserve estimates" were fraudulent. Alleged misrepresentations concerning the benefits of the company's merger with Dresser were not shown to move the market because the alleged corrective disclosures contained multiple pieces of negative news, and plaintiffs' expert "did not perform any statistical or econometrical analyses" of the multiple pieces of news to demonstrate linkage between the alleged corrective disclosure and the stock-price movement.

The alleged misstatements about the company's accounting methodology fared no better because plaintiff failed to show that purported corrective disclosures—that Halliburton would undertake a massive restructuring of its construction business and thereafter that it would take a fourth quarter charge of $120 million because of the restructuring—corrected any prior misleading statements and revealed deceptive practices in Halliburton's accounting assumptions. As with other alleged corrective disclosures, the announcement of the charge also included non-culpable negative information, which plaintiffs' expert failed to differentiate from any allegedly culpable information.

Supreme Court Decision

In a unanimous decision written by Chief Justice John Roberts, the Supreme Court approached the issue by reference to the standard for certifying a Rule 23(b)(3) class alleging a securities fraud claim, observing that "[w]hether common questions of law or fact predominate in a securities fraud action often turns on the element of reliance…. This is because proof of reliance ensures that there is a proper 'connection between a defendant's misrepresentation and a plaintiff's injury.'" To avoid placing an "unnecessarily unrealistic evidentiary burden" on plaintiffs, *Basic* recognized a rebuttable presumption of reliance based on the "fraud on the market" theory, which is based on the hypothesis that the market price of a security traded on an efficient market reflects all publicly available information.

Perhaps acknowledging the intensity with which the availability of the presumption often is litigated, the Court identified the "common ground" on the subject as "for example, that plaintiffs must demonstrate that the alleged misrepresentations were publicly known (else how would the market take them into account?), 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.'" A notable omission from the consensus described was "materiality" of the alleged misrepresentation, which I discuss below.

Noting that the term "loss causation" does not even appear in *Basic*, the Court concluded that neither *Basic* nor "its logic" supported making loss causation "a precondition for invoking *Basic's* rebuttable presumption of reliance." Loss causation, the Court emphasized, "addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock." Reliance examines the investor's decision to engage in the transaction; loss causation, "by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price also caused a subsequent economic loss."

Basic's fundamental premise, wrote Chief Justice Roberts, is "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."

The Court acknowledged *Halliburton's* argument that the Fifth Circuit's approach could be upheld by reading its use of "loss causation" not as requiring loss causation per se, but as shorthand for the inability of plaintiffs to prove the alleged misrepresentation's "price impact," i.e., showing that the issuer's stock price declined following allegedly corrective disclosures. Under the price impact theory, Justice Roberts wrote, "if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation merely because he purchased stock at that price." The Court's straightforward response to this argument was that it "simply cannot ignore the Court of Appeals' repeated and explicit references to 'loss causation'…a familiar and distinct concept in securities law; it is not price impact."

The Court recognized that materiality is an element of a securities fraud claim, but did not elaborate on the role of materiality at the class certification stage. The decision implicitly recognized a role, stating that "an investor presumptively relies on a misrepresentation so long as it was reflected in the market price at the time of his transaction." Properly understood, in a fraud-on-the-market case, a "material" misstatement is, virtually by definition, one that affects the market price. In an efficient market, a statement cannot have been material if it did not have that effect.

In *Dura Pharmaceuticals Inc. v. Broudo*,[5] (which addressed plaintiff's pleading burden), in listing the elements of a 10b-5 claim, the Supreme Court summarized the fraud-on-the-market presumption as "nonconclusively presuming that the price of a publicly traded share reflects a material misrepresentation and that plaintiffs have relied on that misrepresentation as long as they would not have bought the share in its absence." This formulation ties the presumption to the specific statements challenged and an effect on price. *Halliburton* reaffirmed that materiality of the alleged misrepresentation is an element of the claims.

A number of post-*Basic* circuit decisions have noted the nexus between the presumption of reliance and a need to show that the alleged false statement actually inflated the stock price. As then-Judge Samuel Alito explained in the U.S. Court of Appeals for the Third Circuit's *In re Burlington Coat Factory*: "Ordinarily, the law defines 'material' information as information that would be important to a reasonable investor in making his or her investment decision. In the context of an 'efficient' market, the concept of materiality translates into information that alters the price of the firm's stock."[6] Judge Alito then referenced *Shaw v. Digital Equip. Corp.*,[7] in which the U.S. Court of Appeals for the First Circuit held that, in the fraud-on-the-market context, misrepresentations cause injury not "through the plaintiffs' direct reliance upon them, but by dint of the statements' inflating effect on the price of the security purchased."

In 2008 the Second Circuit stated in *In re Salomon Analyst Metromedia Litigation*, that "plaintiffs do not bear the burden of showing an impact on price. The 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."[8] In 2008 the Second Circuit in *United States v. Finnerty* similarly noted that the fraud-on-the-market "presumption of reliance arises where a civil plaintiff can point to 'public, material misrepresentations; that impugned the integrity of a stock's market price," and that the government in that criminal action had failed to show that defendant made a statement that "deceived the public or affected the price of any stock."[9]

Halliburton did not address the recent tightening in general of class certification standards figures, in which consensus has emerged among the U.S. Courts of Appeals that district courts considering class certification must consider evidence, resolve factual disputes that are relevant to Rule 23's criteria, and make determinations under a preponderance standard as to satisfaction of those criteria even if those determinations overlap with merits issues.

Conclusion

In *Halliburton*, the Supreme Court abrogated the line of Fifth Circuit cases holding that private securities fraud plaintiffs need to prove loss causation in order to obtain class certification. The practical effect of *Halliburton* may be limited; the Fifth Circuit was the only appeals court to require proof of loss causation on class certification, and its body of law unreceptive to class actions in general place it at or near the bottom of most plaintiffs' counsel lists of preferred forums. The validity of the Fifth Circuit's approach depended on whether proof that a corrective disclosure concerning an alleged misrepresentation affected market price is relevant to whether a presumption of reliance should arise in a particular case. The Court concluded loss causation "has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory." The decision did not amplify existing teachings on the underpinnings and contours of the fraud-on-the-market presumption.

In *Basic*, the Supreme Court stated that the presumption of classwide reliance may be rebutted by "[a]ny showing that severs the link between the alleged misrepresentation and…the price received (or paid) by the plaintiff." Although

Halliburton declined to address how or when defendants may rebut the presumption, the lower federal courts have widely held that defendant must be permitted to rebut the presumption at the class certification stage.

Left open on remand in *Halliburton* is, among other things, whether the plaintiffs are entitled to the fraud-on-the-market presumption even though they cannot demonstrate any effect by alleged misstatements on Halliburton's stock price. It also bears emphasis that the Court did not question that on class certification a district court must resolve factual and legal disputes relevant to Rule 23's criteria regardless of an overlap with the merits.

Endnotes:

1. 2011 WL 2175208 (U.S. June 6, 2011).

2. 485 U.S. 224, 241 (1988).

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

4. *Fener v. Operating Engineers Const. Industry*, 579 F.3d 401, 407 (5th Cir. 2009).

5. 544 U.S. 336 (2005).

6. 114 F.3d 1410, 1419 n.8, 1425 (3d Cir. 1997) (Alito, J.).

7. 82 F.3d 1194, 1218-19 (1st Cir. 1996).

8. 544 F.3d 474, 483 (2d Cir. 2008).

9. 533 F.3d 143 (2d Cir. 2008).